REPORT TO CONGRESS
of the
U.S. – CHINA SECURITY REVIEW COMMISSION

THE NATIONAL SECURITY IMPLICATIONS
OF THE ECONOMIC RELATIONSHIP BETWEEN
THE UNITED STATES AND CHINA

Pursuant to Public Law 106-398
October 30, 2000, as Amended

July 2002

WASHINGTON, DC
U.S. - China Security Review Commission

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Report to Congress

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U.S. – China Security Review Commission

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of the Economic Relationship between
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U.S.-CHINA SECURITY REVIEW COMMISSION  
Washington, D.C. 20001  

JULY 15, 2002  

The Honorable Robert C. Byrd  
President Pro Tempore of the U.S. Senate  

The Honorable J. Dennis Hastert  
Speaker of the House  

DEAR SENATOR BYRD AND SPEAKER HASTERT:  

On behalf of the U.S.-China Security Review Commission, we are pleased to transmit our first annual Report to the Congress, pursuant to Public Law 106-398 (October 30, 2000). The Commission has reached a broad and bipartisan consensus, approving the report by a vote of 11-1, on the most important aspects of our mandate "to monitor, investigate and report to the Congress on the national security impacts of the bilateral trade and economic relationship between" the U.S. and China. It is highlighted in a number of key findings and recommendations for Congressional action and further work. We believe this consensus is significant given the wide range of difficult issues we were charged to study, and the narrow margin by which Permanent Most Favored Nation Trade Relations (PNTR) was approved by the Congress. During Congressional consideration of that legislation, the Clinton Administration asserted that passage of PNTR and China's entry into the WTO were in the "vital national security interests of the U. S." Congress, in creating this Commission, charged it to evaluate, among other things, that assertion over time.  

U.S. policy toward China has lacked consistency and depth, and has often been driven by narrow commercial interests, specific human rights issues, or particular military and security concerns. Further, since the opening with China begun by President Richard Nixon in 1972, it has been dominated by strong Executive branch personalities and inordinate secrecy. We lack a sustainable consensus on the fundamental national interests of the U.S. among our elected leadership, particularly between the President and the Congress. We believe the nation is poorly served by this shortcoming, and it needs to be corrected as we consider China's growing economic, political and military power and the very substantial role played by our country in helping to bring that about. The Commission is also concerned over serious differences in the perceptions of the other held by each country, together with a lack of agreed-upon goals, core values and shared agendas. The potential for miscommunications and misunderstandings is cause for serious concern, and is compounded by a failure to establish institutions for confidence building, threat reduction, and crisis management.  

As a consequence of this fragmented approach, members of Congress have not been accorded an integrated assessment of the multi-faceted nature of our relations with China, particularly the linkage between our expanding economic ties and U.S. national security interests. The U.S. has its largest trade deficit with China, and is a premier foreign investor in its markets. It also transfers substantial resources on a government-to-government basis, and permits Chinese companies to raise substantial funds in U.S. capital markets. China is attempting to acquire and digest a vast array of advanced Western technology, and the increasing transfers of U.S. research and manufacturing facilities to China could have a negative impact on the strength of our technological and industrial base as well as the relative military strengths of the two countries. Moreover, China is pursuing an accelerated military modernization program, and the volatile Beijing-Taipei relationship risks drawing the U.S. and China into conflict. Its proliferation of technologies associated with weapons of mass destruction and their delivery systems to nations clearly hostile to the U.S. is adverse to our security interests, in the Middle East and Asia in particular.
The Commission believes that American policies must, first, be firmly grounded on a strong calculus of what will best enhance our national economic health and military security. Second, although it is unrealistic to expect the U.S. to fundamentally affect a transformation of the beliefs, structure and governing dynamics of China’s dictatorship, we should continue to strongly advocate democratic values and principles, remembering that in the past strong American actions and influence have materially enhanced such values and practices in Japan, South Korea, the Philippines, and Taiwan. On both scores, we can and should do better.

The Commission used a number of approaches to implement its mandate, including broad ranging hearings, new research in a variety of relevant areas, extensive analysis and translation of current Chinese materials, classified briefings from the intelligence community, and first hand visits to China, Taiwan, Japan, and the WTO in Geneva. We have published an extensive hearing record, and a volume of Commission-contracted original research and translations that accompanies this Report. We also have produced a classified report, which is available to members and cleared staff.

We believe that this Report will provide a baseline for assessing changes in U.S.-China relations — the positive and the negative — in the years ahead. We hope it will also contribute to the development of a strong Congressional and national consensus that will serve as a reliable foundation for our policies toward China, and that ensures the fundamental strengths of our economy and security be its guiding impulse.

Yours truly,

Michael Ledeen
Vice Chairman

C. Richard D’Amato
Chairman
Executive Summary

Relations between the United States and China during the last half-century have not always been smooth. The two countries have sharply contrasting worldviews, competing geo-strategic interests, and opposing political systems. More recently, bilateral ties have centered on rapidly growing economic interactions that have muted political differences. For the moment, these relations have not softened China’s egregious behavior on human rights nor changed its strategic perceptions that the U.S. is its principal obstacle to growing regional influence. No one can reliably predict whether relations between the U.S. and China will remain contentious or grow into a cooperative relationship molded by either converging ideologies or respect for ideological differences, compatible regional interests, and a mutually beneficial economic relationship.

However the relationship develops, it will have a profound impact on the course of the twenty-first century. The policies pursued today by both China and the United States will affect future relations. The Congress created the U.S.-China Security Review Commission to assess “the national security implications and impact of the bilateral trade and economic relationship between the United States and the People’s Republic of China” and to report its conclusions annually to the Congress. It specifically directed the Commission to focus on our deepening economic, trade, and financial linkages with China. The Congress wanted the Commission to evaluate whether our economic policies with China harm or help United States national security and, based on that assessment, to make recommendations in those areas that will improve our nation’s interests.

National security has come to include military, economic and political relationships. At any time, one of these concerns may dominate. They interact with one another and affect our overall security and well-being. Neglect of any one element will diminish our overall security as a nation. The United States must be attentive to the strength and readiness of our military forces, the health of our economy, and the vibrancy of our political relationships.

The Congress also asked the Commission to include in its Report “a full analysis, along with conclusions and recommendations for legislative and administrative actions.” This is the Commission’s first Report. In keeping with the Congressional mandate, this Report provides a comprehensive analysis of the Commission’s year-long review of U.S.-China relations, the principal findings that emerged from that investigation, and the recommendations or measures the Commission believes should be implemented to help safeguard our national security in the years ahead. This initial Report provides a baseline against which to measure and assess year-to-year changes in the relationship.

Main Themes

Our relationship with China is one of the most important bilateral relationships for our nation. If it is not handled properly, it can cause significant economic and security problems for our country. China is emerging as a global economic and military power, and the United States has played, and continues to play a major role in China’s development.

China’s foreign trade has skyrocketed over the past twenty years (from approximately $20 billion in the late 1970s to $475 billion in 2000). Our trade deficit with China has grown at a sharp rate, from $11.5 billion in 1990 to $85 billion in 2000. Foreign investment—with America a leading
investor—grew apace. This trade and investment has helped to strengthen China both economically and militarily.

America's policy of economic engagement with China rests on a belief that the transition to a free market economy and the development of the rule of law in China's business sector would likely lead to more political and social openness and even democracy. This belief, along with the desire to expand American commercial interests, drove U.S. support for China's entry into the World Trade Organization (WTO). Many also believe that a more prosperous China will be a more peaceful country, especially if it is fully integrated into the Pacific and world economies.

But these are hypotheses, and many leading experts are convinced that certain aspects of our policy of engagement have been a mistake. They argue that the PRC faces enormous economic and social problems, that its leaders are intractably antidemocratic, that they are hostile to the U.S. and its prominent role in Asia, and that we are strengthening a country that could challenge us economically, politically and militarily.

The Commission does not believe that anyone can confidently forecast the future of China and the U.S.-China relationship, and contends that while we may work and hope for the best, our policymakers should prepare for all contingencies.

Over the past twenty years, China has created a more market-based economy and allowed more social and economic freedom. Chinese participation in international security and economic regimes has grown. On the other hand, China has made little progress toward granting its citizens political and religious freedom, and protecting human and labor rights. In fact, the government has notably increased its repression of some religious practices, including its brutal campaign against the Falun Gong.

Chinese leaders have repeatedly stressed to their Communist Party supporters and the Chinese people that they have no desire to repeat in China the political and economic collapse that took place in the former Soviet Union. They seek to maintain and strengthen the Communist Party's political and social control while permitting freer economic activity. They consistently limit the freedom of the Chinese people to obtain and exchange information, practice their religious faith, to publicly express their convictions, and to join freely organized labor unions. Chinese leaders frequently use nationalistic themes to rally support for their actions, including crackdowns on dissenters.

China is thus embarked on a highly questionable effort — to open its economy but not its political system — the outcome of which will influence the destinies of many countries, including our own. If the economy fails, or if the Chinese people demand full freedom instead of merely a taste of it, then the leaders will have to choose between reasserting central control and granting greater political and social freedom, with a consequent weakening of their own authority. On the other hand, if China becomes rich but not free, the United States may face a wealthy, powerful nation that could be hostile toward our democratic values, to us, and in direct competition with us for influence in Asia and beyond.

American policymakers must take these scenarios seriously, and to that end the Commission has established benchmarks against which to measure future change. There are important areas in which Chinese policy runs directly counter to U.S. national security interests, such as not controlling exports that contribute to the proliferation of weapons of mass destruction, it's close
relations with terrorist-sponsoring states like Iran, Iraq, Syria, Libya, Sudan and North Korea, its expanding long-range missile forces, its threatening policies toward Taiwan, and its pursuit of both asymmetric warfare capabilities and modern military technology that could menace American military forces.

China's leaders view the United States as a partner of convenience, useful for its capital, technology, know-how and market. They often describe the United States as China's long-term competitor for regional and global military and economic influence. Much rhetoric and a considerable volume of official writings support this hypothesis. The recent empirical study of Chinese newspapers' coverage of the U.S., conducted by University of Maryland scholars for the Commission, found a divided perspective: articles in these newspapers, which we believe generally represent the views of the leadership, are consistently positive on trade and investment matters and applaud Sino-U.S. cooperation in these areas. In contrast, their coverage of U.S. foreign policy is largely negative and frequently depicts the U.S. as hegemonic and unilateralist.

In time we will learn whether China is to become a responsible world power or an aggressive, wealthy dictatorship, and whether the Communist Party maintains its monopoly of political power or shares it with the Chinese people. We will also learn whether the Chinese economy flourishes or stumbles and collapses under the burden of state-owned industries, a weak banking system, enormous debt, wide-scale corruption, social dislocation, and the new challenges of international competition brought about by its WTO entry.

Current U.S. policies and laws fail to adequately monitor the transfers of economic resources and security-related technologies to China, considering the substantial uncertainties and challenges to U.S. national interests in this relationship. This Report attempts to begin to address these uncertainties, trends, and challenges in a systematic manner. It proceeds on the premise that far more prudence must be displayed and far better understanding developed on the part of the Congress on the full extent of this relationship and its impact on U.S. interests. In addition, too little attention has been devoted to the adverse impact of recent Chinese economic strength on our Asian allies and friends. The Commission believes the U.S. must develop a better understanding of the vulnerabilities and needs of our Asian allies and friends, and must carefully construct policies to protect and nurture those relationships.

Summary of Recommendations

The Commission has identified its key findings and recommendations with each chapter in this Report. The Commission developed more than forty recommendations that are listed with each of the ten chapters. We have prepared a separate classified report providing additional details and recommendations. Here, we highlight and summarize those recommendations we believe are the highest priority and which we recommend for immediate action. A more extended analysis is contained in each of the Report's ten chapters.

Conflicting National Perspectives

The United States Government is poorly organized to manage our increasingly complex relationship with China. We are not adequately informed about developments within China and about their leaders' perceptions of the U.S. and we dedicate insufficient resources to understand China. Because Chinese strategic thinking and analysis of military planning differ markedly from
our own, our incomplete understanding enhances the possibilities for miscalculation, misunderstanding, and potential conflict.

- **Recommendation 1:** The U.S. Government should expand its collection, translation and analysis of open source Chinese-language materials, and make them available to the larger community. Despite two studies advocating an improved collection of Chinese materials at the Library of Congress, its collection is nearly unusable and shameful. Congress should provide funds to implement recommendations already submitted by the two previous studies. In addition, the Commission recommends increased funding for Chinese language training and area studies programs, similar to the program in the National Defense Education Act of 1958, and incentives for post-secondary graduates to participate in government service. The relevant executive branch agencies should report annually to the Congress on steps taken to rectify this situation.

- **Recommendation 2:** The U.S. should develop a comprehensive inventory of official government-to-government and U.S. Government-funded programs with China. The President should designate an executive branch agency to coordinate the compilation of a database of all such cooperative programs. The database should include a full description of each program, its achievements to date, and the benefits to the U.S. and should be prepared annually in both classified and unclassified forms. The Commission further recommends that the executive branch prepare a biannual report, beginning in 2004, on the cooperative Science and Technology (S&T) programs with China patterned on the report submitted to Congress in May 2002 at the request of Senator Robert C. Byrd. The President should establish a working group to set standards for S&T transfers, monitor the programs, and coordinate with the intelligence agencies.

- **Recommendation 3:** The Commission recommends that Congress encourage the Department of Defense to renew efforts to develop military-to-military confidence building measures (CBMs) within the context of a strategic dialogue with China and based strictly on the principles of reciprocity, transparency, consistency, and mutual benefit.

**Managing U.S.-China Economic Relations (Trade and Investment)**

The United States has played a major role in China's rise as an economic power. We are China's largest export market and a key investor in its economy. Fueled by China's virtually inexhaustible supply of low-cost labor and large inflows of foreign direct investment (FDI), the U.S. trade deficit with China has grown at a furious pace -- from $11.5 billion in 1990 to $65 billion in 2000. The U.S. trade deficit with China is not only our largest deficit in absolute terms but also the most unbalanced trading relationship the U.S. maintains. U.S. trade with China is only 5 percent of total U.S. trade with the world but our trade deficit with China is 19 percent of the total U.S. trade deficit. U.S. exports to China are only 2 percent of total U.S. exports to the world, while we import over 40 percent of China's exports.

Foreign direct investment has helped China leapfrog forward both economically and technologically. These developments have provided China with large dollar reserves, advanced technologies, and greater R&D capacity, each of which has helped make China an important world manufacturing center and a growing center of R&D, which are contributing to its military-industrial modernization.
U.S. companies have difficulty competing with Chinese based companies, in large part, because the cost of labor in China is depressed through low wages and denial of worker rights. Essentially, Chinese workers do not have the ability to negotiate their wages. Attracted in part by the low wages in China, a growing number of U.S. manufacturers are now operating in China, many of whom are utilizing China as an "export platform" to compete in U.S. and global markets.

China's large trade surplus with the United States, the inflow of U.S. private investment into China, and China's access to U.S. capital markets each contributes, directly or indirectly, to China's economic growth and military modernization.

- **Recommendation 4:** The Commission recommends the creation of a federally mandated corporate reporting system that would gather appropriate data to provide a more comprehensive understanding of the U.S. trade and investment relationship with China. The reporting system should include reports from U.S. companies doing business in China on their initial investment, any transfers of technology, offset or R&D cooperation associated with any investment, and the impact on job relocation and production capacity from the United States or U.S. firms overseas resulting from any investment in China.

- **Recommendation 5:** The Commission recommends that the U.S. make full and active use of various trade tools including special safeguards provisions in the WTO to gain full compliance by China with its World Trade Organization (WTO) accession agreement.

**China's WTO Membership: Conflicting Goals**

The U.S. and China hold differing goals for China's membership in the WTO. (The Chinese saying for this situation is: "same bed, different dreams"). China's leadership sought WTO membership to further the nation's economic reform and growth through export production and the accumulation of foreign investment, capital, and technology in order to become a world power. U.S. support for China's WTO membership was intended to enhance market access for U.S. goods and services, and also to promote internal economic, political and civil reforms, including a more open society.

China has instituted legal reforms to supervise foreign direct investment (FDI), financial markets and private businesses in order to stimulate trade and investment and fulfill the country's WTO commitments. The development of a commercial rule of law in China faces numerous obstacles, including the lack of an independent judiciary and trained judges, local protectionism, and widespread corruption. Despite some advances in commercial legal reforms, China remains grossly deficient in granting its citizens civil and political freedoms, and makes widespread use of prison labor.

- **Recommendation 6:** The Commission recommends that Congress renew the Super 301 provision of U.S. trade law and request the Administration to identify and report on other tools that would be most effective in opening China's market to U.S. exports if China fails to comply with its WTO commitments. In examining these tools, priority should be given to those industry sectors where China expects rapid economic growth in exports to the U.S. market.

- **Recommendation 7:** Congress should authorize and appropriate additional funds to strengthen the Commerce Department's support for commercial rule of law
reform in China, including intellectual property rights and WTO implementation assistance, and to strengthen the Department of State’s promotion of capacity-building programs in the rule of law, administrative reform, judicial reform and related areas.

- **Recommendation 8:** The U.S. should improve enforcement against imports of Chinese goods made from prison labor by shifting the burden of proof to U.S. importers and by more stringent requirements relating to visits to Chinese facilities suspected of producing and exporting prison-made goods to the United States. (Note: The Commission made recommendations to Congress on this issue in a May 2002 letter).

- **Recommendation 9:** The Commission recommends that Congress request the annual Trade Promotion Coordination Committee (TPCC) report prepared by the Department of Commerce include an assessment of China’s progress in compliance with its WTO commitments, recommendations on initiatives to facilitate compliance, and a survey of market access attained by key U.S. industry sectors in China, including agriculture. The report should include comparisons of U.S. market access in those key industry sectors with those gained by the European Union and Japan.

- **Recommendation 10:** The Commission recommends that Congress urge the U.S. Trade Representative (USTR) to request WTO consultations on China’s noncompliance with its obligations under the Trade-related Aspects of Intellectual Property Rights (TRIPS) Agreement, particularly its inadequate enforcement, to deter China’s counterfeiting and piracy of motion pictures and other video products. If China fails to respond, Congress should encourage the USTR to request a WTO dispute settlement panel be convened on the matter.

- **Recommendation 11:** Congress mandated the Commission to evaluate and make recommendations on invoking Article XXI of the General Agreement on Tariffs and Trade (GATT), relating to security exceptions from GATT obligations. The Commission believes that the steel industry is a possible candidate for using Article XXI. If the Administration’s current safeguard measures prove ineffective, the Commission recommends that Congress consider using Article XXI to ensure the survival of the U.S. steel industry.

### Accessing U.S. Capital Markets

Chinese firms raising capital or trading their securities in U.S. markets have almost exclusively been large state-owned enterprises, some of which have ties to China’s military and intelligence services. There is a growing concern that some of these firms may be assisting in the proliferation of weapons of mass destruction or ballistic missile delivery systems. The U.S. lacks adequate institutional mechanisms to monitor national security concerns raised by certain Chinese and other foreign entities accessing the U.S. debt and equity markets. We also lack sufficient disclosure requirements to inform the investing public of the potential risks associated with investing in such entities.

- **Recommendation 12:** The Commission recommends that foreign entities seeking to raise capital or trade their securities in U.S. markets be required to disclose
information to investors regarding their business activities in countries subject to U.S. economic sanctions.

- **Recommendation 13**: The Commission recommends that the Treasury Department, in coordination with other relevant agencies, assess whether China or any other country associated with the proliferation of weapons of mass destruction or ballistic-missile delivery systems are accessing U.S. capital markets and make this information available to the Securities Exchange Commission (SEC), state public pension plans, and U.S. investors. Entities sanctioned by the Department of State for such activities should be denied access to U.S. markets.

**Proliferation of Weapons of Mass Destruction**

China fails to control the export of dual-use items that contribute to the proliferation of weapons of mass destruction and their delivery systems. China is a leading international source of missile-related technologies. Its proliferation activities with terrorist-sponsoring and other states, despite commitments to the U.S. to cease such activities, present serious problems for U.S. national security interests, particularly in the Middle East and Asia.

- **Recommendation 14**: The Commission recommends that the President be provided an extensive range of options to penalize foreign countries for violating commitments or agreements on proliferation involving weapons of mass destruction and technologies and delivery systems relating to them. All current statutes dealing with proliferation should be amended to include a separate authorization for the President to implement economic and other sanctions against offending countries, including quantitative and qualitative export and import restrictions, restricting access to U.S. capital markets, controlling technology transfers, and limiting U.S. direct investment.

- **Recommendation 15**: The United States should work with the United Nations Security Council and other appropriate inter-governmental organizations to formulate a framework for effective multilateral action to counter proliferation of weapons of mass destruction and their delivery systems. Member states found in violation of the agreed framework should be subject to international sanctions.

- **Recommendation 16**: The United States should continue to prohibit satellite launch cooperation with China until it puts into place an effective export-control system consistent with its November 2000 commitment to the U.S. to restrict proliferation of weapons of mass destruction and associated technologies to other countries and entities.

**Cross-Strait and Regional Relations**

Cross-strait relations are a major potential flashpoint in U.S.-China relations. Economic and people-to-people interactions between Taiwan and the Mainland have increased dramatically in recent years, raising prospects that such interactions could help ameliorate cross-strait political tensions. At the same time, China is enhancing its capability to carry out an attack across the Taiwan Strait with special operations, air, navy and missile forces. It continues to deploy short- and intermediate-range missiles opposite Taiwan and although the threat of an immediate attack appears to be low, this buildup appears designed to forestall pro-independence political movements in Taiwan and help bring about an eventual end to the Island's continued separate status.
China's economic integration with its neighbors in East Asia raises the prospects of an Asian economic area dominated or significantly influenced by China. The U.S. has an interest in China's integration in Asia if it gives all parties a stake in avoiding hostilities. Nonetheless, U.S. influence in the area could wane to a degree, particularly on economic and trade matters.

- **Recommendation 17:** The Commission recommends that the Department of Defense continue its substantive military dialogue with Taiwan and conduct exchanges on issues ranging from threat analysis, doctrine, and force planning.

- **Recommendation 18:** The Commission recommends making permanent those provisions in the fiscal years 2001 and 2002 Foreign Operations Appropriations Acts providing for executive branch briefings to the Congress on regular discussions between the administration and the government on Taiwan pertaining to U.S. arms sales to Taiwan.

- **Recommendation 19:** The Commission believes that the Congress should encourage the Administration to initiate consultations with other Asian countries to assess and make recommendations on the impact of the “hollowing out” phenomenon with respect to China on regional economies and on U.S. economic relations with the region.

**China's Military Economy**

China's official defense spending has expanded by more than one-third in the past two years. The Commission estimates that China's official defense budget represents about one-third of its actual spending level. Its ability to increase defense spending in the face of competing priorities is supported by its rapid economic growth. China has the largest standing army in the world and ranks second in actual aggregate spending. The military's role in China's economy has been reduced in recent years, but the military derives extensive financial and technological benefits from the growth and modernization of the domestic economy, which is designed to serve it.

- **Recommendation 20:** The Commission recommends that the Secretary of Defense prepare a biennial report on critical elements of the U.S. defense industrial base that are becoming dependent on Chinese imports or Chinese-owned companies. The Department of Defense should also update its acquisition guidelines and develop information from defense contractors on any dependency for critical parts of essential U.S. weapons systems.

**Technology Transfers and Military Acquisitions**

China has a well-established policy and program to acquire advanced technologies for its industrial development, military capabilities and intelligence services. Over the next ten years, China intends to acquire an industrial capability to build advanced conventional and strategic weapons systems. Current U.S. policies do not adequately consider the impact of the transfers of commercial and security-related technologies to China.

- **Recommendation 21:** The Commission recommends that the Department of Defense and the FBI jointly assess China's targeting of sensitive U.S. weapons-related technologies, the means employed to gain access to these technologies and the
steps that have been and should be taken to deny access and acquisition. This assessment should include an annual report on Chinese companies and Chinese PLA-affiliated companies operating in the United States. Such reports are mandated by statute but have never been provided to Congress.

The Commission cannot forecast with certainty the future course of U.S.-China relations. Nor can we predict with any confidence how China and Chinese society will develop in the next ten to twenty years. We do know that China now ranks among our most important and most troubling bilateral relationships and believe that China's importance to the United States will increase in the years ahead. As its economy and military grow and its influence expands, China's actions will carry increased importance for the American people and for our national interests.

For this reason, the Commission believes that there is a pressing need to fully understand the increasingly complex economic, political and military challenges posed by China's drive toward modernity. To gain such comprehension will require the allocation of more resources and the elevation of China in our foreign and national security priorities. The Commission hopes that U.S.-China relations will develop in a positive direction but we must urge caution that this outcome, though preferred, may not happen. The U.S. must, therefore, be prepared for all possible contingencies.
Introduction

The United States relationship with China is complex and includes military, diplomatic, financial, environmental, political and moral aspects. U.S. policies in these areas have been disjointed, and not necessarily based on a uniform view of what is in our national interest. We believe that our relationship with China, which can be of great potential benefit to our country or result in harm to our country, must be viewed in its totality. We do not believe that trade and economic issues can be separated from security and military issues.

In the past, the Executive Branch has provided Congress with periodic reviews of U.S.-PRC strategic relations, but this requirement lapsed with the passage of legislation granting China Permanent Normal Trade Relations. Shortly after passage of that legislation, Congress in October 2000, created the bipartisan United States-China Security Review Commission to "monitor, investigate and report to Congress on the national security implications of the bilateral trade and economic relationship between the United States and the People's Republic of China." As Senator Robert C. Byrd, one of the founders of the Commission, stated, "this Commission was created to ensure that in opening the door to expanded trade with China we do not close our eyes to our national security concerns."

The Commission is required to file an annual report in both classified and unclassified versions, so that legislators are kept fully informed about this strategic relationship. The annual report to the Congress, with an independent assessment of this complicated relationship, is the sole purpose of the Commission and was the reason for the extensive hearings and research program pursued.

As part of the process of preparing this first Report, the Commission, over the past year, held nine hearings, heard testimony from 115 witnesses, including policy officials from most of the relevant Executive Branch departments, including State, Defense and Commerce, independent scholars, military and economic experts, and business and labor leaders. The hearings included discussions of those matters we were charged by Congress to examine:

- Chinese leaders' perceptions of the U.S. and the image of the United States promoted through the official Chinese media;
- The significance of China's World Trade Organization (WTO) entry, and such related matters as compliance and capacity building;
- The impact of our trade and investment policies with China on key U.S. civilian and defense sectors, including telecommunications and computers, steel, electronics, agriculture, energy, financial services, motion pictures, Internet, TV broadcasting, intellectual property, aerospace, and automotive;
- The effects of our trade and investments in China on the U.S. trade deficit, plant closures, employment, wages, and overall standard of living;
- China's access to, and use of U.S. capital markets to raise billions of dollars;
- China's proliferation of technologies needed to make weapons of mass destruction and their delivery systems;
- The triangular relationship among the U.S., Taiwan and the PRC;
- The Chinese budget and the economic role of the People's Liberation Army in the Chinese economy;
- U.S. export control policies and practices; and
- Chinese cooperation in the war against terrorism.
In addition, the Commissioners received numerous briefings from the Central Intelligence Agency (CIA), the Defense Intelligence Agency (DIA), the Federal Bureau of Investigation (FBI), and other Executive Branch agencies, and hosted many meetings and seminars with scholars and representatives of non-governmental organizations.

The Commission also contracted independent research, including:

- A team of Chinese researchers to surf PRC web sites daily for current information, which was then translated and posted on the Commission's website;
- Research and analysis of corruption in China, and its impact on the Chinese economy, conducted by a newly-emigrated Chinese scholar; and
- Translations of articles from Chinese military and intelligence journals. These materials were not otherwise available in the United States.

The Commission also supported original research on:

- The pattern of U.S. trade and investment with China;
- China's capital requirements;
- China's fundraising activities in U.S. capital markets;
- China's compliance with its WTO requirements;
- The growing dependence of U.S. defense industries on Chinese manufactures;
- The patterns of U.S. trade and investment with China; and
- Chinese strategic perceptions of the United States.

In addition, the Commission initiated a three-month survey of major Chinese newspapers by scholars at the University of Maryland in order to observe perceptions over time of how the United States was presented in the Chinese media.

Commission members visited China, Japan, Taiwan, and the World Trade Organization (WTO) in Geneva.

The Commission's interactive website (www.uscc.gov) posts the transcripts of all public hearings, its research products, and other activities. In addition, hearing transcripts are available in hard copy.

The year 2002 is an important one for China. It has entered the WTO, and it is undergoing a major political transition. The Sixteenth Party Congress will be held this fall, at which more than half the Politburo is expected to be replaced, and the occupants of the three top leadership positions are expected to change.

This Report deals with several elements we believe American policy makers should consider in formulating national strategy:

- Chapter One examines Chinese leaders' perceptions of the United States, which underlie their international strategies at all levels.
- Chapter Two assesses our current trade and investment policies with China, and asks whether they threaten the loss of strategically vital industries important to our defense industrial base. It also discusses the economic security concerns relating to the "hollowing out" of our economic base, the differing trading patterns China has developed with the United States and with other leading commercial partners, and the effects on our economy.
• Chapter Three assesses the contrasting American and Chinese goals for China’s economic integration into the world’s trading system, with specific emphasis on the challenges to China and to China’s leaders presented by its WTO accession. It also discusses problems and issues dealing with market access to China under the WTO.
• Chapter Four discusses whether trade and economic reforms in China have led to political liberalization and how that affects U.S. national interests.
• Chapter Five discusses China’s growth as a regional economic power and its implications on U.S. national interests in Asia.
• Chapter Six analyzes China’s presence in, and access to, U.S. and global capital markets and the security dimensions of these activities.
• Chapter Seven deals with China’s relations with terrorist-sponsoring states, China’s proliferation policies, and other direct conflicts with American national security concerns.
• Chapter Eight assesses cross-strait security issues and the implications for the United States.
• Chapter Nine analyzes the Chinese defense budget and the effects of Chinese economic reforms on the PLA.
• Chapter Ten discusses U.S. technology transfers to China and the military acquisition policies of the Chinese military.

Future Commission Reports will measure and analyze the evolution of the issues discussed in this Report. Not all of these issues lend themselves to easy quantification. We found the accuracy of Chinese statistics to be questionable, for example, but we believe it is worthwhile to measure them as accurately and carefully as possible.

As also required by statute, we are making recommendations for legislative and/or executive Branch action. These recommendations are based on the Commission’s conviction that U.S. policy toward China must seek to achieve:

• A China that will become a responsible regional power and that will work with us to combat terrorism and control the proliferation of weapons of mass destruction;
• Ensuring that U.S.-Chinese economic interdependence does not have an adverse impact on our national security by eroding our defense industrial base and our technological capacity;
• Ensuring that U.S. investment and trade, in particular technology and capital transfers, do not contribute to a dangerous Chinese military buildup; and
• Ensuring that China fulfills its WTO commitments by carefully monitoring its compliance and by helping it develop a commercial rule of law.
Chapter 1 - China's Perceptions of the United States and Strategic Thinking

Key Findings

- The U.S. Government has dedicated insufficient resources to collect, translate, and analyze Chinese writings and statements. Consequently, it has a limited understanding of the perceptions of the United States held by Chinese leaders and the Chinese people. This undermines our government's ability to respond appropriately to the challenges and opportunities of the relationship, as well as to prepare for potential crises.

- China's leaders consistently characterize the United States as a "hegemon", connoting a powerful protagonist and overbearing bully that is China's major competitor, but they also believe that the United States is a declining power with important military vulnerabilities that can be exploited. China views itself as an emerging power.

- Chinese leaders say that they pursued World Trade Organization (WTO) membership as a means to continue China's rapid economic growth, which they consider essential to become a major power. Such rapid economic growth would also help the Chinese Communist Party maintain its monopoly on power. This objective is quite different from one of the main U.S. goals for China's accession, which is to promote the development of economic, legal and democratic reforms in China, as well as regional stability in Asia.

- China's leaders seek to deter the United States from effectively intervening in any Chinese use of force against Taiwan, by denying the United States the unfettered freedom under international law to operate in the seas and airspace near China.

- The U.S.-China bilateral relationship is uncoordinated within the U.S. Government and does not include the necessary permanent institutions for managing and resolving conflicts. At worst, current U.S. practices have the effect of supporting Chinese efforts to enhance science, economic, financial and technology bases without adequate oversight within our government.

- Chinese strategic thinking and military planning differ markedly from our own, underscoring the need to study such differences more carefully. Such Chinese thinking draws heavily on ancient Chinese military lore and history, as well as Chinese Communist revolutionary history, and emphasizes nontraditional and asymmetrical techniques designed to enable an inferior power to defeat a superior one. Such techniques include deception, preemption, use of "assassin's mace" or trump card weaponry, as well as information and cyber warfare. The possibilities of miscalculation, miscommunications, and misunderstandings are high, given the substantial differences in each country's thinking and planning, and require far more attention from U.S. policymakers and the Congress.

- Attempts to build crises-management and confidence-building measures (CBMs) between the United States and China have failed. This is due in part to Chinese strategic thinking which does not value openness, which the Chinese fear could result in revealing weaknesses, and also be construed as negotiation with a "superior" power. This has resulted in a dangerous lack of "circuit breakers" in the U.S.-China military relationship. This contrasts starkly with CBMs China has executed with India, Russia and the ASEAN and the Shanghai Cooperation Organization.
Introduction

The U.S.-China relationship is one of the most important and most difficult bilateral relationships for this nation. Yet U.S. Government officials know woefully little about prevailing Chinese perceptions and strategic thinking.

American policymakers know less than they should about how Chinese leaders assess U.S. foreign policy and the exercise of U.S. power, how China views its role in Asia and beyond, how Chinese leaders have incorporated their thinking and perceptions into economic, political and military planning, and how the Chinese Government has portrayed the United States to its own populace. Over the past year, the Commission has held a series of hearings and briefings with leading U.S. scholars, policymakers, and analysts and translated and analyzed official, semi-official and other Chinese publications, both unclassified and classified, to identify Chinese leadership perceptions and attitudes of the United States and how they might affect U.S. national security interests.

In addition, the Commission contracted independent research, including a major study conducted by the University of Maryland to provide empirical evidence on the messages and tone of Chinese reporting on the U.S. over time, and how it is affected by various events. Given the control of the Chinese leadership over the media, such messages give us insight into how the leadership attempts to portray the United States and thus develop attitudes toward the U.S. among the Chinese people.

The U.S. Government must dedicate far greater resources to collecting and analyzing both open and classified Chinese sources in order to better understand the views of Chinese leaders. U.S. Government efforts in this area are far less extensive than similar efforts our country made to understand the Soviet Union during the Cold War. As the Defense Department noted in its December 2000 Net Assessment Report to Congress, in order to judge whether China is deterred by U.S. military capabilities, we need to understand how the Chinese authorities assess the situation.

The Commission has found that while there are ongoing debates among China’s leaders on various aspects and timelines of their security environment, China’s strategic assessments and public portrayals of U.S. power are shaped by the view that U.S.-style democratic liberalism and the U.S. presence and position of power in the Asian periphery threaten the Communist Party’s monopoly on political power. Specifically,

1) China sees the United States as a hegemonic power that is a major obstacle and competitor for influence in Asia;
2) China believes the United States is a superpower in decline, losing economic, political, and military influence around the world;
3) China aspires to be a major international power and the dominant power in Asia. To that end, China is actively pursuing a multipolar world where it could align with other rising powers such as Russia, Japan, and Europe in order to check or challenge U.S. power;
4) China’s leaders want to maintain stable and good relations with the United States because the United States is an important market for Chinese goods and an important source of science and technology, financial capital, and foreign direct investment—all central components of China’s rising status and strength.
5) China’s leaders believe that the United States, although technologically superior in almost every area of military power, can be defeated, most particularly, in a fight over Taiwan in which China controls the timing. Along with logistical and operational weaknesses, Chinese analysts also believe that the United States will not and cannot sustain casualties in pursuit of its vital interests. China is dedicating considerable resources toward preparing for potential conflict with the United States, especially over Taiwan.\(^1\) and

6) September 11 changed the context of China’s approach to the United States but did not change the fundamentals.\(^2\)

The beliefs of the Chinese leaders shape and direct China’s relations with the United States and China’s economic and military programs. They also influence China’s relations with our major allies, its neighbors, terrorist sponsoring states, and its military doctrine and weapons acquisition programs.

**The United States as a “Hegemon”**

The term “hegemon,” according to Chinese thinking, has a negative connotation, and depicts a power that desires imperialistic control over other powers, and is overbearing and controlling. China has traditionally characterized as hegemons only foreign powers with which it has highly antagonistic relationships. When China split with the Soviet Union during the Cold War, it began characterizing the Soviet Union as a Socialist hegemon. When Vietnam invaded Cambodia, and just prior to the Chinese invasion of Vietnam, Beijing characterized Hanoi as a “regional hegemon.”

The word “hegemon,” usually used alongside other terms such as “imperialist,” “unilateralist,” and “self-appointed world policeman,” is precisely how official Chinese media characterize the United States. Such characterization communicates to the Chinese people that the United States, from the point of view of its foreign policies toward China, is a power with which China has a competitive, if not antagonistic, relationship.

Since the collapse of the Soviet Union, China has viewed the U.S. global position with deep suspicion, if not hostility. Chinese leaders believe that the fundamental drive of the United States is to maintain global hegemony by engaging in the shameless pursuit of “power politics,” often disguised as a quest for democratization.\(^3\)

China’s Defense White Paper of 2000 reflects deep concern about an international order predominantly shaped by the United States. It states that “certain big powers” (i.e., the United States) are contributing to instability and “threatening world peace” by pursuing neo-interventionism, new gunboat policy, and neo-economic colonialism.\(^4\) The document links such new problems to “hegemonism” and the hegemon’s proclivities for playing “power politics.”\(^5\)

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\(^2\) Ibid.


\(^5\) Ibid.
China has viewed high-profile U.S. military actions of 1999-2001—including the NATO campaign against Yugoslavia, the bombing of the Chinese embassy in Belgrade, the EP-3 incident over the South China coast—as glaring examples of "hegemonism" at work, and believes that they have produced an "extremely negative impact" on the international situation. Beijing has compared the United States to Nazi Germany for the bombing of the Chinese embassy in Belgrade; it has labeled U.S. involvement in Bosnia and Kosovo as an attempt to maintain U.S. dominance in Europe; it has characterized the enlargement of NATO as an effort to contain and encircle China; and it has criticized U.S. development of ballistic missile defenses as contributing to the proliferation of weapons of mass destruction.

Furthermore, Beijing has perceived Washington's "anti-China" streak—from what some American China policy analysts call the "China Threat" theory to others' regular condemnation of China's human rights record—as a U.S. attempt to preempt China's impending challenge to American influence in Asia. Persistent efforts by some members of the U.S. Congress to deny China most-favored nation (MFN) status for much of the 1990s, and to block Chinese accession to the WTO based on labor, human rights and economic grounds, were viewed by the Chinese as a blatant intervention in China's internal affairs and a convenient excuse to prolong and protect U.S. hegemony.

To Beijing, the U.S. Government practices deception and repeatedly lies about its intentions to maintain hegemony. Therefore, U.S. actions, including those taken in the name of some global public good (such as humanitarian intervention in the Balkans), are seen as part of a conspiracy to impose the U.S. vision of the world on others. By this logic, even the U.S. policy of engagement with China itself is a new form of "containment" and U.S. support for peaceful evolution toward democracy is no more than a sinister ploy to destroy the Chinese Communist Party.

For instance, even though the top Chinese leadership aggressively pursued China's entry into the WTO, many Chinese officials still view American support for China's WTO entry as part of a larger effort to promote democracy in China through economic integration and "peaceful evolution," or to maintain power by disseminating "Americanization."

Paradoxically, Chinese suspicions of U.S. intentions and hostility toward American unipolarity exist alongside the recognition that U.S. trade and investment, technology, and know-how are crucial to China's search for modernization. The investigative research done by the University of Maryland indicates a contradiction in the leadership's characterization of the United States to the Chinese people. The contradiction is between their portrayal of U.S. foreign policy and that of the economic relationship, as well as general U.S. relations with China. The former is uniformly negative across the entire survey period by the researchers, and the latter is very positive across the same period. The characterization of the Sino-American relationship is generally positive. As pointed out by the research report to the Commission:

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6 Ibid.
7 Observer, "We Urge Hegemonism Today to Take a Look at the Mirror of History," People's Daily, 22 June 1999; translated in FBIS.
A major theme emerging from the extensive reporting done on U.S. foreign policy is of the United States as a hegemonic power that acts unilaterally and in opposition to general international principles. Aside from the embassy bombing and reconnaissance plane issues, other major themes that emerged included the U.S. war on terrorism, in which the U.S. is taking increasingly strident steps away from international norms.\(^{10}\)

Similarly, Chinese leaders can aggressively seek U.S. trade, investment and financial assistance while simultaneously denouncing U.S. intentions and power.

**Post-September 11**

Chinese suspicions of the United States did not subside even after a notable upswing in official Sino-American relations after September 11. Rather, official Chinese media has continued to portray the United States as a hegemon, albeit a wounded one. The state media blamed the September 11 terrorist attacks on a misguided and aggressive U.S. foreign policy. The University of Maryland study looked at Chinese media coverage in the time period after September 11 and found that the media, “although supportive at first of the U.S. anti-terrorist position, soon after introduced a more wary tone” and characterized the U.S. war on terrorism as “taking increasingly strident steps away from international norms.”\(^{11}\)

In the month immediately following September 11, Chinese open sources reiterated three constant decades-old themes: a relative decline in U.S. power is underway, the U.S. Government practices deception and continually lies about its intentions, and China must be vigilant about U.S. actions against China, because the U.S. is making China its enemy. Two days following the attack, the Chinese owned Hong Kong newspaper *Ta Kung Pao* featured an interview in Beijing with two active duty colonels, who said, “The United States has been too self-willed and conceited, likes to dominate others, and has made so many enemies that it has been unable to determine who the enemies were since the attacks occurred.”\(^{12}\)

In a more lengthy analysis of the impact of September 11 on U.S.-Sino relations, the Deputy Director of the influential Chinese Institute of Contemporary International Relations (CICIR), Yuan Peng, challenged the analysis of some American scholars that counter terrorism cooperation between the United States and China would be the new strategic foundation of U.S.-China relations. Peng argued that cooperation over counter-terrorism would hardly change [the United States'] deep prejudice towards certain countries. Fundamental contradictions will re-emerge at the end of the counter-terrorist war...And, second, differences between China and the US over a number of related important issues like the definition of terrorism, the goal of the current war, etc. have come to the surface despite good bilateral cooperation over counter-terrorism so far. Such divergences over concrete issues, plus existing problems between the two, might cast shadows over their future ties.”\(^{13}\)

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\(^{10}\) University of Maryland’s Institute for Global Chinese Affairs and the Department of Communication, “Perspectives toward the United States in Selected Newspapers of the People’s Republic of China,” prepared for the U.S. China Security Review Commission, 30 May 2002, 9.

\(^{11}\) Ibid.

\(^{12}\) Michael Pillsbury, “China’s Perceptions of the USA: The View from Open Sources,” Report prepared for the U.S.-China Security Review Commission, 4-5; The two PRC colonels quoted were also authors of *Unrestricted Warfare*, a 1999 book that advocated asymmetric warfare with Chinese characteristics and called on the Chinese Government to explore all possible means—including political, economic, financial, and military—in warfare against a superior power.

Within days of September 11, videos and DVDs produced by the government appeared in China explaining the attacks. Most notably, a video entitled The Pentagon in Action painstakingly portrays the U.S. Government as a wounded bully whose hegemonic power and ego have been challenged and which is obsessed with irresponsible military retaliations. Despite its occasional sympathetic tone, the video repeatedly cites “the world’s opinions” to criticize America’s “immature and revengeful” counter-terrorist measures. The French prime minister and foreign minister, the German defense minister, the Russian President and China’s President, all “earnestly” urge the U.S. to be cautious, and “don’t behave just like the terrorists.” Saddam Hussein appears in this program as a rational statesman urging the U.S. to utilize wisdom rather than force. And Jiang Zemin advises the Americans to use “wisdom, rationality and courage,” not just blunt force, in dealing with the world’s real problems.

America’s geopolitical position after September 11 continues to feed Chinese anxiety. Russia, which China has actively courted to balance U.S. hegemony, has drawn even closer to the United States since September 11. This has been underscored by the U.S.-Russia agreement in St. Petersburg and the formation of the NATO-Russian Council. In Central Asia, the United States gained access to bases and facilities in Tajikistan, Kyrgyzstan and Uzbekistan and was granted permission to overfly the territories of Kazakhstan, Azerbaijan, and Georgia. In South Asia, the United States cemented a crucial alliance with Pakistan through President Pervez Musharraf. In sum, America’s heightened military presence in China’s “backyard” and improved relations with its neighbors have created anxiety in Beijing about U.S. designs to encircle or contain it. Furthermore, not only has the United States not condoned China’s crackdown on Muslims in Xinjiang Province, it has stepped up pressure on issues ranging from religious freedom to controlling the proliferation of weapons of mass destruction (WMD).

**America’s Relative Decline and Perceived Weaknesses**

**Relative Decline**

China’s leaders have been predicting the relative decline of American economic, political and military influence relative to other powers, for decades. Without the decline of the “capitalist” United States, Chinese Marxism would be proven wrong. The debate in China is how long it will take. In the 1990’s, Chinese analysts were predicting that the decline would take five years. Today, revisionists admit that the rate of decline is going to be slower.

U.S. unipolarity, they argue, will in time be balanced by rising poles such as the European Union (EU), Russia, Japan, and China. In a multipolar world, U.S. influence would be weakened to accommodate the interests and desires of other powers, especially China.

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Chinese strategists measure national standing by evaluating both quantitatively and qualitatively the politics, economics, military, science and technology, and foreign affairs of a country to determine relative "comprehensive national power (CNP)." The analysts predictably see U.S. decline in virtually all arenas, and symbols of that decline can be seen everywhere in macro and micro trends, including, for example, the building of newer and higher skyscrapers in Asia.

Among Chinese strategic thinkers, the economic growth of the rising powers, particularly China, is a central component of (relative) U.S. economic decline and the inevitable trend toward multipolarity. An article from CICIR states: "As a result of their economic growth, more and more countries now dare to say 'no' to the United States." U.S. hegemonic impulses and, consequently its "mistaken foreign policy", will, over time, alienate key European and Asian allies, who after the collapse of the Soviet Union, will be unwilling to remain subordinate to a grand U.S. strategy but instead will assert their own "polarity." China believes that the enhancement of its economic and political power and international influence will lead the new poles, such as the EU and Japan, to seek better relations with Beijing as American hegemony declines. The results of the struggles among the United States, Europe and Japan will lead all three to "attach more importance to the China factor in their foreign strategies" because of the "enhancement of China's Comprehensive National Power and the extension of China's international influence."

Perceived Military Weaknesses

Chinese strategists also view the United States as relatively weak militarily. Foremost in their strategic considerations are:

- The United States will not and cannot sustain casualties in pursuit of vital interests. If China could kill or wound enough American service personnel, as occurred in Somalia, it could effectively deter U.S. forces or force their defeat in the event of a military conflict in East Asia, including in the defense of Taiwan.
- Despite overwhelming U.S. military and technological superiority, China can still defeat the United States by transforming its weakness into strength and exploiting U.S. vulnerabilities through asymmetric warfare, assassin's mace weapons, deception, surprise, and preemptive strikes.

In general, Chinese authors assert: the United States barely won the Gulf War (Saddam Hussein could have won with a better strategy); the United States today cannot contain Chinese power; the United States cannot execute its past military strategy of two major regional contingencies; and that U.S. munitions cannot damage deep underground bunkers like those in China.

24 Ibid., 6-9.
26 Wortzel, Written Testimony, 5.
Lieutenant General Li Jijun, Vice President of the Academy of Military Science, wrote about the weaknesses of the U.S. military during the Gulf War:

**U.S. Armed Forces revealed many weak points. For example, the combat consumption was too great, and it could not last long. There was great reliance on the allied countries. The high-tech equipment was intensive and its key links were rather weak; once they were damaged, combat effectiveness was greatly reduced. Also, if the adversary of the United States was not Iraq, if the battle was not fought on the flat desert, if the Iraqi Armed Forces struck first during the phase when U.S. Armed Forces were still assembling, or if Iraqi Armed forces withdrew suddenly before the U.S. Armed Forces struck, then the outcome of the war might have been quite different.**

Chinese assessments of American military weaknesses have led to a broad conclusion by many Chinese strategists and military authors that the U.S. forces will one day be vulnerable to a Chinese strategy of deception, special silver-bullet “trump card” weapons, and classic defeat of the “superior” by the “inferior.”

Finally, a recurring Chinese theme is that the “decay” of American global predominance stems from rampant social problems in the United States, including drugs, crime, social inequality, homelessness, racial tensions, and spiritual and moral crises.

**Chinese Strategic Priorities**

It is clear that China anticipates America’s decline and is working to shape a world with a weaker United States and stronger competing poles of power where it can play a central role. China’s strategy to help achieve this objective appears to include biding its time by avoiding confrontation with the United States, and meanwhile gaining access to American investment, technology and know-how. At the same time, Beijing is working to counter U.S. influence and competition by preparing if needed to subdue American forces via military modernization, including asymmetrical means of warfare.

**Economic Growth**

Economic growth is a central pillar of Chinese power. The Chinese Government and its industries share an overwhelming common and driving goal to increase the power and international standing of China as a nation state. While China’s leaders remain wary of U.S. support for WTO entry, they view accession as essential to continue rapid growth by accelerating economic reform, attracting higher levels of foreign investment, maintaining and expanding export markets and playing a more influential role in shaping the rules of the world trading system.

Over the past two decades, China has undertaken a prodigious economic reform and has seen a dramatic growth in its economy. This growth has been largely propelled by exports from China and foreign direct investment in China, in both of which the United States plays a lead role.

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31 Wortzel, Written Testimony, 1-2.
China’s growth strategy has also included a stringent commitment to improving its science and technology base by importing both civilian and military technologies from advanced industrial nations, again most importantly, from the United States.

Chinese policy has been guided since the 1970's by the maxim enunciated by Deng Xiaoping that science and technology from abroad is the prime force of production and central to China’s rise from poverty and weakness. The United States is seen as a major source for this technology. The Chinese have used a variety of overt and covert methods to acquire this technology, including sending large numbers of students abroad to study relevant disciplines, forming joint ventures, partnerships, and using the attraction of its potential consumer market to induce firms to sign investment agreements that require some form of technology transfer.\(^{32}\)

Chinese leaders have repeatedly insisted that peace is fundamental for economic growth. As China’s White paper on National Defense states, “A peaceful international environment and a favorable surrounding environment serves China’s fundamental interests.”\(^{33}\)

In the short-to-mid term, China needs the United States to achieve its objective of developing its economy, its science and technology base and its military force.\(^ {34}\) While debate periodically erupts among its strategists on how to deal with the United States, patience has been the guiding dictum since Deng Xiaoping launched the modernization drive. Deng’s often quoted advice was, keep cool-headed to observe, be composed to make reactions, stand firmly, hide our capabilities and bide our time, never try to take the lead and be able to accomplish something.

Deng’s advice is followed today. The only real debate in China on U.S. decline is when. The leaders counsel patience, and tolerating whatever the United States does to China, in order to allow China to grow for the next 20 years. The leaders believe that at that time, China will, at best, be equal to the United States or, at least, be able to combine with other powers to check American power. There is a basic sense of confidence at the highest levels that the U.S.-PRC relationship is achieving China’s immediate objectives of growth in exports and foreign direct investment, which will lead to economic growth.\(^ {35}\)

**Strengthening the Party**

Chinese leaders believe that American-style democratic capitalism threatens the Chinese Communist Party’s political monopoly, but they believe they can grow economically and still maintain their power. This matter was recently addressed in Jiang Zemin’s announcement of the “Three Represents” in which he called on the Chinese Communist Party (CCP) to represent the forces of production, the progressive course of China’s culture, and the broad interests of the majority of the Chinese people. According to Jiang, the Three Represents would make the CCP more relevant to the Chinese people amidst the rapid social and economic developments now taking place within China.


\(^{34}\) Mark A. Stokes, China’s Strategic Modernization: Implications for the United States (Carlisle, PA: Strategic Studies Institute, 1999), 140.

\(^{35}\) Pillsbury, Oral Testimony, 22, 69.
Viewed as the centerpiece of Jiang’s effort to modernize the CCP, the strategy was announced together with Jiang’s invitation to intellectuals and entrepreneurs—traditionally viewed as “red capitalists” or the “exploiting class”—to join the CCP. These new members, Jiang argued, would strengthen the CCP with their technological know-how, education, and skills and therefore help strengthen “socialism with Chinese characteristics.”

This theory was developed at the Party School, headed by Hu Jintao, Jiang’s anticipated successor. At the time that the theory was announced, approximately 100,000 CCP members were business owners. If fully implemented, the strategy would fundamentally change the CCP and dilute its traditional membership of workers and peasants. For that reason, Jiang has been accused by ideological hard-liners of betraying the core principles. Some even argue that Jiang is using the Three Represents to build a cult of personality around himself before retiring as President at the upcoming Party Congress in October 2002.

Despite some internal dissent, the CCP has pressed on with a nationwide propaganda campaign to spread Jiang’s theory. Cadres, academic institutions and ordinary citizens have all been instructed to study and practice it much like they studied Mao Zedong Thought and Deng Xiaoping Theory.

**Expanding China’s International Role**

In response to a world in which the United States has not declined as quickly as the Chinese hoped, Beijing put forth a “New Security Concept” in 1996-97, which calls for the abandonment of “Cold War mentality” and a new security order based on “mutual trust, mutual benefit, equality, and cooperation.” Having failed to achieve parity or dominance through their own efforts and our failures, the Chinese are now attempting to gain equal footing through diplomacy. The emphasis on equality and cooperation reflects China’s preference for a multi-polar world that conforms less to U.S. influence and more to their own desires.

Beijing has described traditional U.S. alliances as vestiges of “Cold War Thinking” while at the same time it has sought to establish its own “partnerships” in Asia and around the world. In the past decade, Beijing has established multiple “cooperative” or “constructive partnerships” with countries from Japan to India, from the European Union to the United Kingdom, from Mexico to South Africa.

Asserting greater influence in the Asia Pacific region is central to China’s strategic policy. And Chinese analysts also see the region as an important source of technology, investment and modern management techniques.

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38 Gill, Written Testimony, 10-11.
40 Wang Yizhou, Multi-Polarity Does Not Equal an Anti-US Position, *The Globe Times*, (Summer 1999), 4, trans., U.S.-China Security Review Commission, Wang Yizhou argues: “To maintain good relations with our neighboring countries, especially with countries in the Asia-Pacific region, is and has always been our most important diplomatic task. In a new and multi-polar environment, our guidelines of maintaining friendly relations with our neighbors and stabilizing relationships with other surrounding countries’ should not only be continued, they should even push for China to ‘exert greater influence and become a leading force.’ We should strive to make our voice heard more in regional affairs.”
Since 1989, China has sought to create an environment conducive to domestic economic development and regional stability by engaging in confidence building measures (CBMs) with other Asian countries. Such measures have contributed to a reduction of tensions between China and border states such as India, Russia, and three Central Asia republics (Kazakhstan, Kyrgyzstan, and Tajikistan). In addition, Beijing has agreed to CBMs with other key players in the Asia region, such as the Association of Southeast Asian Nations (ASEAN). As a result, China has successfully eliminated any dramatic or compelling military threat to its borders, at least for the short term. Most notably, Beijing aggressively sought and reached a friendship and cooperation treaty with Russia, which was intended, in part, to counter-balance U.S. and European global influence.

The record stands in stark contrast to the resistance by China to U.S. Government attempts to develop CBM’s between itself and China. Authoritative U.S. Government sources involved in years of such futile efforts concluded the Chinese simply did not want such CBMs to have a central place in U.S.-China relations. The results were a nearly complete failure in the face of no interest by Chinese. Perhaps even more worrisome is the same lack of interest and success in reducing misunderstandings or miscalculations between Beijing and Taiwan, resulting in no CBMs between them.

Similarly, China’s economic relations with Europe and Japan reflect both an interest in building relations with America’s traditional allies and also decreasing China’s own dependency on the United States. To this end, China has courted Europe and Japan for technology, investments, and markets. China has also thrown a broad net in its efforts to acquire advanced science and technology from abroad. China has cooperative arrangements in both civilian industrial and military areas with countries such as Germany, France, the United Kingdom, Russia, Israel, Brazil, Japan, Korea, and Australia. Its membership in WTO helps broaden China’s outreach to the players in the world trading system, lessens its dependency on the United States for investment and trade, and makes it even more attractive to foreign investors.

In addition, Beijing is attempting to broadly counter American influence by increasing its involvement in multilateral organizations. On the international level, Beijing has increasingly supported the United Nations, where it has a permanent seat or the Security Council, as a legitimate arbiter of conflicts around the world. Regionally, Beijing has actively sought to strengthen ties with neighbors by signing a statement of friendship and cooperation with the Shanghai Cooperation Organization, increasing involvement with the ASEAN Regional Forum (ARF), participating in ASEAN +3 discussions and hosting the all-Asia Boao Economic Forum.42

**Military Modernization**

On the military front, China is dedicating considerable resources to a military modernization effort, the focus of which is preparing for conflict involving the United States over Taiwan. China is upgrading its missile force structure, shortening its response time, and enhancing its reliability and survivability.

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42 Gill, Written Testimony, 14.
43 Tenet, "DCI Worldwide Threat Briefing 2002: Converging Dangers in a Post 9/11 World".

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Over the past year, China has emphasized a “real world focus” in its military training exercises, emphasizing “rigorous practice in operational capabilities and improving the military’s actual ability to use force.” Among other measures, China is preparing to respond to U.S. forces, if necessary, by developing the capacity to control sea lines of communication and project force there. These objectives entail a substantial build-up of air, marine, airborne, and naval forces. China is not only adding longer range cruise missiles to its inventory, it is also developing through military purchases from traditional U.S. allies an over-the-horizon capability for its cruise missiles to extend the range at which they can strike U.S. naval forces. China has also publicly stated its intention to be able to neutralize an American aircraft carrier. This objective may, in part, be based on its belief that the United States does not have the will to sustain casualties.

While reaffirming their commitment to economic growth and development, senior Chinese leaders have agreed to a significant increase in funding for military modernization, announcing in March 2002, a 17.8 percent increase in military spending.

The bulk of Chinese defense investment is still commanded by the PLA ground forces and the Chinese military school of thought that endorses the concept of People’s War or Active Defense. This concept supports a large standing army, a suitable defense mobilization base, and opposes dependence on foreign weapons. Nevertheless, beginning in 1985, competition for resources has come from the Local War advocates who were embraced by Deng Xiaoping and have characterized China’s most likely future conflicts as intense but limited local wars. Since the Gulf War, competition for resources has also come from reformists who are “Revolution in Military Affairs (RMA)” advocates, who call for investment in the most exotic and advanced form of weaponry, including what they term “assassin’s mace weapons,” which can deliver decisive blows in carefully calculated surprise moves and change the balance of power. There is evidence that the Chinese leadership is allocating resources among these three distinct paths.

Since the Gulf War, PLA analysts seem convinced that their traditional approach to warfare, which focuses on mass and the annihilation of their enemies, would not be successful against an enemy with advanced technologies. In facing a high-tech enemy that relies on the RMA concepts, the PLA’s revised doctrine seeks to exploit perceived weaknesses in such concepts.

Chinese thinking on military planning and action differs markedly from our own, underscoring the need to understand their thinking better than we do now. Drawing on analyses of ancient and modern warfare in China as well as their own extensive revolutionary experience, the Chinese conclude it is not necessary to match U.S. capabilities to achieve victory and believe that the “inferior can defeat the superior.” According to such thinking, China can transform weakness into strength by employing deception, surprise and preemptive strikes, creating or leveraging discord amongst the enemy’s internal units, capitalizing on the opponent’s complacency, and using “trump cards” or “assassin’s mace weapons.” In fact, assassin’s mace weapons have been given the highest level of attention since August 1999 when Jiang Zemin called for their priority development in a speech. Such weapons fell in line with a host of other asymmetrical

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44 Ibid.
45 Wortzel, Written Testimony, 10.

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strategies—such as cyber warfare—that the Chinese believe would help to counter U.S. military superiority.\textsuperscript{50}

Information warfare—focusing on gaining and exploiting information, attacking the enemy's information systems and defending one's own information—is an important component of this asymmetric warfare strategy. Asserted Major General Wang Pufeng, former director of the strategy department of China's Academy of Military Science: "In the future, information warfare will control the form and future of war. We recognize this developmental trend... and see it has a driving force in the modernization of China's military and combat readiness. This trend will be highly critical to achieving victory in future wars."\textsuperscript{51} One of the consequences of this analysis is that China is increasing its investment in space warfare.\textsuperscript{52} China's efforts include the pursuit of a viable indigenous space force. Particular attention is being paid to the development of small boosters able to launch satellites at a moment's notice in a contingency.\textsuperscript{53}

The PLA's strategy of defeating a "high-tech" opponent through surprise and preemptive attacks "calls for operations aimed at destroying the enemy command system, crippling the enemy information system, destroying the enemy's most advanced weapons systems, crippling the enemy support (logistics) systems, and disrupting the critical links in the enemy's campaign systems."\textsuperscript{54}

To deal with the gap between mission requirements and capabilities, China's weapons acquisition policy continues to require weapons purchases and technology acquisition from a host of advanced industrial nations including, along with the United States, Russia, Israel, Great Britain, Italy, France, and Germany. It has also been relying very heavily on its ability to develop and produce missiles to bridge the gap,\textsuperscript{55} while it seeks to build and improve its defense, science and technology and industry and develop its indigenous capacity to build weapons.\textsuperscript{56}

Given the PLA assessment methods from the model of "weak defeating the strong," normal western strategies and communications may not operate effectively. The use of "direct" communications cannot be trusted to establish the credibility of Chinese intentions, and may not be interpreted correctly. Thus, so-called confidence building measures might be used to deceive or may be interpreted as a means of Western deception. Once in a crisis, the Chinese may not escalate at the same pace or by the same means as the West, which may lead to misperceptions of the Chinese level of commitment. Indeed, thinking on asymmetric warfare appears to be so pervasive in China today that the Commission believes the troubling possibility of Chinese self-deception could be worrisome in that it could lead to major miscalculations on their part. It is worthy of more attention by American policymakers.

\textsuperscript{54} \textit{Ibid.}
\textsuperscript{55} Gill, Written Testimony, 13.
Promoting Nationalism

On the domestic front, China has carefully fanned the flames of nationalism and anti-Americanism through state-controlled media. To counter persistent U.S. objections to China's behavior in areas from trade to human rights, from weapons proliferation to Taiwan, the Chinese state media has portrayed Washington as the self-appointed policeman of the world, whose foreign policy is inherently aggressive and bent on undermining others' countries' national sovereignty.\(^{57}\) The Chinese leadership has projected these negative images while also deliberately embracing those American achievements they would like China to emulate for its own development, such as American advances in high technology.

Years of anti-American propaganda greatly contributed to the popular reaction to September 11, as Chinese Internet users gloated online over America's national tragedy. The degree of anti-Americanism so embarrassed Beijing that Internet censors were instructed to delete such online content.\(^{58}\)

China's promotion of nationalism and anti-Americanism reflects a larger strategy on the part of the CCP to maintain stability and control as the economy rapidly opens up to the outside world and American values and culture.

Official Sino-American Relations

The U.S.-PRC bilateral relationship is at best, deficient for conflict resolution, uncoordinated within the U.S. bureaucracy and, at worst, has the effect of supporting Chinese efforts to enhance their science and technology base without adequate oversight within the U.S. Government.

Science & Technology Exchanges

The main elements of the existing bilateral relationship were established by President Carter in 1979, shortly after the normalization of relations with the PRC. At that time, President Carter and Premier Deng Xiaoping signed the U.S.-China Agreement on Cooperation in Science and Technology, which set up a series of joint commissions and committees to facilitate and promote bilateral dialogue and cooperation. Eleven U.S. Federal Agencies and numerous branches currently participate in cooperative exchanges under the Science and Technology agreement and its nearly 60 protocols, memoranda of understanding, and annexes. These agreements cover cooperative research in diverse fields, including energy, mathematics and chemistry, fisheries, the earth and atmospheric sciences, high-energy physics and other energy related areas, agriculture, cooperation in civil industrial technology, mine safety and miners' health and disaster research.

According to the Congressional Research Service, which was asked to examine the structure of these agreements, there is no centralized mechanism for coordinating, funding or reporting to Congress on the various cooperative programs occurring within these agencies or commissions.\(^{59}\) However, the Department of State in its first comprehensive assessment to

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\(^{59}\) Kerry Dumbaugh, "The early infrastructure of U.S. relations with the People's Republic of China (PRC) during the Carter Administration," *Congressional Research Service Memorandum*, 23 April 2002. (This
Congress of the history and implications of these arrangements reported that the bilateral S&T relationship is coordinated through two mechanisms: the Joint Commission on S&T Cooperation and the S&T Executive Secretaries. But the Department of State acknowledged that these coordination meetings are infrequent and clearly insufficient to monitor, much less direct, set guidelines, or evaluate the detailed technology transfers being made. The Joint Commission Meeting originally scheduled to meet once a year to coordinate the overall effort meets customarily every two years with the personnel on both sides varying greatly from meeting to meeting. Similarly, according to State, the Executive Secretariat Meeting should annually occur, but in reality the meetings are less frequent.

During President George W. Bush’s visit to China, he and President Jiang Zemin agreed to set up further exchanges and cooperation in the fields of trade, energy, science and technology, environmental protection, AIDS prevention and cure, and law enforcement. Given the history of these activities, the Commission finds that the Executive Branch needs to undertake a major effort to coordinate these exchanges and to inform Congress of the activities and progress on a regular basis.

The Chinese value the economic relationship with the United States very highly and have made strenuous efforts to insulate it from the vagaries of episodic military incidents, tensions, and even confrontations. For example, during the U.S. reconnaissance plane crisis, they “quietly” renewed, according to the Department of State, the agreement on scientific and technology exchanges with the United States. Furthermore, in the early morning after the plane incident, the mayor and other Shanghai officials fanned out across the U.S. firms located in the area to assure these executives that they and their firms would be protected, to encourage them to remain in a business-as-usual mode, despite the rhetoric and tensions associated with the military incident.

Confidence Building Measures

The U.S. China relationship is event driven with very few structured mechanisms for conflict resolution or threat reduction. The Four Party Talks addressing the Korean Peninsula and the US-China coalition addressing the South Asian Nuclear Tests in 1998 are two examples of temporary mechanisms that terminated once the issue was resolved or was no longer of central importance. This lack of durable architecture is particularly important, and even dangerous, given the Chinese perceptions of the United States. The United States worked diligently for years with the Soviet Union to establish threat reduction mechanisms to avoid unnecessary or potentially cataclysmic conflict. Despite extensive efforts by the United States to do the same thing, the result has been near total failure.

Over the past decade, the United States has sought to establish a more stable architecture of military CBMs with China, in part, because of growing concern over China’s negative perceptions of U.S. activities in the Asia-Pacific region, specific worrisome military incidents, and the general need to manage crisis. PLA reluctance to acknowledge any legitimacy to U.S. national security concerns has been mainly responsible for the general failure of these initiatives. An underlying factor complicating these efforts has been the Chinese Government’s apprehension about

memorandum was requested on behalf of the U.S.-China Security Review Commission by Senator Robert C. Byrd).


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revealing any weakness to the United States. On this latter point the Commission has noted that, whether in the area of threat reduction, budget discussions, or military to military exchanges, the Chinese pattern has been to absorb as much information as possible and share as little as possible.

The implementation of CBMs between China and the United States since 1989 has largely reflected these attitudes and the vicissitudes of a very contentious Sino-American relationship. Following the Tiananmen Massacre of 1989, the United States suspended all military cooperation with China. Regular contact did not resume until September 1993, when the Clinton administration began its policy of "Comprehensive Engagement." Between 1993 to 1995, the following measures were established:62

- Restoration of high-level military exchanges, such as visits to China by Defense Secretary William Perry and two former commanders-in-chief of the U.S. Pacific Command;
- Enhanced military transparency, including consultations and briefings regarding defense budgets and military strategies;
- Restoration of exchanges of military academic units, such as visits between the American National Defense University (NDU) with the Chinese NDU;
- Establishing joint agreements on preventing nuclear proliferation and the proliferation of weapons of mass destruction;
- Cooperation on defense conversion; and
- Reciprocal visits of naval warships.

The sum total of these efforts is meager, given the increasing level of military operations and interfaces between the Chinese and U.S. military and subsequent events. The CBMs were put aside after China became incensed by Washington's willingness to permit Taiwanese President Lee Teng-hui to attend his alumni reunion at Cornell University, on a private visit to the United States in 1995. Momentum was regained after the 1995-1996 Taiwan Strait crisis when the U.S. began a discussion with the Chinese about creating a crisis-management mechanism similar to the U.S.-Russian Incidents at Sea Agreement. Helped by the momentum of the 1998 Sino-American presidential summit, a direct presidential communications link (hotline) was established between Presidents Clinton and Jiang, several decades after one was established with the Soviet Union. Subsequently, the two militaries exchanged port visits and reciprocal senior defense and military visits were conducted through the respective National Defense Universities.63

After much effort, the Military Maritime Consultation Agreement was also established to foster a process for dialogue. Unfortunately, it is essentially a hollow shell and only calls for periodic discussions between U.S. and PRC military officials on navigation in international waters to enhance understanding when maritime and air forces operate in close proximity.64 This arrangement fell far short of the more robust structure the United States wanted.

The shortcomings of our CBM efforts were dramatically evident in April 2001 during the EP3 incident. At that time the Chinese refused to use the Military Maritime Consultation Agreement to help resolve the crisis. The Chinese refusal was due, in part, to their reluctance to give legitimacy to U.S. activities in the region and also Chinese perceptions of the U.S. as a hegemon with

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64 Ibid.
aggressive intent. These elements help to block the development of crisis reduction mechanisms and, consequently, raise the possibility of conflict between the two countries. Similarly, the Chinese are very reluctant to engage in confidence building measures with the Taiwanese. The overriding reason appears to be China's fears that they will convey legitimacy on the Taiwan regime and reveal their own weaknesses.

By stark contrast, the Chinese are far more forthcoming in establishing CBMs when they clearly perceive them as enhancing China's rising power. Beijing has successfully used a variety of CBMs to establish better relations with neighboring countries (See appendix for further discussion). The CBMs also have opened up doors to acquiring much-needed weapons systems and technology from Russia and have facilitated force reductions along shared borders with India and Central Asian states. At the same time, the CBMs have allowed China to reassure its neighbors of the benign nature of its rapid military growth.

In sum, China is keen to encourage any organization or structure that could speed the formation of a multi-polar world. Beijing's participation in the Shanghai Cooperation Organization, which consists of China, Russia and four Central Asian Republics, could potentially serve as a counter to U.S. foreign policy, while its participation in the ASEAN Regional Forum (ARF), because of ARF's emphasis on consensus, prevents any major power (like the United States) from dominating the agenda. Beijing uses CBMs to achieve regional stability and create options that would undermine U.S. influence and power in Asia.

Library of Congress

Understanding Chinese perceptions and strategic thinking is crucial to the formulation of a sound U.S.-China policy. The Library of Congress China collection is the national repository of published and other material on contemporary China, and plays a critical role in informing the Congress, the Executive Branch, and the public for the national policy debate on China. Unfortunately, in recent years, the Library's China collection has been poorly maintained and sorely neglected. Insufficient attention has been paid to collecting and organizing open source Chinese materials in key areas relevant to the policy debate, such as military affairs and national security, Chinese foreign policy, and Sino-American relations. Materials that do exist in the Library are not available for easy and free access to the public. Recent studies conducted by reputable China scholars have also called attention to this problem. The Library's China collection needs to be greatly improved to serve the nation's policy debate on China.

National Security Implications

Chinese perceptions of the United States as a hegemonic power and China's principal rival and competitor have serious implications for U.S. national security.

China is seeking to enhance its national power relative to U.S. power. Potential conflict with the United States over Taiwan is the primary focus for that effort and the reason underlying China's growing interest in asymmetric warfare. We must not ignore China's dedicated effort to develop

65 Ibid., 23.
67 Professors June Teufel Dreyer and David Shambaugh have conducted separate studies on the Library of Congress China collection and come to similar conclusions about its glaring deficiencies.
its science and technology base, to acquire advanced technology, and to intimidate and threaten Taiwan. In addition, U.S. security interests are put at risk by China's proliferation of WMD to terrorist sponsoring states.

Chinese perceptions of the United States as an aggressive power become highly destabilizing when combined with a deliberately weak architecture of crisis management. The efforts to resolve the EP-3 incident last year is an example of this deficiency.

Understanding Chinese perceptions of the United States is central to a successful deterrence and crisis management policy, military and diplomatic strategies and our economic relationship. We do not know as much as we should about Chinese perceptions; we do know that the Chinese have a world view very different from ours and that they devise their policies and strategies from such a view. Given, for example, the PLA's use of ancient models of the weak defeating the strong, western notions of deterrence may not operate effectively. In a crisis the Chinese may not escalate at the same pace or by the same means as the West, causing the West to miss the level of commitment the Chinese are applying. Unless we understand Chinese perceptions, we run the risk of implementing policies that are ineffective. All of this increases the potential for misunderstanding and miscalculations.

China's perceptions of the United States and its related strategic objective of multi-polarity impose limits on the extent of genuine cooperation with shared goals and a common agenda. China's reliance on deception casts further doubt on the credibility of its cooperation. Nonetheless, China's recognition that the United States is vital in its modernization, and its recognition that a peaceful international environment is essential for its growth, provides the United States important opportunities and leverage.

The combination of Chinese leaders' perceptions of America as an adversarial hegemon, and the lack of solid bilateral institutions for crisis-management response, is potentially explosive. Chinese leaders may well believe the worst of American intentions, and there is no regular mechanism for resolving misunderstandings. In the worst case, this could lead to military conflict. It is urgent for American leaders to work to correct mistaken Chinese perceptions of us, so that future Chinese leaders will come to share more of our values—particularly in the areas of democracy and human and labor rights—and view us as reliable partners in the search for peace. There is no short-term solution, and we will most likely have to navigate some highly choppy waters before reaching mutual understanding. But there is no more important mission for our policymakers than this one.

Recommendations

- The Library of Congress China collection today is nearly unusable and is a disgrace, despite two major studies advocating a more robust and sophisticated collection. The Commission recommends, therefore, on an urgent basis that the Congress fund the appropriate implementation of the detailed recommendations already submitted by these two previous investigations.

- The Commission recommends that Congress expand the U.S. Government's capacities for collection, translation and analysis of open source Chinese language materials, including expanding the scope of Chinese materials translated by the Foreign Broadcast Information Service (FBIS) and enhancing the Library of Congress's collection. The Central Intelligence Agency, the Defense Intelligence Agency, and other appropriate Executive
Branch agencies should report annually to the Congress on their resources and progress in this area.

- The Commission recommends that Congress request that the Foreign Broadcast Information Service restore and maintain a national research data bank which identifies Chinese authors and publications and determines their relative authority. Such a data bank would help policy makers and scholars determine the significance of the publications and their relative influence on Chinese policymaking.

- The Commission recommends that Congress provide federal funding and other incentives to strengthen Chinese language and area studies programs in U.S. universities, similar to the program that was developed with regard to the Soviet Union and Eastern Europe in the National Defense Education Act of 1958. In conjunction, there should also be incentives given to post-secondary graduates in this field to provide government service.

- The Commission recommends that Congress request that the President designate an Executive Branch agency to develop a database of all government-to-government and government-funded cooperative programs between the U.S. and China. The database should include a full description of each program, including its history, origin, activities, and statutory basis (if any), and a status report on its achievements to date, and should be in both unclassified and classified form, as appropriate. Congress should receive an annual report on official U.S.-China bilateral programs, based on the database, and the agreements should be submitted to Congress pursuant to the Case Act (PL 92-403).

- The Commission recommends that Congress encourage the Department of Defense to make renewed attempts to develop military-to-military confidence building measures, within the context of a strategic dialogue with China and strictly based on the principles of reciprocity, transparency, consistency and mutual benefit.
Chapter 1 Appendix

China’s Confidence Building Measures with Neighboring Countries

India

The Sino-Indian relationship has experienced extreme animosity and repeated attempts to reduce bilateral tensions. China’s invasion of India in 1962 has resulted in unsettled border areas and mutual distrust. In addition, India deeply resents China’s effort to balance Indian power in South Asia through the persistent proliferation of nuclear technology and components to Pakistan. Hostilities between the China and India reached a new height in 1998 when India cited the rise of China and its close ties with Pakistan as key threats that led India to detonate a nuclear bomb. Despite these and other chronic disagreements, China and India have attempted to forge a more stable relationship. Most notably, they agreed to CBMs in 1993 and in 1996 to reduce tension in disputed areas along their common border.

In September 1993, India and China entered into an agreement to maintain peace and tranquility along the Line of Actual Control (LAC), declaring that the boundary question should be resolved through peaceful and friendly consultations. Pending a settlement, the two countries will respect the LAC and rely on experts to check and determine the line where there are differences of alignment. Beijing and Delhi also agreed to a reduction of military forces along the border, to be maintained at levels in conformity with the principle of “mutual and equal security.”

As part of this agreement, the two sides agreed to a series of CBMs, including the prohibition of specified levels of military exercises in mutually identified zones and prior notification of exercises at specified levels near the LAC.

In November 1996, during the visit of Chinese President Jiang Zemin to India, the two countries signed the Agreement on Confidence Building Measures in the Military Field along the Line of Actual Control in the India-China Border Areas. The agreement reaffirmed the 1993 commitment to seek a peaceful solution to the boundary dispute and to observe the LAC. The two sides agreed to refrain from deploying armed forces along the LAC to attack the other side; to reduce the strength of armed forces to a minimum along the common border; and provide for bringing down the number of field army, border defense and the paramilitary forces to mutually agreed ceilings and the geographical zones. In addition, both promised to avoid holding large-scale

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68 Agreement on the Maintenance of Peace and Tranquility along the Line of Actual Control in the India-China Border Areas, 7 September 1993.
70 Agreement on the Maintenance of Peace and Tranquility along the Line of Actual Control in the India-China Border Areas, 7 September 1993.
71 Agreement between the government of the republic of India and the government of the people’s republic of China on confidence-building measures in the military field and line of actual control in the India-china border areas, 29 November 1996.
72 “Accords Signed with China,” All-India Radio, 2 December 1996, 16.
military exercises and to give prior information of any such exercise involving more than one hazardous chemicals within the 10 km area. CBM agreements between China and India have contributed to the reduction of military tensions on the two countries' shared borders. While mutual distrust and deep-seeded animosity linger, China and India today are no longer facing imminent war.

**Shanghai Cooperation Organization (SCO)**

Since the collapse of the former Soviet Union, China has pursued improved military relations and strategic partnerships with Russia and the central Asian republics, bilaterally and multilaterally, despite its continuing struggle in broader relationships with these counties. Most significant is the creation of the "Shanghai Five" (later renamed as the Shanghai Cooperation Organization), which consists of Russia, Kazakhstan, Kyrgyzstan, Tajikistan and China and first convened in Shanghai in April 1996. The group signed the "Agreement on Confidence-Building in the Military Field in the Border Area," which called for mutual non-use of force and renunciation of military superiority through confidence building measures along their common border. Under the agreement, the armed forces deployed in the 100-km zone on either side of the border shall not be used in attacks against the other side and shall not be engaged in any activities that would endanger the other side or threaten peace and stability in the region.

According to the CBMs, the parties shall:

- Exchange information on the number of personnel and amounts of essential armaments and equipment of land forces, paratroopers, border guards and air defense forces deployed in the 100-km zone;
- Refrain from carrying out military games aimed against the other parties; inform each other of the military activities in the 100 km zone; invite observers to watch large scale exercises along the border;
- Allow warships to enter the 100-km zone only on strictly specified occasions, with notable exceptions for Russian warships;
- Prevent dangerous military activities in the zone: redeployment should not acquire a dangerous form and the parties should take measures to prevent stray bullets, shells and rockets from hitting the territory of the other side during military games;
- Promote military cooperation in adjacent districts, such as official visits by military commanders, trips by teams of experts at various levels and observers to watch military exercises;
- Stipulate that border guard units establish contact and exchange information to promote cooperation.

Since 1996, the Shanghai Cooperation Organization has held annual summits and has deepened their cooperation in military, cultural and trade and security areas. Recently, statements by the group indicate an inclination to seek an expanded role in international affairs. For example, in July 2000, the group even voiced a thinly veiled criticism of U.S. policy when it declared opposition to "intervention in other countries' internal affairs on the pretexts of 'humanitarianism' and 'protecting human rights.'"

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73 Ibid.
75 "Yeltsin Visits China: Details of Confidence-building Measures between Four CIS States and China," ITAR-TASS News Agency (World Service), 26 April 1996.
Southeast Asia

China has pursued CBMs with individual Southeast Asian states to reduce tensions resulting from territorial or border disputes and with Southeast Asia in general through the Association of Southeast Asian Nations (ASEAN).

In the 1990s, China signed border agreements with Laos and Vietnam and set up CBMs to promote border cooperation. In 1999, China agreed to CBMs with Thailand, which included: enhanced cooperation between the two countries' strategic and security research institutes, strengthened consultations between military personnel and diplomatic officials in security issues, exchange between the two militaries on humanitarian assistance and rescue, and general exchange of information on military science and technology. China has also established CBMs with the Philippines to address their territorial dispute over the Spratly Islands in the South China Sea, especially after the Philippines accused China of taking over one of the islands, the Mischief Reef, in 1995. The CBMs undertaken have included vice-ministerial talks, promotion of high-level visits, agreement to establish a "bilateral consultative mechanism" to cooperate in the South China Sea, and the establishment of the China-Philippines Working Group on Confidence Building Measures.

In addition to establishing CBMs with individual Southeast Asian countries, China has shown great interest in working with ASEAN and the ASEAN Regional Forum (ARF) to maintain good relations with Southeast Asia. China proposed a free-trade area with ASEAN as a form of "political confidence-building." The Chinese initiative, endorsed by both sides in November 2001, offers to ASEAN trade liberalization measures and tariff reductions even greater than those that China agreed to under the WTO.

China has viewed ARF as a useful venue for China to diffuse tensions with Southeast Asian countries over the disputed ownership of the Spratly Islands in the South China Sea. ARF have focused heavily on CBMs, which include: multilateral dialogues on security perceptions, a voluntary annual submission of a defense policy statement, high-level defense contacts and exchanges and participation and observation of other members' military exercises.

China has actively pursued involvement in and CBMs with multilateral organizations such as the SCO and ARF for better relations with its neighbors and to seek arrangements that could serve as an alternative to U.S.-style bilateral alliances in Asia.

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79 The ASEAN members are: Brunei, Burma, Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand and Vietnam. The ASEAN Regional Forum is a 23-nation security forum, proposed in 1993, that groups the ten ASEAN members with Australia, Canada, China, Democratic People's Republic of Korea, European Union, Japan, Republic of Korea, Myanmar, Mongolia, New Zealand, Papua New Guinea, Russia and the United States.
Chapter 2 - Trade and Investment

Key Findings

- With a virtually inexhaustible supply of low-cost labor and large inflows of foreign direct investment (FDI) accompanied by transferred manufacturing facilities and technologies, China has positioned itself as a global export platform. China runs trade surpluses with most of the industrialized world and has been the recipient of transplanted manufacturing capabilities from the United States, the European Union, Japan, and Taiwan, among others.

- The United States has been a major contributor to China's rise as an economic power. As China's largest export market and a key investor in the Chinese economy, the United States has helped China become a global manufacturing center and an increasingly important center for research and development (R&D). The result of this trade and investment has enabled China to accumulate large U.S. dollar reserves. In addition, U.S. universities, laboratories, and industries have trained many thousands of Chinese scientists who have aided in a massive transfer of technology and know-how to China.

- The United States trade deficit with China is not only our largest deficit in absolute terms, but it is the most imbalanced trading relationship the U.S. maintains. In 2000, U.S. trade with China was only 6 percent of total two-way U.S. goods trade, but the U.S. deficit with China accounted for 19 percent of the total U.S. trade deficit. U.S. imports from China were over 41 percent of China's total exports, but U.S. exports to China were only 2 percent of total U.S. exports to the world. Both the EU and Japan import much less from and export much more to China than does the United States. Some U.S. exports are lost due to China's politicization of trade. The Commission finds there is plausible evidence that the burgeoning trade deficit with China will worsen regardless of China's entry into the World Trade Organization (WTO).

- During the 1990s, the U.S. trade deficit with China grew to alarming proportions -- from $11.5 billion in 1990 to $83 billion in 2001. Most U.S. imports from China over the past decade have been the product of low-skilled, labor-intensive manufacturing industries. However, this trend has begun to shift rapidly -- China's exports of advanced technology products (ATP) to the United States have skyrocketed from virtually zero in 1990 to $13.3 billion in 2001. The United States is now running a trade deficit with China in a majority of the items on the ATP list compiled by the Commerce Department. The U.S. Government's ability to identify vulnerabilities and dependencies of our military-industrial base is complicated by global supply chains and limited by insufficient data. The Commission is concerned that the United States may be developing a reliance on Chinese imports that might in time undermine the U.S. defense industrial base.

- U.S. FDI into China has resulted in increased foreign affiliate sales in the Chinese market and increased related party imports back into the U.S. market. Globalization has increased the trend towards subcontractors outsourcing key components and multinational companies utilizing China as an "export platform". Over 90 percent of the FDI attracted to the U.S. was for the purpose of acquiring ownership of existing U.S. businesses. The opposite is true for FDI flows into China where estimates indicate that 90 percent of FDI is destined to establish new operations. In short, U.S. capital and Chinese labor are manufacturing products in China for both the Chinese and American markets. U.S. manufacturing workers are increasingly displaced.

- Investment in R&D has been a growing component of U.S. investment agreements with China. There has not been adequate U.S. Government oversight or analysis of these investments and their impact on U.S. economic and national security interests.
• Under the WTO, China has agreed not to condition investment or import approvals on performance requirements, including transfer of technology or requirements to conduct research and development in China. China's full compliance with these obligations is in the U.S. national security interest.

• Over the past decade, China's import and investment policies have promoted technological modernization in their industrial and military sectors. The United States has been a key target of China's efforts.

• China is a conspicuous abuser of human rights, labor rights and the environment and its refusal to follow international standards in these and other areas gives them an unfair competitive advantage vis-a-vis U.S. workers and businesses.

• Continuing trade surpluses, vast investment inflows, and very high foreign exchange reserves are evidence that China is manipulating its currency by holding down its value thereby gaining an unfair trade advantage that increases the U.S. trade deficit.

• The State Department has informed the Commission that the large number of Chinese students, scholars, and researchers present in the U.S. academic and industrial establishment is a principal means used by China to acquire U.S. science and technology. The U.S. Government has limited knowledge of their number, backgrounds, and activities.

Introduction

Over the past two decades, China has emerged as a major participant in the international economy. China's two-way international goods trade grew from roughly $28 billion in 1982 to $510 billion in 2001. In 2000, Mainland China was the world's seventh largest goods exporter ($249.3 billion) and eighth largest importer ($225.1 billion). During the mid- to late 1990s, China has become one of the world’s largest recipients of foreign direct investment (FDI). According to Chinese statistics, FDI into China in 2001 was a record $46.8 billion. To accomplish such sustained growth in exports and investment over the past decade, China's leadership targeted technological modernization as the main pillar for such growth and steered the country's trade and investment policies to support that objective.

The importance of the United States to China's economic growth during the past decade cannot be overstated. The United States is China's biggest export market, a key investor in its economy, and a principal source of technology and know-how. Since trade relations resumed in 1978, overall U.S. trade with China has grown from $1 billion to $119.5 billion in 2000. From 1990 to 2000, the U.S. direct investment position in China grew from $354 million to $9.58 billion, according to U.S. Government figures. The U.S. capital markets have also been an important source of capital: the Chinese have raised approximately $20 billion dollars over the past three years.

Unfortunately, the U.S. role in China's economic growth has some negative implications for the U.S. economy. From 1990 to 2000, the U.S. goods trade deficit with China grew seven-fold from

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1 To put U.S., E.U., and Japan trade data on a comparable basis this chapter uses WTO trade data when available. 2001 WTO data have yet to be released. All other data comes from individual country sources. (According to U.S. Census Bureau data the U.S. trade deficit with China declined modestly from $83.8 billion in 2000 to $80.0 billion in 2001).

$11.5 billion to $87 billion and surpassed Japan as our largest trade deficit. Such an imbalanced relationship has troubling implications for U.S. jobs and wages, as well as for the overall economic health of the U.S. manufacturing sector.

In this chapter the Commission details the uniqueness and causes of the U.S. trade deficit with China and describes the shifting composition of China's trade toward higher technology goods. We also examine the impact of U.S. investment on China's economic growth and technological modernization. The chapter ends with the Commission's assessment of the national security implications of these developments and recommendations in key areas.

U.S.-China Trade

China has had one of the world's fastest growing economies and has shown substantial export prowess across a wide range of goods. In just the past ten years, China has experienced rapid growth in its goods trade, with total value soaring from around $100 billion in 1990 to nearly $510 billion in 2001. China's worldwide exports outpaced imports for all but one of those years (1993), generating annual world-wide trade surpluses, albeit not huge ones.

The U.S. Trade Deficit with China - The United States has played a significant role in helping China's export-led growth policies succeed in a way that is not evidenced by China's other trading relationships. The U.S. consumer goods market was the cornerstone for China's growth in trade in the 1990s. As trade between the United States and China expanded, so too did the U.S. trade deficit. The growth of U.S. Imports from China has far exceeded the growth in our exports to China. According to WTO data, in 2000, the United States took 41.3 percent of China's total exports, while China purchased about 2 percent of total U.S. exports. From 1990 to 2000, U.S. exports to China increased from $4.8 billion to $16 billion, while imports from China leaped six-fold from $16.3 billion to $103 billion. The result has been a U.S. goods trade deficit with China that has ballooned from approximately $6 billion in 1989 to $87 billion in 2000. Notably, U.S.-China trade in manufactures accounts for virtually the entire U.S. trade deficit with China.³

³For example, manufactures represented nearly 80 percent of U.S. exports to China and more than 95 percent of U.S. imports from China in 2000. The other categories of goods trade are agricultural and mining, for which the U.S. posted a surplus with China of less than $1 billion in 2000.
The U.S. trade deficit with China is not only the largest in absolute terms, but trade with China is also the most imbalanced trade relationship the United States has with any of its major trading partners.

Trade with China represents only 6.5 percent of U.S. worldwide trade, but accounts for approximately 20 percent of the U.S. global trade deficit. As shown above, in 2001, the ratio of imports to exports in trade with China was 5.32 to 1, as compared to a ratio of 2.2 to 1 with Japan and 1.38 to 1 with the European Union (E.U.).

Together the United States, E.U., and Japan received about 88 percent of China’s total exports in 2000, and took over 90 percent their exports in manufactured goods. However, Japan and Europe imported less from and exported more to China than did the United States. The most striking feature of U.S. exports to China is that the United States competes directly with both Japan and the E.U. and frequently comes in a distant third. In both the aggregate and at sectoral levels, the U.S. is selling less to China. Particularly stark are the relatively small U.S. sales of manufactured goods. The exceptions are aircraft and fertilizers, where U.S. sales are greater.
than its competitors. The skewed trading relationship raises questions not only of competitiveness, but also whether China is managing or politicizing aspects of its trading relationships.

Figure 2.3

Source: China Statistical Yearbook, various issues; compiled by USCC

Japan's Trade Deficit with China - Japan's trade deficit with China was $24.7 billion in 2000; Japan exported $30.4 billion and imported $55.1 billion. In general, the Japanese are more successful in selling to China across a broader range of manufactures categories. As a result, Japan has the highest exports to China among the three major trading partners. Japan dominates markets for many products that it exports to China. Japan sells more iron and steel, fabric and fibers, and chemicals than the E.U. or the United States. Additionally, the Japanese sales of electrical machinery and machinery, which are mostly components for assembly and re-export, have been higher than U.S. sales in these sectors.

The European Union's Trade Deficit with China - The E.U. trade deficit with China was $33.4 billion in 2000; the E.U. exported $27.8 billion and imported $61.2 billion. The E.U. is selling more pharmaceutical products than either Japan or the United States does to China. The E.U., like Japan, also exports more vehicles, vehicle parts, machinery, and electrical machinery to China than does the United States.

Factors Contributing to the U.S. Deficit with China

Openness of the U.S. Market – Along with more open markets than the EU or Japan to foreign imports of many consumer goods, the U.S. has a more highly developed distribution network for imports. Significantly, a sizeable portion of U.S. imports from China is comprised of shipments to U.S. companies from their affiliates in China or from their China-based subcontractors. Increasingly, U.S. multinationals are utilizing China as an export platform in order to compete more aggressively in the global economy. While it is difficult to obtain precise figures for imports that U.S. retailers have subcontracted, there is no doubt that large U.S. retailers make up a significant portion of the import market. For example, news reports indicate that American retailer Wal-Mart alone imported over $10 billion worth of Chinese goods in 2001, equivalent to around 10 percent of total U.S. goods imports from China for that year.4

Comparative Advantage - U.S.-based companies may have difficulties competing in the U.S. market with some Chinese imports due to China's low-cost labor. The Commission underscores that China's cost advantage is in part due to the country's lack of government restrictions on environmentally damaging commercial activities and the Chinese government's repression of civil organizations, trade unions, and other political and human rights.

Investment and China's Rise as an Exporting Platform - Throughout the 1990s, FDI flows into China, which have been primarily concentrated in the manufacturing sector, helped China become a world center for manufacturing and continue to have a significant impact on China's export-led growth. The Commission has reviewed a study reporting that over 90 percent of FDI into China was for the establishment of new businesses, while over 90 percent of the FDI into the United States was for acquisition of existing U.S. businesses.  

The share of exports to the United States produced by foreign-invested firms has steadily increased over the last decade and a half. China required export performance as part of its investment agreements with foreign firms. In 1985, foreign-invested firms produced 1 percent of China's exports. In 1990, they produced 12.5 percent, and in 2000 48 percent. Researchers at the New York Federal Reserve Bank estimate that only 20 percent of China's total imports reach China's domestic markets, while the other 80 percent consist of capital goods and industrial inputs used for the country's exporting zones. Morgan Stanley's most recent report on the U.S. deficit with China described the contribution of foreign enterprises to China's export ascendancy as "nothing short of staggering." China reported a new record in FDI actually absorbed for 2001 of $46.8 billion and expects to attract over $50 billion in new FDI in 2002, with much of the new FDI focused on high-tech sectors. Just as investment in labor-intensive industries drove a dramatic rise in China's exports in those sectors, there is a high probability that increasing investment in advanced sectors will cause exports in the higher value-added goods to continue to rise dramatically.

Also, contributing to the expanding U.S. trade deficit with China is the shifting composition of the U.S. trade deficit with Asian nations. In many instances, U.S. imports from China displaced low-cost goods from other Asian countries. As Chinese goods put price pressures on the labor-intensive manufactured goods from the newly industrialized countries of Asia in the early 1990s, these countries were compelled to move up the quality and value-added ladder into goods like advanced personal and professional electronics and computer-related hardware. By 2000, all of the Asian Tigers, and even Japan, began to see many of their manufacturers migrate to China where they could sell in China but also use it as an export platform to the U.S. The Commission believes this trend is important to note, and in Chapter 5 we have assessed it in greater depth.

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9 "China '02 Direct Foreign Invest Seen up 7 percent to $50 billion," Dow Jones Wire, 2 April 2002.
10 Lardy, Oral Testimony, 180.
In part, the U.S. trade deficit with China represents a shift in trading patterns between the U.S. and Asia as a whole. Many of the Asian nations have shifted some of their production to China to take advantage of the comparatively lower cost-of-production. U.S. imports from China have displaced some of the imports from these nations. The U.S. trade deficit with China accounted for 20 percent of our deficit with the Asian region in 1992, and doubled to 40 percent by 2001. The U.S. trade deficit with the entire Asian region also continued to grow during this same time period from $91.7 billion to $212.5 billion.

**U.S. Investment and Growth of Related Party Trade** — Running counter to the traditional trade policy view that investment leads to trade, the increasing amounts of investment into China by U.S. firms appear to be contributing to the widening U.S. trade deficit. Many U.S. companies make products in China and then export them back to the U.S. or export them to other countries (thereby displacing U.S. exports to those countries). Related party trade (trade between a company and its foreign affiliate) as a subcomponent of U.S.-China trade has grown dramatically. According to U.S. Department of Commerce data, around 18 percent of U.S. imports from China in 2000 came from related parties, a number that has steadily risen over the past decade. For example, as reported in a Xinhua News Agency dispatch this year: "Motorola has opened eight joint-ventures in China, a $3.4 billion investment. These joint-ventures exported over $1 billion worth of goods last year, making Motorola the largest exporter among China's foreign-invested firms."\(^{11}\) Motorola plans to increase its total investment in China to $10 billion by 2006.\(^{12}\) As Motorola's investments and production in China have increased, it has reduced employment at its U.S. facilities.

**Figure 2.4 — U.S. Imports from China (1992-2000)**

![Graph showing U.S. imports from China (1992-2000)]

Source: USITC Dataweb, U.S. Bureau of Economic Analysis; compiled by USCC Staff

# Percentage of imports due to Related Party Trade

**Lack of Market Access to China** — In part, the U.S. trade deficit with China results from a market that has been relatively closed to U.S. goods through restrictive tariff and non-tariff trade policies, as well as the politicization of its trade policies. China has closely guided its import policies to support its growth objectives. Despite attempts throughout the 1990s by the U.S. and other foreign governments to gain greater market access in China for their domestically produced goods, much of China's imports have been inputs for assembly and re-export. Although China reduced tariffs from an average of 43 percent in 1994 to an average of 15 percent by the end of

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2001, the government and state-owned enterprises sought protection through a series of non-tariff barriers targeted at imports not related to re-export trade. As one witness told the Commission: "[O]f even greater significance to our trade deficit with China are the costly and burdensome non-tariff barriers which confront our companies. These barriers take many forms, from a distribution system which discriminates against our companies, to the discriminatory buying practices of state-owned enterprises, to the arbitrary customs procedures we face at the ports-of-entry."\(^{13}\)

The United States, as well as China's other major trading partners, supported China's entry into the WTO in part to address the non-tariff barriers and trade-distorting practices of the Chinese government and state-owned entities, with the goal of enhancing market access for their goods. But, there is no indication that China's accession to the WTO will significantly reduce the burgeoning U.S. trade deficit with China.\(^ {14}\) In testimony before the Commission, representatives of the Bush Administration made clear that reduction of the U.S. trade deficit with China was not a necessary objective of China's accession. Assistant Secretary of Commerce William Lash stated:

\[\text{[T]he WTO was not designed to address the trade deficit; it was designed to increase our market access and to increase, frankly, a level playing field with the rule of law so that our exporters and our workers can get a fair deal when trying to export to the Chinese market.}\(^{15}\)

\[\text{Currency Manipulation - The exchange rate of the Chinese yuan (or Renminbi) to the dollar is also an important contributing factor to the U.S. deficit. While the United States has a free-floating exchange rate in which official intervention is both rare and done in small amounts, China holds a soft peg to the dollar with its currency nonconvertible on the capital account. In 2001, despite the country's $23 billion global trade surplus and FDI inflow of $46.6 billion, China maintained its soft peg. China accomplishes this through large official purchases of dollars in order to maintain an exchange rate lower than would otherwise occur by market forces alone. By holding down the exchange rate, China gains an unfair trade advantage that increases the U.S. trade deficit beyond what the market would dictate. Ernest H. Preeg, Senior Fellow in Trade and Productivity at the Manufacturers Alliance/MAPI, who testified before the Commission in May 2001, wrote in his testimony to the Senate Banking Committee in May 2002:}\]

\[\text{Based on the IMF definition, China has clearly been manipulating its currency for mercantilist purposes. The Bank of China has made protracted large scale purchases of foreign exchange- $150 billion since 1995- in order to maintain a large trade surplus as an offset to poor growth performance in the domestic [Chinese] economy.}\(^{16}\)


\(^{14}\text{In September 1999, the International Trade Commission (ITC) issued a report that attempted to estimate the impact of China's entry into the WTO on the trade flows between the U.S. and China. The report, which based its assessment on the status of negotiations at that time, estimated that U.S. exports to China would increase by approximately 10 percent and U.S. imports from China would increase by approximately 7 percent. This would result in an increase in the U.S. trade deficit with China (due to the fact that the volume of imports far exceeded the volume of exports).}\)


\(^{16}\text{Senate Committee on Banking, Housing, and Urban Affairs, Hearing on The Treasury Department's Report to Congress on International Economic and Exchange Rate Policy, Written Testimony of Ernest H. Preeg, 106th Congress, 2nd Session, 1 May 2002, 5.}\)
C. Fred Bergsten, Director of the Institute for International Economics, has also advocated pressuring China to change its exchange system. "Because of the exchange controls, they require the export earnings of a Chinese exporter to be sold to the central bank for local currency...I'm proposing that we suggest they not do it...The implication would then be an appreciation of the Renminbi and some modest depreciation of the dollar."\textsuperscript{17} The Commission believes China's currency manipulation needs to be addressed and that the Chinese should be pressured to change their exchange rate policy and eliminate capital controls. Moreover, while it is not presently in China's interest to use its very large dollar reserves as an economic weapon against the U.S., in the future, this possibility exists. The Commission will continue to monitor this issue.

**China's Growth in the Export of Advanced Technology Products**

The bulk of U.S. imports from China over the past decade have been labor-intensive and low-skilled assembly manufactured products. While these products still dominate U.S.--China trade and the absolute size of China's surplus in this area is growing dramatically, the composition is shifting.\textsuperscript{18} China is now also exporting to the U.S. higher value-added manufactured goods and an increasing amount now qualify as Advanced Technology Products (ATP).\textsuperscript{19} A Commission study has found that China's rapid technological and economic success and its unique overall trading relationship with the U.S. is a strong, contributing factor to China's shift toward exporting more ATP goods.\textsuperscript{20}

Global ATP trade has historically been one of the areas of U.S. strength, even as manufactured goods trade fell to record deficits during the past decade. However, the export advantage that the U.S. enjoyed in ATP trade with China in 1990 was lost by 1995, and the U.S. has seen a general trend of broadening and deepening ATP deficits with China every year since. In less than a decade, China, in its trade with the U.S., has shifted from being a net importer of ATP goods to a net exporter. While U.S. ATP exports to China grew by 483 percent between 1990 and 2001 ($1.24 billion to $7.24 billion), Chinese ATP exports to the United States increased 8,126 percent (from $0.16 billion to $13.38 billion) and accounted for 6.8 percent of all U.S. ATP imports. China's shift in trade composition has widened the U.S. trade deficit for ATP goods with China from $1 billion in 1995 to $6.95 billion in 2000, (easing to $6.12 billion in last year's U.S. recession and technology slump but soaring by 40 percent for the first quarter of 2002). The United States now runs a deficit with China in almost two-thirds of the 650 individual ATP product lines tracked by the Commerce Department.\textsuperscript{21}

In 2001, bilateral technology trade was primarily (more than 99 percent) in four product areas: Mechanical Equipment including Computers (46 percent); Electrical Machinery (35 percent); Aircraft and Spacecraft (12 percent); and Optical-Photographic and Measuring Equipment (almost

\textsuperscript{17} Senate Committee on Banking, Housing, and Urban Affairs, *Hearing on The Treasury Department's Report to Congress on International Economic and Exchange Rate Policy*, Oral Testimony of C. Fred Bergsten, 1 May 2002 (unofficial transcript reported by Federal News Service, Inc).

\textsuperscript{18} For one example of media coverage on China's role in the high tech sector and future ambitions, see Jim Erickson, "The Next Tech Superpower," *AsiaWeek.com*, 27 July – 3 August 2001.

\textsuperscript{19} Since 1989, the U.S. Department of Commerce has maintained a continually updated list of Advanced Technology Products (ATP). This ATP list is maintained at the 10-digit Harmonized Code level of specificity. In 2001, two-way ATP trade accounted for $395 billion – 21 percent of total U.S. trade with the world.

\textsuperscript{20} McMillion, *China's Very Rapid Economic, Industrial and Technical Emergence*, 3-4.

\textsuperscript{21} *Ibid.* 3-5.
7 percent. Among these product areas, between 1997 and 2001, the U.S. deficit with China increased by $5.4 billion for the first two categories, while the U.S. trade surplus in the later two categories increased by less than $500 million.\textsuperscript{22}

China is increasing capital investment in manufacturing capacity for advanced telecommunications and information technology products (such as silicon wafers) that are likely aimed at export to the United States.\textsuperscript{23} The trends in the computer and peripheral equipment industries suggest U.S. reliance on Chinese manufactured components in such products is increasing. As noted by one financial analyst report, "China consumes 6 percent of global integrated circuit demand but only produces 1 percent itself; having moved operations to China, multinational corporations are demanding suppliers join them. China’s integrated circuit sector is just emerging."\textsuperscript{24} The trend in the telecommunication industry also suggests the manufacture of Chinese components is increasingly important.

**Potential U.S. Dependency on Chinese Advanced Technology Imports** - A key issue, along with the U.S. deficits in this trade area, is whether the United States is developing a dependency on Chinese imports that might undermine the U.S. defense industrial base. According to Commission research, China’s capture of much of the U.S. manufacturing capacity in the high technology area could have serious implications for the United States. To the extent that U.S. surge capacity becomes increasingly dependent on component imports from China, the U.S. defense industrial base is correspondingly put at risk. The Commission intends to aggressively examine this issue and the potential impact on downstream and related industries.

According to a report on China’s WTO agreement contracted by the Commission, the inability of import-sensitive sectors to compete with Chinese imports can raise import dependency issues and, by implication, national security concerns. China has shown an extraordinary ability to rapidly expand production and exports in a wide range of products. It is unclear how much of this success flows from government subsidies and closed domestic markets. To date, the United States has paid little attention to dependency on imported products from any one nation, including China.\textsuperscript{25}

The Commission has found that U.S. government data are currently inadequate to track properly industrial-technological-military dependencies. The Harmonized Standard codes, used by the U.S. Customs Service, and the Military Critical Technologies List, are impossible to cross-reference due to the insufficient specificity of both lists. Without the ability to cross-reference these lists, analyses of U.S. technological and military dependencies on imports from China are deficient. With globalization, sub-contractors are outsourcing key components. In 1992, the U.S. Navy and the Commerce Department traced the sourcing on three major projects and found 115 distinct items where a foreign dependency existed.\textsuperscript{26} Shifts in the U.S. and world technology trade since 1992 have almost certainly increased that number.

\textsuperscript{22}Ibid., 3-5.
\textsuperscript{24}Credit Lyonnais Securities Asia Emerging Markets, “The Janus Face,” (Hong Kong; January 2002), 31.
U.S.-China Investment and Technology Transfer

An important factor behind the Chinese leadership’s decision to embrace WTO membership was its continuing need to attract foreign investment, especially in high-technology sectors, from the U.S. and elsewhere. Foreign direct investment (FDI) has been a critical component of China’s effort to develop its economy and advance its science and technology base. FDI both fuels China’s economic growth and enhances aspects of its military development.

Over the past decade China has become the largest recipient of FDI in the developing world and one of the world’s principal destinations for FDI. Between 1996 and 2000, almost 75 percent of China’s capital inflows ($290 billion) were in the form of FDI ($217 billion).\(^{27}\) Unlike other developing countries, China has not heavily relied on foreign loans to finance its economic modernization; in fact, new foreign borrowing declined from a peak of $12.7 billion in 1996 to $10 billion in 2000.\(^{28}\) The model of export-led growth and import substitution policies, conducted in tandem with increasing amounts of foreign direct investment and a tightly controlled currency, underpinned a decade of rapid economic growth.

The U.S. has been a key investor in the Chinese economy over the last ten years, with U.S. data indicating the direct investment position growing from $354 million in 1990 to $9.58 billion in 2000. Including Hong Kong, the gateway by which many U.S. firms gain access to the mainland, China became the preferred location of U.S. FDI not only in Asia but also among other developing nations. Only Mexico (as a result of NAFTA) and Brazil attracted more U.S. investment among the developing nations than China/Hong Kong over the second half of the 1990’s, and in 2000 China overtook Mexico as the U.S.’s largest investment target.\(^{29}\) Increasingly, U.S. firms have sought not only market access with their investments, but also low-cost manufacturing platforms to better compete in the global market.\(^{30}\) According to Morgan Stanley, “China’s massive consumer and labor markets do set it apart from the rest of the world, and for many U.S. firms, there is simply no choice but to be on the ground there.”\(^{31}\)

![Figure 2.5 U.S. FDI Position in China by Sector](image)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Invest Position in 2000 ($b)</th>
<th>% of Total Position in 2000</th>
<th>% Increase 1994-2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Petroleum</td>
<td>1.846</td>
<td>19.3%</td>
<td>106%</td>
</tr>
<tr>
<td>Food Manufacturing</td>
<td>.181</td>
<td>1.8%</td>
<td>38%</td>
</tr>
<tr>
<td>Chemical Manufacturing</td>
<td>.245</td>
<td>2.6%</td>
<td>11%</td>
</tr>
<tr>
<td>Metals Manufacturing</td>
<td>.183</td>
<td>1.9%</td>
<td>76%</td>
</tr>
<tr>
<td>Machinery Manufacturing</td>
<td>.931</td>
<td>9.7%</td>
<td>N/a</td>
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<tr>
<td>Elec Equip Manufacturing</td>
<td>3.208</td>
<td>33.5%</td>
<td>1787%</td>
</tr>
<tr>
<td>Transport Equip Manuf.</td>
<td>.147</td>
<td>1.5%</td>
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<tr>
<td>Other Manufacturing</td>
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<td>168%</td>
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<td>11.6%</td>
<td>179%</td>
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<tr>
<td>Other</td>
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</tr>
<tr>
<td>TOTAL</td>
<td>9.577</td>
<td>100%</td>
<td>275%</td>
</tr>
</tbody>
</table>

Source: United States Bureau of Economic Analysis data compiled by USCC staff

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\(^{27}\) China Statistical Year Book 2001, Table 17-13, Compiled by USCC Staff.

\(^{28}\) Ibid.

\(^{29}\) Quinlan, "America's Trade Deficit with China: Why It's Here to Stay," 3.

\(^{30}\) Ibid., 5.

\(^{31}\) Ibid., 5.

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Over 400 of the world’s 500 largest companies are now invested in China, with U.S.-based firms having been the largest investors for three consecutive years. U.S. direct investment outflow to China and Hong Kong in 2000 hit a record high of $4.4 billion - a 4 percent increase over 1999 and 3.1 percent of total U.S. direct investment abroad. American corporations’ investments have been concentrated in higher value added manufacturing (electronics equipment, telecommunications equipment, transportation parts and equipment, etc.), services (insurance, financial and distribution), and petroleum, rather than labor-intensive manufactures (footwear, apparel, textiles, plastics).

Technology Transfer – With the objectives of modernization and self-sufficiency of the country’s industrial and military sectors, China’s leadership has methodically guided a remarkable drive for technological modernization. ³² China’s leaders, including President Jiang Zemin, repeatedly emphasize the importance of developing independent, proprietary high-technology capabilities as a means to boost China’s economic and military prowess to counter “hegemonic” actions of the United States. ³³

In an effort to develop indigenous high-tech industries, China’s foreign import and investment policies have increasingly emphasized industry-specific investment and high technology imports. ³⁴ China maintains a carefully integrated set of evolving industrial policies to “encourage, permit, restrict or ban” foreign involvement in very specific areas of technology and production. These guidelines were designed to encourage foreign investors to move away from labor-intensive projects towards joint-ventures in advanced technology, modern infrastructure development and high value-added goods. Beijing is also encouraging investment in the Western part of the country—raising concerns regarding joint partnerships with the many defense-related firms located in those inland regions.

In April 2002, the Chinese government issued its latest investment policy document, titled “Catalogue for Guiding Foreign Investment in Industry.” The list of encouraged sectors grew by nearly 70 categories, while the list of restricted sectors grew by six categories. Most of the additional encouraged sectors were in manufacturing of advanced biotechnology, materials, electronics, communications equipment, and machine tools and manufacturing systems. Clearly, the identification of these sectors reflects the Chinese government’s intent to direct foreign investment, management, and production technologies toward advanced manufacturing sectors.

Prior to agreeing with its WTO obligations to cease such practices, China’s laws, regulations and policies with regard to foreign investment and trade included numerous provisions and mandates for foreign technology transfer. Technology transfers have also been used as a deal maker by U.S. firms seeking joint-venture contracts. The most significant offset initiative put forward by U.S. high-tech companies in seeking approval for joint-venture manufacturing partnerships or

facilities in China is the establishment of an institution, center, or lab devoted to joint research and development (R&D). \(^{35}\)

In 2001, China's Academy of Sciences identified 124 high-tech R&D centers in China that had been set up by foreign firms. A large number of global technology firms have at least one R&D center working jointly with Chinese state controlled firms and universities, signifying a shift for multinational companies that had previously withheld their R&D work from China. \(^{36}\) As China increasingly becomes a center for R&D, more technology transfer will occur and thereby threaten the U.S. domestic R&D base. \(^{37}\)

The rate of U.S. investment in R&D in China by U.S. majority-owned foreign affiliates has increased significantly over the past two years. In 1997, U.S. firms invested $35 million in China and $14.5 billion worldwide for R&D. In 1999, investment jumped to $305 million in China (a 771 percent increase) - $292 million invested by manufacturing firms, and $26 million of that by chemical firms- and $18.3 billion worldwide (a 25 percent increase) for R&D. \(^{38}\)

The scope and nature of research done in China are advancing very rapidly. \(^{39}\) As Alcatel's executive vice-president Ron Spithill recently told the Financial Times, "Very soon (China) will be a source of innovative technology." \(^{40}\)

According to the Department of Commerce commissioned report *U.S. Commercial Technology Transfers to the People's Republic of China*, Chinese officials "frequently play foreign competitors against one another in their bids for joint-venture contracts and large-scale, government funded infrastructure projects in China. The typical result is usually more technology being transferred as competitors bid up the level or type of technology that they are willing to offer." \(^{41}\) The report also stated: "...it is clear that foreign firms are being coerced into transferring technology (which they probably would not otherwise do) as the price to be paid for access to China's market." \(^{42}\)

Under WTO, China has agreed not to condition investment or import approvals on technology transfer or requirements to conduct R&D in China. USTR officials informed the Commission that this commitment would apply to pre- as well as post-accession contracts. \(^{43}\) Concerns exist that the government may impose more obligations, perhaps unofficially, to continue such requirements in exchange for favorable, extra-legal decisions by government officials at both the national and regional level. \(^{44}\) This is an area that will be extremely difficult to police, as many companies wishing to do business in China make undisclosed concessions to beat out their competitors.

\(^{35}\) *Ibid.*


\(^{38}\) Bureau of Economic Analysis statistics, U.S. Department of Commerce. These R&D figures are only available for U.S. majority owned foreign affiliates of U.S. parent firms. Compiled by USCC Staff.


\(^{42}\)*Ibid.*, 96.


\(^{44}\) United States Trade Representative, *Foreign Trade Barriers 2001*, April 2002, 98.
The American Chamber of Commerce in China (AmCham-China) explicitly expressed its skepticism in its annual white paper in 2001: "Despite the updating of provisional regulations on technology licensing in preparation for China's WTO entry, foreign companies are still required to submit technology licensing documents to the Chinese government for review – and licensors often must trade significant technology rights for approval to continue their project. In some industries, informal administrative measures in the form of 'advice' to foreign companies make technology transfer a pre-condition to market entry. AmCham-China strongly believes China needs to take a more progressive and open approach to end such irregular practices."\(^{45}\)

The significance of these arrangements is profound. In a recent report to Congress on U.S.-China Science and Technology Cooperation, the State Department concluded: "This Chinese investment strategy, designed to extract technology transfer from American firms as a condition for entering the Chinese market, is, in State's estimation, the principal source of technology transfer from the U.S. to China."\(^{46}\) State goes on to say that China "reaps a technology bonanza" from these investment policies. And, this trend will most likely continue, if not accelerate. The Chinese Academy of Sciences recently detailed a study that found that in 1997 only 13 percent of foreign firms in China applied the parent company's most advanced technologies in China. By 2001 that proportion had already risen to 41 percent and the Academy expects it will exceed 50 percent in 2002.\(^{47}\)

**Foreign Nationals Studying in the United States** - The Commission finds that another principal means China is using to channel scientific and technological information to China is through Chinese foreign nationals studying and working in the U.S.

The recent State Department-coordinated report *U.S.-China Science and Technology Cooperation* concludes:\(^{48}\)

- *it is clear that a major facilitating channel for the flow of scientific/technological information and know-how from the U.S. is the vast number of Chinese students annually present throughout the U.S. higher education system;*
- *it is State's belief that the large numbers of Chinese students, scholars, researchers and high-tech workers, ubiquitously present throughout the U.S. academic and industrial research establishment, collectively represent China's chief means of gathering information on U.S. scientific and technological development;*
- *viewed against the context of what China can glean from the proliferation of its nationals working in U.S. laboratories, whatever knowledge China might possibly have gained from cooperative S&T activities conducted under the 1979 S&T agreement would be negligible by comparison.*

Of particular importance is the fact that the large majority of these Chinese students are engaged in courses of study or research in fields related to mathematics, science and technology.\(^{49}\) In 1999, 8 percent of the doctorates awarded in the United States in the sciences and engineering went to Chinese foreign nationals while U.S. citizens accounted for 22 percent of the


\(^{49}\)Ibid., 61

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doctorates.\textsuperscript{50} The Commission emphasizes the State Department finding that "U.S. academic research laboratories throughout the country are hosts to thousands of Chinese students and researchers who have first-hand knowledge and participation in some of the most advanced S&T research projects across a spectrum of scientific disciplines. Many of these students return to China, taking their knowledge and expertise obtained in U.S. labs with them. Many others remain in the U.S., working in U.S. high-tech industry or remaining in academia."\textsuperscript{51} U.S. high-tech firms, where the latest technologies are being developed, apparently also employ "thousands" of Chinese who have completed their studies in the United States, largely because they are unable to find sufficient numbers of S&T trained Americans.\textsuperscript{52} The U.S. Embassy in Beijing reports that it issued over 9,000 H1-B visas to Chinese in FY2001 for working in these high-tech firms.\textsuperscript{53}

As with all foreign students studying in the United States, the U.S. Government has very limited knowledge as to their numbers, backgrounds, and activities here. In many cases, the U.S. Government loses track of them.

According to the Institute of International Education's "Open Doors On the Web," there were 59,939 Chinese students in the United States in the 2000/2001 academic year, a 10 percent increase over the previous academic year. Constituting the largest percentage of foreign students studying in the U.S., Chinese students accounted for 10.9 percent of all foreign students.\textsuperscript{54}

The Commission recognizes that the U.S. high-tech community depends on the talent of foreign nationals, and similarly, that the size and configuration of the U.S. college and university system assumes that there will be large numbers of foreign students. Furthermore, the Commission values and recognizes the importance of exposing foreign nationals directly to our democracy and freedoms. However, the Commission believes that the lack of oversight of Chinese foreign nationals, as well as those of many other countries, studying and working in sensitive disciplines can have serious national security implications. The transfer of "know how" could potentially be applied to China's military industrial base. Consequently, the Commission concludes that increased oversight, review, screening and tracking of Chinese foreign nationals studying and working in the U.S. is necessary, and we support the recently signed into law "Enhanced Border Security and Visa Reform Act of 2002". The Commission stresses the importance of implementing and enforcing the law's provisions that seek to improve efforts to track foreign students in the U.S. to ensure that they maintain their appropriate visa status.

**Impact on U.S. Jobs and Wages**

There has been considerable debate over the impact that the U.S.-China economic relationship has on wages and employment levels in the United States. Evaluating the economic relationship with China is not only a matter of understanding the merits and drawbacks of free trade and globalization, but also involves questions of fair competition and American values. There are serious implications in exposing U.S. workers to competition with China - a non-market economy that is a conspicuous abuser of human, political, and labor rights and the environment.

\textsuperscript{52}ibid.
\textsuperscript{53}ibid.
\textsuperscript{54}ibid.
A key question that the Commission's contracted research and public hearings have repeatedly raised is whether U.S. trade and investment with China are adversely impacting are not only wages and jobs in traditional manufacturing areas, but those in high-technology industries as well. Paul Craig Roberts, an economist and columnist, who served as an Assistant Secretary of Treasury in the Reagan Administration, recently wrote: "The upshot is that both American and Chinese firms produce for the U.S. and Chinese markets with Chinese labor. U.S. labor is not in the picture."\(^{55}\)

While numerous arguments have been presented to the Commission that the U.S. economy benefits tremendously from its trade with China, we have also heard from labor representatives about the dislocation and virtual stagnation or decreasing standard of living that many U.S. workers face. The impact of trade with China on U.S. security interests – both military and economic – is complex. There are positive and negative aspects to the relationship which all parties must recognize in order to allow reasoned analysis and debate. In the opinion of the Commission, however, simply to accept a "business as usual" approach is not acceptable.

Through the course of three hearings on the impact of the U.S.-China trade and investment relationship on key American industries, the Commission heard a variety of opinions on the contentious topic of globalization. The Commission heard from academics such as William Overholt, a Senior Fellow at Harvard University Asia Center, about the benefits of the U.S.-China trade relationship:

They [China] get foreign investment in the things that they are good at, which are labor-intensive things; what has happened in the past decade is that because we have restructured in a way that countries like Japan haven't, we have let the stuff that the Chinese should be doing go to China, and they are making shoes and shirts and so on; we have focused our energies on the things we have been good at. We have had the lowest unemployment rate in our modern history. We have had the highest economic growth rates. We have had the longest economic boom. And a lot of that was because of China.\(^{56}\)

The Commission heard of a different side of the relationship from labor representatives such as Richard L. Trumka, Secretary-Treasurer of the AFL-CIO:

When consumer demand is met with imports instead of domestic production, existing jobs can be lost, and new manufacturing jobs are not created in the U.S. Just since July of 2000 we have lost 675,000 manufacturing jobs in this country. In fact, the '90's boom is the only recovery in modern history during which we actually lost manufacturing jobs. This latest loss means that we now have fewer manufacturing workers in the United States than we did in 1965. U.S. workers who lose manufacturing jobs due to import competition take a pay cut of over 9 percent on average – when they are lucky enough to find a new job.\(^{57}\)

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While the overall American economy experienced great growth and prosperity in the 1990s, not all workers or sectors of our economy benefited equally. The Commerce Department has argued that each $1 billion in exports creates 11,000 to 20,000 jobs. The Economic Policy Institute has stated that each $1 billion in imports may also cost 11,000 to 20,000 jobs. Hundreds of major U.S. brand name companies now manufacture in China and are no longer part of American communities producing jobs for American workers. The Commission heard from William Wolman, Chief Economist of Business Week: "Because U.S. imports have been growing faster than U.S. exports, it is likely that the international position of American workers is not improving but deteriorating. That is a major reason why there is no end in sight to wage stagnation in the United States and in other industrial countries." The Commission has heard that this trend of wage stagnation is not exclusive to blue-collar jobs but seems set to move into white-collar jobs as well. While the Commission notes the low level of unemployment the U.S. has enjoyed, we are troubled that many Americans have not only been left out of wage increases but have in fact suffered wage decreases.

Implications of Competition with Chinese Workers - Many of the labor representatives that testified before the Commission detailed the implications of American workers competing with Chinese workers in a "race to the bottom". Pointing at the unfair competition implicit in Americans competing against Chinese workers who have been denied fundamental human rights such as the right to organize and collectively bargain, labor representatives such as Leo W. Gerard, International President of the United Steelworkers of America (USWA), have explained:

The right to strike, which is a fundamental right... was removed in China in 1982. There is no vehicle for workers to improve their standard of living. There is no vehicle for workers to dissent. There is no vehicle for workers to have an open opportunity to share in the wealth that they may create. So I don't know how we can expect ourselves to compete, and I don't know that we should expect ourselves to compete with that kind of a system...

Everything that is going on in China in its industries is diametrically opposed to the values that this country holds so dear.

Lack of Adequate Data – Due to the inadequate statistics currently available, an accurate understanding of the wage and employment effects of the U.S. trade and investment relationship with China is difficult. In particular, while there are numerous statistics detailing how globalization is holding down inflation and increasing the profitability of U.S. corporations, there is a dearth of information regarding precisely how globalization is effecting American workers in the manufacturing and low-wage service sectors.

In part, the statistical inadequacies result from political bias. For example, during the Congressional debate on Permanent Normal Trade Relations with China, the Clinton Administration chose to release data on export sales state-by-state. In part, they extrapolated what the job gains would be for each state based on the rough estimate by the Commerce Department that each $1 billion in exports creates 11,000-20,000 jobs. At the same time, the Administration did not release import statistics on a state-by-state basis that would provide a clearer picture of the impact of the increased trade on job losses. Another example is the decision by the Department of Labor to stop releasing trade adjustment data sorted by zip code?

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for fear that opponents of Administration policy initiatives would use the data to highlight the “cost” of Administration trade policies.

In an effort to overcome these statistical inadequacies, the U.S. Trade Deficit Review Commission contracted with Professor Kate Bronfenbrenner at Cornell University’s School of Industrial and Labor Relations to complete a study that provided empirical findings through the use of a media-tracking system. The study tracked all media-reported production shifts out of the U.S. to China, Mexico, and other Asian and Latin American countries and out of Asian and Latin American countries into China that occurred between October 1, 2000 and April 30, 2001. The information was combined with macroeconomic data on imports, exports and investment. The study is the first and only national database on production shifts out of the U.S. 61

Professor Bronfenbrenner detailed the study’s key findings in her testimony before the Commission:

_As increasing numbers of workers are displaced from manufacturing and export-related jobs into the service sector and import-related jobs; for many of them it has been a dramatic shift from permanent, unionized, full-time employment with good wages, health benefits, pension benefits, and regular hours to less secure, non-union jobs in the service sector and import-related industries, with lower wages, limited benefits, irregular part-time jobs, and less chance of union representation...In addition, increased publicity about global capital mobility has contributed to the effectiveness of employer threats of full or partial plant closure when bargaining with individual workers and unions over work rules, wages or benefits, or when campaigning against union-organizing initiatives._ 62

Other significant highlights of the research were:

- _An increasing percentage of the jobs leaving the U.S. are in higher-paying industries ... It is these higher-end jobs that are most likely to be unionized and therefore more likely to have a much larger wage and benefit package. Many of those who lost their jobs were high seniority, top-of-the-pay scale employees, who have a great deal invested in their jobs and in their communities..._
- _There is a direct linkage between increases in trade deficits and foreign direct investment in certain industries and production and employment shifts out of the U.S. and into China in those industries._ 63

The Commission believes that the U.S. Government needs to establish a federally mandated corporate reporting system that requires companies to report the presence and shift of production both from within the United States to overseas and from one overseas location to another. A thorough understanding of the impact trade and investment policies have on employment, workers, wages and communities, requires more information on such matters to allow policymakers to make informed decisions.

**U.S. Supported Funding of Overcapacity** - The Commission is also concerned about the impact on American workers of the U.S. Export-Import Bank and international financial

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61 The study can be found at [www.ustdrc.gov](http://www.ustdrc.gov).
institutions’ (IFI) assistance to China. China accounts for approximately $6 billion of Ex-Im Bank’s exposure, the largest of any country. China also has the largest portfolio in the World Bank, standing at $34.8 billion in commitments.

The most notable case of U.S.-support for funding global overcapacity has been Ex-Im Bank’s guaranteeing of an $18 million medium-term loan to support the $21.7 million export of equipment and services by General Electric and other U.S. suppliers to the Benxi Iron & Steel Co. in Benxi, Liaoning, China. The Commission heard from representatives of the steel industry about the effect of Ex-Im Bank’s guarantee to Benxi as well as their concerns about the implications for further action. As Leo W. Gerard, International President of the United Steelworkers of America testified:

*It is irrational to have in excess of 20 steel companies in America either in bankruptcy, struggling to get out of bankruptcy with a half-a-dozen others on their way to bankruptcy, to have American taxpayer dollars through various funding agencies, whether it is the Export-Import Bank or others, funding that global overcapacity and to fund it in a non-market economy.*

The issue becomes more complex when one considers that the guarantee to Benxi Iron & Steel directly supported 300 union jobs at GE’s 1,600-employee Salem, VA plant, and represented 10 percent of the plant’s production. Regardless, Ex-Im Bank agreed to reassess its economic impact procedures. In addition, the recently passed Export-Import Bank reauthorization bill prohibits the Bank from providing financing that would be used by foreign entities to produce a product that is the subject of an antidumping or countervailing duty order. Entities that are the subject of a preliminary determination will be required to undergo an economic impact assessment before receiving Ex-Im financing.

While the effectiveness of the new procedures remains to be seen, there appears to have been little spillover on this topic to the examining of U.S.-supported international financial institutions (IFIs). The International Finance Corporation (IFC), for example, the arm of the World Bank Group that invests in the private sector, has invested in two different steel projects that are joint-ventures between Chinese and European companies: Scana Leshan Metallurgical Joint-venture Co., Ltd. and Shanghai Krupp Stainless Co., Ltd. Each project contributes to increasing global overcapacity in steel products. While these two projects may result in developing portions of China’s economy, there has been no economic impact assessment on the U.S. steel industry. China is currently the IFC’s ninth-largest country portfolio and is one of its fastest growing client countries. Without proper oversight in the form of an economic impact assessment on the U.S., U.S. taxpayers may have invested in an IFI that is harming the U.S. economy and U.S. workers.

Witnesses have expressed concern to the Commission that with over 105 million Chinese living on less than $1.00 a day and with little or no access to clean water, productive farmland, sufficient education, or adequate health services, U.S. taxpayer funding that was targeted towards poverty reduction is being diverted to increasing the international competitiveness of

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64Gerard, Oral Testimony, 22.
China's steel industry. Witnesses have found this particularly troubling in light of China's massive currency reserves that would be more appropriately used for improving their own steel industry. U.S. participation in International Financial Institutions should reflect U.S. policy; in particular, U.S. delegates to the IFIs should not counter actions taken by the U.S. Government to stem the global oversupply of steel. Other important policy objectives must also be reflected in U.S. efforts at the IFIs.

National Security Implications

The U.S.-PRC trade and investment relationship over the past decade has had serious implications for U.S. national security. U.S. policies have played an important role in helping the Chinese leadership achieve stunning economic growth and the modernization of their military industrial complex.

The large and growing U.S. trade deficits with China pose economic and security concerns for the U.S. Many observers, including Federal Reserve Board Chairman Alan Greenspan and former Treasury Secretary Robert Rubin have stated that the U.S. trade deficit is unsustainable. In 2001, the contribution of the U.S.-China trade deficit to the overall U.S. trade deficit constituted about one-fifth of the $393 billion total. As U.S. imports far outpace exports, the U.S. must finance this imbalance.

The U.S.-PRC trade relationship plays an important role in China's ability to maintain global trade surpluses and accumulate large foreign reserves. If China's $83 billion surplus with the United States were removed, China would have had a 2001 trade deficit of $60 billion with the rest of the world. Large trade surpluses and large net financial inflows have allowed China to build up foreign reserves that stood at $212.2 billion at the end of 2001 - a one-year increase of $46.6 billion. These reserves are in addition to China's 500 tons of gold reserves. China's foreign reserves are now second only to Japan's, assuring increasingly significant financial and strategic options. They are particularly important to China's military modernization, as Beijing continues to rely on hard currency to purchase advanced weapon systems abroad. The Commission is concerned with the military implications of China's foreign reserves and discusses them in more detail in Chapter 9.

The Chinese leadership guided their trade and investment strategies with the objective of leapfrogging in developing their science and technology base. U.S. firms, to obtain a foothold in the Chinese consumer market, played a significant role in this development. With U.S. help, China has developed into a major global manufacturing center and a rising global R&D center, raising serious questions as to U.S. dependency on China for key items of our defense industrial base.

Over the past decade U.S. trade and investment policy with China has too often favored short-term commercial and corporate interests over broader national economic and military security concerns. As we move forward in the relationship, the United States needs to strike a more appropriate balance. The U.S. government should provide more oversight of U.S. firms' R&D investment and commercial technology transfers. As well, more oversight and tracking is needed.

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67 Ibid.
to evaluate the hollowing-out of the U.S. industrial base and to determine whether import dependencies may be developing that can undermine our defense industrial base and thereby threaten national security.

The Commission will continue to monitor and report regularly on the composition of trade and investment, shifting patterns and trends and dependencies, commercial technology transfers and R&D collaboration, and the challenges to U.S. exporters and workers.

**Recommendations**

- The Commission recommends the Congress request the U.S. Government review the statistical discrepancy between the National Institute of Science and Technology (NIST) and the Census Bureau trade figures that are based on different methodologies and definitions, in order to remove the complications and discrepancies that have plagued analysis of U.S. China trade and investment analysis.

- The Commission recommends the Congress request the Commerce and Defense Departments to increase the level of detail of the Harmonized Standard (HS) code and Military Critical Technologies List (MCTL) so they may be cross-referenced to track any developing U.S. dependency on China. To further enhance the U.S. Government’s ability to track dependencies, Congress should also direct the Department of Defense to require its contractors and subcontractors to identify components and sourcing using the HS codes.

- The Commission recommends the Congress support efforts of various government agencies to increase contracts and exports of U.S. goods to China but should monitor and evaluate these efforts to ensure that they are enhancing U.S. job creation and are not increasing capacity in industries that already have excess world capacity.

- The Commission recommends the Congress establish and fund a federally mandated corporate reporting system to gather sufficient data to provide a comprehensive understanding of the trade and investment relationship with China. Within such a system, companies should be required to report their initial investments in China; any technology transfer, offset, or R&D cooperation agreed to as part of the investment; the shift of production capacity and job relocations resulting from the investment, both from within the United States to overseas and from one overseas location to another; and contracting relationships with Chinese firms. In addition, Congress should require the Commerce Department to maintain an authoritative account of U.S. firms’ investment in R&D centers in China and a comprehensive assessment of their activities.

- The Commission recommends the Congress request the Treasury Department to conduct employment impact studies of International Financial Institutions’ (IFI) projects. U.S. representatives to the IFIs should be instructed to use their voice and vote to support programs that promote U.S. interests and do not negatively effect U.S. employment or fund industries, such as steel, with global over-capacity.

- The Commission recommends the Congress should closely monitor the implementation of the “Enhanced Border Security and Visa Reform Act of 2002”. The U.S. government has a poor record of implementing any effective mechanism to track and assess the activities of the very large number of Chinese students, scholars, and researchers present in the U.S. academic and industrial establishment. Careful implementation of the new legislation is required, if the U.S. is to address this serious matter.
Chapter 3 - China and the World Trade Organization

Key Findings

- The U.S. Government supported China’s entry into the World Trade Organization (WTO) as part of its overall national security strategy for relations with China. U.S. support was premised on both commercial and political goals. While enhanced market access for U.S. goods and services was a central goal, equally important were the development of economic, civil, and political reform within China, and the promotion of regional stability in Asia.

- China’s leaders pursued WTO membership as a means to continue China’s rapid economic growth through increased exports and to attract foreign investment, capital, and technology. They believe that continued economic reform and growth is essential for China to become a preeminent world power.

- China’s WTO accession carries high stakes and risks for both the United States and China. Both countries seek China’s continued economic reform. The United States hopes such reform will foster a democratic and more open society. The risk to the United States is that China will become economically stronger, but not more democratic. China’s leaders hope that WTO membership will bolster China’s economic growth, but they will likely work to minimize any accompanying political liberalization. The risk to the Chinese one-party regime is that economic liberalization may lead to political liberalization.

- China’s WTO accession may exacerbate economic and social strains and lead to further social unrest, political instability, and an economic downturn, with an uncertain outcome for U.S.-China relations. The future direction of the Chinese economy—whether it is marked by continued growth, stagnation, or collapse—has important implications for U.S. national security and therefore the U.S. Government should be prepared for each of these scenarios.

- China’s WTO accession agreement is unprecedented in its complexity and scope. China’s broad commitments to eliminate its discriminatory and trade-distorting practices have the potential to significantly enhance market access for U.S. goods and services. However, WTO implementation will be a tremendous challenge to China. Localism and provincialism heavily influence the Chinese economy and decision-making process, and the willingness of provincial and municipal governments to comply with WTO commitments is uncertain.

- China’s WTO membership is in the national security interest of the United States if it promotes economic reform in China that is accompanied by the development of political and personal freedoms and broadly shared prosperity.

Introduction

Both Republican and Democratic Administrations strongly supported China’s accession to the WTO, arguing that integrating China into the world trading system would economically enrich both countries and, over the long-term, would stimulate development of the “rule of law” and democracy in China and temper regional hostilities in Asia. The writings and public statements of officials in China suggest that the Chinese leadership had significantly different long-term objectives for joining the WTO. China’s leaders sought WTO accession as a means to foster
continued economic growth, with the goal of both enhancing China's economic wealth and, by so doing, maintaining the Chinese Communist Party's legitimacy and monopoly on power.

The long-term consequences of China's accession to the WTO will not be known for several decades, but clearly the United States has much at stake in the outcome. Accordingly, it is essential that U.S. policymakers carefully assess post-accession developments in China as they unfold, and adequately prepare for the full range of potential scenarios. The U.S. Government must make it a priority to provide bilateral or multilateral support to encourage WTO compliance and broader economic and political liberalization in China, while at the same time preparing for situations where China's actions may be inimical to U.S. interests.

The U.S. and Chinese Leadership's Goals for China's WTO Accession

U.S. Goals

The final stages of China's accession to the WTO were negotiated under the Clinton and present Bush Administrations, both of which strongly supported bringing China into the world trading system. During the run-up to Congress' consideration of legislation in 2000 to grant China Permanent Normal Trade Relations (PNTR), a necessary precursor of U.S. support for China's WTO accession, President Clinton highlighted both PNTR's trade benefits and its importance to U.S. national security. He noted, "even though for me the economic choice is clear . . . far, far more important to me are the moral and national security arguments." President Clinton explained his arguments as follows (bullets added):

- [B]y forcing China to slash subsidies and tariffs that protect inefficient industries, which the Communist Party has long used to exercise day-to-day control, by letting our high-tech companies in to bring the Internet and the information revolution to China, we will be unleashing forces that no totalitarian operation rooted in the last century's industrial society can control.
- [T]he more China operates within rules-based systems, with us and with other countries, the more likely they are to see the benefit of the rule of law, and the more likely that benefit is to flow down to ordinary people.

President Clinton's National Security Advisor, Samuel Berger, reinforced the national security argument for supporting China's WTO accession:

"[T]his debate should not be defined as economic rights versus human rights — or economic security versus national security. That is a trap, a false choice. This agreement is just as vital "if not more vital" to our national security as it is to our economic security. It is far more likely to move China in the right direction — not the wrong direction — on all of our other concerns. We can't duck these issues by saying we're only interested in talking about economics. If we are going to win this debate, we must be persuasive that it promotes both growth and jobs in America and progress toward change in China."

2 Ibid.
The policy has been consistent under the current Bush Administration. Following the WTO’s decision to admit China at its meeting last November, President Bush echoed his predecessor in lauding the non-economic benefits of China’s accession:

*I am confident that China’s entry into the WTO will bring other benefits to China beyond the expected economic benefits. WTO membership, for example, will require China to strengthen the rule of law and introduce certain civil reforms, such as the publication of rules. In the long run, an open, rules-based Chinese economy will be an important underpinning for Chinese democratic reform.*

As these public statements demonstrate, the U.S. Government’s support for China’s accession to the WTO was premised not only on achieving immediate commercial benefits for the United States but also on achieving long-term economic and political change in China. As articulated in these statements, not only would China’s WTO accession reap economic benefits for U.S. exporters in terms of market access, but also, equally important, it would lead to fundamental civil and political reforms inside China.

The key U.S. goals for supporting China’s accession can be summarized as follows:

**Market Access** - The most concrete economic goal U.S. policymakers touted in support of China’s accession to the WTO is the market access benefits that would accrue to U.S. firms. Despite the enormous and growing volume of Chinese goods flowing into the U.S. market, U.S. exports have largely been restricted from China’s market through a variety of tariff and non-tariff measures. Pursuant to its terms of accession, China has agreed to significantly lower tariffs and other barriers to trade, raising the prospects of greatly enhanced U.S. exports to this market.

**Economic Reform** - China has made remarkable progress in modernizing its economy in the past two decades; but still has a long road ahead to develop a mature market economy. China’s accession to the WTO is viewed by many U.S. policymakers as providing the best opportunity for China to move forward in reforming its economy, by forcing it to open up to foreign competition and investment and by subjecting it to the strictures of the WTO. Supporters of China’s accession feared that China’s economic development would stall in the absence of these outside influences.

**Political and Civil Reform** - A belief that political liberalization and development of the “rule of law” will follow China’s economic liberalization as a result of joining the WTO underpinned U.S. support for China’s membership. The hope is that WTO membership will force China to open up its economy to foreign business and develop new legal institutions and regimes to enforce its WTO commitments, and that these developments will foster broader political and civil reforms.

**Regional Stability** - With both China and Taiwan joining the WTO, there is optimism that this development will improve cross-strait relations by increasing economic linkages between the two and providing a forum for dialogue between Chinese and Taiwan officials. There is also the hope

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that it will promote peaceful relations between China and its Asian neighbors as these nations become more economically integrated and thereby vested in avoiding hostilities.

China’s WTO accession was not uniformly supported within the U.S. Government. Nonetheless, the statements of President Clinton, President Bush and other Administration officials represent the prevailing rationales and goals that were provided at the highest levels of the U.S. Government for supporting China’s WTO accession.

These goals – political and civil reform, market access, economic reform, and regional stability – are key issues discussed in more detailed in other sections of this Report. These goals will serve as important benchmarks that the Commission will use to assess progress in the U.S.-China relationship.

**Chinese Leadership’s Goals**

The Chinese leadership made economic reform and WTO accession a top national priority and persisted in its negotiations to join the trade organization for more than 15 years. Underpinning the Chinese leaders’ effort has been a belief that greater economic integration and the reforms it would necessitate are essential to China’s continued growth and prosperity. Despite apprehensions of U.S. motives and of opening the doors to foreign competition, China’s leaders appear to have supported accession to the WTO because of their belief that China’s ability to assume the status of a preeminent world power depends on further integration into the global economic system.

Long Yongtu, China’s chief trade negotiator for its WTO agreement, cited the following advantages of WTO membership in a presentation to CCP officials in January 1999:

- Facilitate creating a better image of China abroad – especially diminishing the perception that China will become a threat to the West.
- Enable China to participate in formulating new trade rules.
- Instill in Chinese citizens a culture of obedience to law and social responsibility akin to those virtues embraced by the West.
- Take advantage of WTO rules of arbitration and multilateral negotiations to counter the influence of the United States.
- Demonstrate to foreign countries that China is practicing a market economy and should not be treated in a discriminative manner.
- Gain permanent most-favored-nation status from the United States.  

On December 11, 2001, the day China formally entered the WTO, The People’s Daily, the Party’s official news outlet, discussed China’s goals as a WTO member (bullets added):

- We should take WTO entry as a new starting point to strive to raise our level of opening to the outside world.
- We should make full use of the favorable conditions offered by entry into the WTO, implement diversified strategies and try by every possible means to enlarge exports. While guaranteeing maintenance of our traditional export markets, we should actively explore new export markets and vigorously advance the diversity of markets.

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For example, see Regular Media Availability with House Minority Leader Richard Gephardt, 18 May 2000.

*PRC Media Reiterate Standard Line on WTO Entry, Hint at Internal Beijing Tensions on Market Opening,* 11 January 1999, translated in FBIS.
We should continue to deepen reform of the foreign trade system, make major efforts to foster new growth points of export and promote the diversification of the mainstays of foreign trade management.

We should continue to stimulate "going out", encourage qualified domestic enterprises to go abroad to engage in the businesses of investment and development and undertake contracted projects as well as labor cooperation, so as to boost the exports of domestic equipment, materials and labor through investing in foreign countries, thereby diversifying the methods of export.

We should strengthen energy resource cooperation with foreign countries and gradually realize the diversification of channels for the import of important strategic materials.

We should strengthen and perfect the import management system in accordance with the WTO rules.

In addition, we should seize the opportunity of joining the WTO to raise the level of the use of foreign capital.

We should closely integrate the absorption of foreign capital with the upgrading of domestic industries, the coordinate development of regional economies, the reorganization and transformation of State-owned enterprises and the expansion of exports.

We should further improve the investment environment, particularly the soft environment, maintain the stability and continuity of the policies on attracting foreign investment, strengthen the protection of intellectual property rights and enhance China's attraction to foreign investment.

We should actively spur foreign capital to flow into high and new technological industries, and encourage transnational corporations to come to China to set up R&D centers and regional headquarters.

We should gradually expand market access for finance, insurance, commerce and trade, tourism, intermediary and other service trades, at the same time, we should study new situations emerged after opening these sectors and solve new problems, so that these sectors can develop in a healthy and orderly way.

As a new WTO member, China will, together with other WTO members, play an active and constructive role in promoting the world economic, and trading development and establishing and perfecting a multilateral trading system.7

In sum, the Chinese leadership views WTO membership as a means to continue economic growth and enhance China's wealth and international standing through the following:

Economic Reform - Despite a growing private sector, China's economy is still dominated by state-owned enterprises (SOEs), many of which have been financially unviable for years. China's leaders embraced WTO accession as a means for imposing outside pressure on the SOEs, through increased foreign competition, to undertake necessary reforms.

Attraction of Foreign Investment, Capital, and Technology - Chinese leaders see WTO membership as a means for attracting the foreign investment, capital and advanced technology necessary for continued economic progress. China's economic growth over the past two decades has been fueled by foreign direct investment (FDI) and such investment will be critical to its future growth as well. The Chinese leadership in particular is seeking FDI in the high-tech sector, since investment in that sector often is accompanied by transfers of technology and know-how. WTO accession is expected to result in a large influx of FDI into China, with some investment banks predicting that FDI could rise from current annual levels of $40-45 billion to $100 billion in the near term. Although China has an exceptionally high rate of savings, and a

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domestic stock market that has grown dramatically in terms of capitalization over the past decade, it likely will need to tap foreign capital in order to meet its growing capital needs.

**Expanding/Maintaining Export Markets** - Chinese officials view WTO membership as a means to expand, or at least maintain, their vital export markets. While China's trading partners have focused on China's market opening concessions, China too is looking at its trading partners to lower barriers, or to not raise new barriers, to its products. Given the burgeoning size of China's trade surplus with the United States, it is likely that Chinese officials sought WTO membership as a means to prevent the U.S. Government from reacting to the growing trade deficit with new bilateral restrictions on its products, preferring instead to have disputes handled in the more neutral WTO dispute resolution process. As Long Yongtu's statement indicates, China views its entry into WTO as an opportunity to counter U.S. unilateral trade actions against China, by subjecting U.S.-China trade to the multilateral rules and processes of the WTO.

**Influencing the “Rules of the Road”** - WTO membership confers on China the opportunity to help develop and shape the rules governing the international trading system. With China now the world's seventh largest trading nation, it has a significant stake in the outcome of these rules, and now will be able to play an active role in their development.

**Prestige/Legitimacy** - Becoming a member of the WTO is another key component in China's efforts to gain international prestige and legitimacy. China's absence from the most important multilateral organization governing international trade was likely viewed as a loss of face for one of the world's most important trading nations. Just as awarding the Olympics to Beijing for 2008 has elevated its international standing, so too does its WTO membership.

**China’s Economy as it Enters the WTO**

The future direction of the Chinese economy following its entry into the WTO — whether it is marked by continued growth, stagnation or collapse — will have a direct impact on U.S. national security. Consequently, understanding and analyzing the Chinese economy has been, and will continue to be, an important component of the Commission's efforts.

Despite the impressive performance of the Chinese economy over the past two decades, serious structural and fiscal challenges remain. Beijing must overcome these challenges to continue its rapid economic progress. As noted above, China's entry into the WTO was motivated in part by a belief that outside pressures are needed to achieve economic reform and continued economic growth.

The Commission received testimony and briefings from economists and other experts on the Chinese economy about China's economic prospects over the medium or long-term. There were strong differences of opinion among these observers.

Experts who foresee China's continued economic ascendency emphasize the many successful reforms that have been implemented to date, such as:

- The gradual end to central planning in nearly all sectors of the Chinese economy,
- The agricultural production reforms that stimulated peasants to participate in local market economics (the "rural household contract responsibility system"),
- The gradual freeing of some sectors of workers from a strict labor regime that limited their mobility and opportunity,
• The creation of an investment friendly and export-oriented economy, that has resulted in large inflows of foreign investment and technology and spurred China’s entrance into the global capital markets,
• And the reduction in import tariffs and other trade barriers.

These observers tend to believe that China’s WTO membership will positively influence its economy. They argue that the strictures of the WTO will force China to undertake continued market-oriented reforms and to further open up its economy to trade and investment. Dr. William Overholt, Senior Fellow at the Harvard University Asia Center, told the Commission that China has been more aggressive than its Asian neighbors in opening up its economy and tackling some of its most significant structural problems:

China, although it has not been commented on much in the press, has gone far beyond most of its capitalist neighbors in opening its economy. Its trade to GDP ratio is now three times that of Japan. It is more welcoming of foreign investment than anybody else in the Third World – I’m talking in terms of institutional structures and rules -- than anybody except Hong Kong, Taiwan, and Singapore. 8

Others in this camp predict that China will continue its rapid economic expansion following WTO accession and may in the foreseeable future become the world’s second largest trading economy. Nicholas Lardy of the Brookings Institution testified:

Within five years or so, they [China] could easily surpass countries like Canada, France, and the UK and become the fourth-largest trading country within the world; within a decade, they might surpass Germany and Japan and be the second-largest trading economy in the world. It is within the realm of possibility given the very large role that foreign firms in China are already playing in generating exports and the additional liberalization that is coming with their WTO obligations. 9

Those who believe that China’s impressive growth over the past two decades rests on an unstable foundation and that the economy is heading for stagnation or collapse emphasize problems such as:

• The continued misallocation of capital by government planners, through state-owned banks or otherwise, to inefficient SOEs instead of to private, market-driven enterprises,
• The reliance on government fiscal spending to maintain high growth levels,
• The government’s rapidly expanding fiscal burdens, including a state-owned banking sector plagued with bad debt levels significantly higher than reported and “hidden obligations” in the form of underfunded pensions and other social security costs,
• The lack of a social safety net to support the high levels of unemployed and “furloughed” workers that have resulted from the termination of unviable SOEs and other economic reforms, and the rise in large-scale worker protests in response,
• Poor worker and environmental standards,
• Corruption and arbitrary regulation by government officials,
• And the replacement of tariffs with equally restrictive non-tariff barriers.

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This group believes WTO membership will exacerbate many of China's underlying economic and social problems as domestic firms are subject to increased foreign competition and the norms of the international trading regime.

The Commission heard dramatic testimony on the precarious state of the Chinese economy from Gordon Chang, an American attorney who practiced law in China for more than twenty years and wrote *The Coming Collapse of China*:

*In the WTO era, the state-owned enterprises, which are the pride of Chinese socialism, will just not be prepared for the enhanced competition that accession will bring. Beijing has essentially deferred structural reform of the SOEs. There has been some window dressing. The SOEs look more profitable, but they are not more competitive. Some analysts say that in the years following accession, only a few of the approximately 1,100 Chinese companies that are listed on Chinese stock exchanges will survive. I don't know if the shake-out will be that horrendous, but certainly, there will be a change. With state-owned banks, the story is similar. They have gone through two major recapitalizations, one in 1998 and the other in 1999 and 2000. Yet even after the recapitalizations, they still are insolvent and they're not prepared for accession.*

**China's Real Economic Growth**

One overarching problem facing all observers of the Chinese economy, and a problem that constrains the ability of U.S. policymakers to accurately assess the situation, is the general unreliability of official Chinese economic statistics. Perhaps the most significant example is China's pronouncements of its official economic growth rates. While official statistics indicate annual GDP growth averaging over 9 percent since 1978, there is a general consensus among economists that have studied China that the actual rates are likely several percentage points less than the announced rates, with some economists concluding that China may in fact have experienced negative growth in recent years.

In particular, the Commission notes the work of Professor Thomas Rawski, an expert on the Chinese economy from the University of Pittsburgh, who briefed the Commission on his assessment of China's real growth rate for the period 1997-2001. Professor Rawski argues that China's actual growth rate during this period is likely in the range of 2 to 4 percent annually at best (with corresponding low-end estimates ranging from −2 to 3 percent) given the country's negative growth in energy consumption, modest employment growth, and falling consumer prices.

A similar sentiment was expressed by the brokerage house Credit Lyonnais in a January 2002 report that concluded that "the data that show China as the fastest growing economy in the world are not worth the paper they are written on" and therefore Credit Lyonnais "lack[s] the basic statistical information to be able to construct even a rudimentary model" to forecast China's future GDP growth.

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These assessments demonstrate the difficulty in gaining a clear picture of the current state of the Chinese economy. If the more pessimistic estimates of China's recent growth rates are correct, this analysis would indicate an economy growing modestly if at all.

Economic Challenges

Reform of State Sector

Among the key constraints on China's continued economic growth are the significant structural impediments present in its economic system, most notably the weakness of its SOEs and state-owned banking system.

The problems of the SOEs and state-owned banks are interrelated, and arise from the continued intervention by the state in investment decisions and allocation of capital. Widespread bankruptcy of the state sector has in part been avoided thus far because the state has propped up many SOEs with so-called "policy loans" from the state-owned banking system, which holds the assets of millions of Chinese who have no other investment alternatives. Instead of confronting the problem of unviable state enterprises, Beijing's policies created insolvent state-owned banks saddled with the bad loans they made to the SOEs. China's leaders have shown little resolve or ability to curtail policies of state-directed lending to SOEs, or to free the domestic capital markets and financial service industry from state dominance.

Financial Challenges

The Chinese Government has pumped billions of dollars into the economy in the past few years, in infrastructure and other projects, to stimulate economic growth. This "pump-priming" spending has contributed to record budget deficit levels, which according to official accounts have risen from $11.1 billion in 1998 to an estimated $37.4 billion in 2002. Both economists and Chinese officials have underscored the importance of this fiscal spending to China's economy.

Finance Minister Xiang Huaicheng recently estimated that fiscal spending contributed 1.5 to 2 percent to GDP growth in the past four years. This represents approximately one-quarter of the official growth rate during that period, and is equivalent or exceeds some economists' estimates of the real GDP growth for those years, as discussed above. In a dramatic assessment of the key role of fiscal spending to the Chinese economy, Premier Zhu Rongji admitted, "if we hadn't adopted a proactive fiscal policy and a prudent monetary policy, the country would have collapsed."

In addition to stimulating the economy, Beijing faces other formidable financial challenges in the next decade. The SOEs must be restructured so that financially unviable enterprises are shut down and profitable enterprises given the ability to develop. This task has become more urgent given the increased competition China's SOEs will face in the post-WTO accession period. Another major challenge is the need to recapitalize the state-owned banking system.

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estimates put the percentage of nonperforming loans in this sector above 50 percent, well above the officially reported level of 27 percent. China must also address the fiscal costs of its substantially underfunded pension and other social security obligations and invest heavily in infrastructure improvements and energy resources in the coming decade, including its buildup for the Olympics in 2008. Lastly, as discussed in Chapter 9, China's ongoing military modernization program is drawing a growing share of the government's budget resources.

Cost estimates for such capital needs vary. In testimony before the Commission, Stephen Harner, a financial services consultant based in Shanghai, suggested China will invest some $2.5 trillion ($487 billion a year) in fixed assets and major infrastructure projects during its next Five Year Plan period (2001-2005), an amount in line with investment of $1.7 trillion in such assets during its past Five Year Plan period. Harner estimated that China will need $466 billion, equivalent to 43 percent of GDP in 2000, to recapitalize its banking sector. A report on China's capital needs prepared for the Commission estimates the cost of bank recapitalization to be $510 billion and the cost to finance pension and other social security obligations to be nearly $1 trillion. In an attempt to quantify China's total capital needs over the next five years, and China's ability to meet them through revenue generation, the report concludes that China's budget deficit will soar to over $150 billion by 2005.

Projecting the scope of China's financial needs over the next decade involves some guesswork at this point in time. Nonetheless, there appears to be a general consensus that these needs are enormous and that China faces a monumental challenge in meeting them. How China addresses these fiscal challenges and its ability to tap domestic and international capital to assist in this effort will be critical to its long-term economic success.

Corruption

China's endemic corruption poses a formidable obstacle to its future economic growth. Although Beijing has undertaken public anti-corruption campaigns and periodic high-profile trials (and even executions) of corrupt Party officials, large-scale corruption in both the central and regional government and in the commercial sector in general continues unabated. Analysts who represent commercial interests in China regularly identify corruption as one of the contributing factors to the possible social backlash against economic reforms. A detailed discussion of the scope and nature of corruption in China is presented in Chapter 4.

Instability/Social Unrest

The Commission heard repeated testimony on the social strains that would likely result from China's WTO accession, most notably mass unemployment and an accompanying widening income gap between rich and poor. Many observers predict that unemployment in the rural regions of the country, already at high levels, could escalate markedly as the agriculture sector would be particularly hard-hit by foreign competition. In addition, if WTO accession forces the

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16 Clay Chandler, "Trying to Make Good On Bad-Debt Reform," *Washington Post*, 15 January 2002, E1. This article references an Ernst & Young study that put the amount of unprofitable loans at $460 billion, or 44 percent of total bank lending.

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restructuring or closure of inefficient SOEs, these enterprises will be laying off significant numbers of workers. The Development Research Center of the State Council, a Chinese governmental research institute, estimates high employment losses due to WTO accession in the agricultural and automotive sectors: in rice, wheat and cotton production, it forecasts an aggregate loss of nearly 13 million jobs; in “road vehicle” production, it forecasts a loss of nearly 500,000.\(^\text{21}\) Given the official nature of these estimates, they may underestimate the potential employment impacts.

The expected increase in unemployment following WTO accession will be countered to some extent by new employment opportunities in certain export-oriented industries, including new foreign-invested enterprises. The Development Research Center forecasts significant employment increases in textiles, apparel and other sectors to offset the losses in agriculture and the automotive industry.\(^\text{22}\) Even if this assessment proves accurate, China’s WTO accession likely will result in large-scale unemployment in certain sectors, particularly in rural areas.

The potential for social instability and unrest and the concerns this raises for U.S. national security, was recognized by Director of Central Intelligence George Tenet in his most recent annual threat briefing before the Senate Select Committee on Intelligence:

*China’s entry into the WTO underscores the trepidation the succession contenders will have about maintaining internal stability. WTO membership is a major challenge to Chinese stability because the economic requirements of accession will upset already disaffected sectors of the population and increase unemployment. If China’s leaders stumble in WTO implementation – and even if they succeed – they will face rising socioeconomic tensions at a time when the stakes in the succession contest are pushing them toward a cautious approach to problems. In the case of social unrest, that response is more likely to be harsh than accommodative toward the population at large.*\(^\text{23}\)

If high levels of unemployment materialize in the wake of WTO accession, the possibility exists for a marked escalation of mass protests against government institutions by unemployed workers, which are already occurring on a frequent basis. In some instances, local governments that have a vested interest in the economic status quo may join in the protests. The leadership’s response will be a marker for accessing China’s progress toward the rule of law and political reform. If the response is characterized by enhanced repression, as Director Tenet predicts, this will signal backward movement on these important U.S. goals for China’s WTO accession. Similarly, if the leadership responds by protecting its SOEs against competitive market forces, thereby minimizing employment losses, economic reform (and the hoped-for U.S. commercial benefits) will be undermined as well. At the same time, unchecked social unrest could lead to a breakdown in the current political system and an accompanying period of instability, with uncertain implications for China, Asia and U.S.-China relations.


\(^{22}\) Ibid.


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Market Access and Compliance

China's WTO accession could yield substantial economic benefits for the U.S. economy. But for this to occur, China must comply with its WTO obligations, a massive undertaking that will require fundamental changes to its economic system. The Commission held hearings on the potential impact of China's WTO membership on certain key U.S. industry sectors and on China's prospects for compliance. Set forth below is an overview of these topics, as well as a discussion of the mechanisms and tools available to the U.S. Government to monitor and enforce China's implementation of its WTO obligations.

China's WTO Commitments

China's accession documents are unprecedented within the WTO or its predecessor, the General Agreement on Tariffs and Trade (GATT), in terms of their complexity, range of specific commitments, and number of deviations permitted at the time of accession. As Peter Davidson, General Counsel of USTR, explained to the Commission, the major market access concessions under the agreement are (bullets added):

- China will reduce average tariff levels on goods of interest to the United States from 24% to 7%;
- China will phase-out all tariffs on Information Technology Products by 2005;
- China will broadly open up its services sectors, such as insurance, banking, securities, telecommunications, express mail, legal, accounting and computer-related services; and
- China will permit U.S. companies to operate wholesale, retail, and franchised distribution networks.24

In addition, China has agreed to considerable non-tariff concessions, to join WTO agreements regarding areas such as law reform, import licensing, and subsidies for SOEs, and to assume the obligations of more than twenty existing multilateral WTO agreements, such as the GATT, General Agreement on Trade in Services (GATS), Technical Barriers to Trade (TBT), Trade-related Investment Measures (TRIMs), and Trade-related Aspects of Intellectual Property Rights (TRIPs). China has also committed to reforming its state trading enterprises and SOEs and the elimination of price controls.

Market Access

U.S. officials touted the market access benefits that would accrue to U.S. firms as a result of China's accession to the WTO, and this became an important factor motivating U.S. support for China's WTO membership. The Commission heard testimony during its first year from representatives of several key industry sectors of U.S.-China trade – aerospace, agriculture, automotive, electronics and information technology products, entertainment and communications, financial services, and steel. There certainly are other important sectors in U.S.-China trade, and the Commission intends to hear from them in future years.

The industry representatives that came before the Commission during the past year discussed both the potential market access benefits they foresee as well as the challenges they face in achieving these benefits.25


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- **Aerospace** – China’s WTO accession agreement requires it to reduce average tariff rates on civil aircraft products from 10.5 percent to 7.2 percent and to immediately eliminate all non-tariff measures, including quotas and licenses, for all items listed in the Agreement on Trade in Civil Aircraft (though China is not a signatory). Moreover, China has agreed not to condition import or investment approvals on technology transfer, research and development, or production offsets. In testimony before the Commission, John Douglas, President and Chief Executive Officer of the Aerospace Industries Association of America (AIA), estimated that China’s demand for commercial aircraft would be $144 billion over the next twenty years, making it the world’s second largest market for commercial aircraft after the U.S. market, and that China will purchase at least $3 billion in communications satellites and related equipment over the next ten years.\(^25\)

- **Agriculture** – China has committed to reduce tariffs on agricultural products from an average of 22 percent to 17.5 percent, with the average duty on certain U.S. priority agricultural products falling from an average of 31 percent to 14 percent. In addition, China has agreed to utilize only scientific-based sanitary and phytosanitary standards on agricultural goods and to otherwise eliminate non-tariff barriers in this sector. A representative of the U.S. Department of Agriculture (USDA) testified that “[w]hen fully implemented, USDA estimates that by 2005, China’s WTO commitments could add approximately $2 billion a year to U.S. agricultural exports due to tariff reductions.”\(^27\)

- **Automotive** – China has agreed to lower tariffs on imported automobiles from current levels of 80-100 percent to 25 percent by July 2006, and to eliminate quotas by 2005. Tariffs on auto parts will be reduced from an average of 23.4 percent to an average of 10 percent. In addition, foreign firms will be permitted to operate their own sales and service networks within three years of accession.

- **Electronics and Information Technology Products** – China has agreed to join the WTO’s Information Technology Agreement (ITA) upon accession, thereby committing to eliminate tariffs on all products covered by the ITA, including semiconductors, computers, peripherals, and telecom equipment. China’s WTO commitments also provide for greater foreign ownership and market access for foreign firms in telecommunications services and enhanced protection of intellectual property rights through adherence to the TRIPs Agreement. Dave McCurdy, President of the Electronic Industries Alliance, told the Commission that “China is the single most promising emerging market in the world today, and this fact is especially true for the U.S. electronics industry.”\(^28\)

- **Entertainment and Communications** – Under its WTO obligations, China has committed to allow at least 20 foreign films into the country annually on a revenue-sharing basis, reduce tariffs on films from 9 percent to 5 percent and on home videos from 15 percent to 10 percent, and permit greater levels of foreign ownership in video distribution ventures and cinemas.\(^29\) Bonnie Richardson of the Motion Picture Association of America noted to the Commission that

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"[]It is our good fortune in the film industry to have reached a level of mutual respect and communication with our Chinese partners that we can now speak with total candor about how to expand our cooperation to the benefit of both industries. The WTO framework with its clear predictability in legal and trade terms adds immeasurably to the success of this process."

- **Financial Services** - China's WTO negotiations resulted in key market opening commitments for foreign banking, insurance, and securities firms, including broadening the scope of permitted services, phasing-out of geographic restrictions, and establishment of transparent and prudential criteria for awarding licenses. A financial services industry representative testified that "[]The development of the financial service industry in China will offer many exciting opportunities for banks, insurance companies, securities firms and other players in the industry. China has the potential to emerge during the next fifty years as one of the largest markets in the world for a wide range of products."

- **Steel** - China's WTO agreement calls for a reduction in tariffs on steel and steel mill products from an average of 7.5 percent to 6 percent and the elimination of restrictions on the number of enterprises permitted to import or export steel products. Although skeptical about China's prospects for complying with these commitments, Thomas Usher, Chairman and CEO of USX Corporation, explained that "[]If China fully adheres to its WTO commitments upon accession, most of the principal restrictions which limit access to the Chinese market will be eliminated - most importantly, the quota/licensing system. The result: will be an increase in imports from nearby Asian countries as well as producers in the former Soviet Union. This will relieve pressure on the U.S. market and will subject inefficient Chinese producers to intensified competition."

The industry representatives acknowledged the considerable challenges they face in realizing the potential market access benefits discussed above. They identified the following cross-cutting areas of concern:

**Legal Reform** - One of the most crucial issues facing foreign companies in China is the country's lack of a functioning legal system. Transparency of laws, uniform application of the law, and impartial review are the three most glaring deficiencies. The WTO addresses these three areas, and the Commission will closely monitor them. The Commission is highly skeptical that China can comply with this obligation, particularly given the country's lack of a truly independent adjudicative body. We discuss this issue in Chapter 4.

**Trade-Related Investment Measures (TRIMs)** - Under the TRIMs agreement China will not be able to condition the award of contracts on requirements such as technology transfers or offsets. While the TRIMs agreement is clear in this regard, the Commission is concerned that it will prove ineffective in practice, as companies are pressured into technology transfer or offset contracts in order to remain competitive. We discuss this issue further in Chapter 2.

**Trade-Related Aspects of Intellectual Property Rights (TRIPs)** - In evaluating China's compliance with the TRIPs agreement, the Commission heard testimony from representatives of the Motion Picture Association of America, the International Intellectual Property Alliance, the International Anti-Counterfeiting Coalition and that of an independent film producer. The consensus was that China's record on IPR enforcement has improved, but that violations still

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continue on a wide scale. In part as result of U.S. pressure, the Chinese Government has shut down many production facilities for pirated audio-visual products, which has halted the problem of China being a major exporter of such products. But with the production base of pirated goods shifted to Southeast Asia, China's domestic market for U.S. audio-visual products remains closed. The Commission heard from independent film producer Larry Spiegel that despite these improvements "China, it appears, is condoning robbery on a grand scale...The loss in real dollars is staggering." The International Intellectual Property Alliance estimates that U.S. firms lost $1.5 billion in 2001 due to the piracy of audio-visual products and software, and that piracy levels for such products were around 90 percent that year.

China's record for trademark protection has been even worse. With techniques such as "salting," in which the top layer of goods in a container are authentic while the products below are counterfeits, China remains a major exporter of pirated trademarked goods, with its products reaching markets throughout Asia and Europe. China's own Development and Research Center has issued a report indicating that counterfeiting in China is a $16 billion industry.

A major obstacle to effective enforcement of IPR is the lack of criminal penalties that would make IPR violations a serious matter, as opposed to a pre-calculated cost of business. As a member of the WTO TRIPs Agreement, China is now required to impose criminal penalties for such violations. To date, China's laws treat IPR violations as a criminal offense but rarely do authorities enforce them as such. In its 2002 Special 301 decision on China, the USTR noted administrative penalties have failed to deter further infringements. Criminal investigations and sanctions are rare (i.e. administrative fines imposed are nominal), and very few cases are referred to criminal prosecution.

The recognition by Chinese business interests and the Chinese Government that China itself has potentially lucrative intellectual property worth protecting has been the most significant impetus in fostering improvements in IPR. The United States should encourage this domestic drive by Chinese entrepreneurs and business people to protect their burgeoning market for intellectual property by providing education and legal assistance programs in this area. Such programs are discussed in greater detail below.

State Owned or Invested Enterprises - Foreign businesses are concerned that China will not comply with its WTO obligation to force SOEs or state-invested enterprises (SIEs) to operate on a commercial basis, thus allowing an uncompetitive situation to continue. Discrimination between foreign and domestic suppliers to these enterprises is also a concern. Because of the complex cost structures and accounting systems used, a major obstacle to assessing China's compliance is the difficulty of evaluating whether SOEs and SIEs are profitable or subsidized.

Areas Outside the WTO - Outside of the Trade-related Investment Measures (TRIMs) Agreement, which deals with investment tied to trade flows, the WTO generally does not address

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investment restrictions. With the exception of dumping and subsidization, anticompetitive practices (e.g., price-fixing and cartels) are also not restricted by the WTO. These two issues are part of the Doha Development Agenda of the WTO. China is currently an "observer" of the WTO’s Government Procurement Agreement (GPA) and has pledged to join the agreement. China’s participation in the GPA is necessary to allow U.S. companies to compete fairly when selling to China’s large state-owned sectors.

Only time will tell whether the hoped-for market access gains for U.S. firms in China will materialize. This will depend on whether China has both the will and institutional capacity to adhere to its broad commitments under the WTO. Surely some U.S. industry sectors will enjoy expanded market access, but how broadly beneficial China’s accession will be to the U.S. economy as a whole remains to be seen. Moreover, China’s accession may open the door more to U.S. investment than to U.S. goods and services, which could have a deleterious impact on U.S. employment if such investment flows into export production that displaces U.S.-based production. These issues are discussed in more detail in Chapter 2.

**China’s Prospects for Compliance**

China’s record of compliance with past U.S.-China bilateral agreements has been inconsistent and raises questions about its prospects for complying with its broad WTO commitments. The following is a description of China’s adherence to its most significant bilateral trade agreements with the United States over the past decade.\(^{37}\)

1992 Memorandum of Understanding (MOU) on Market Access – In 1991, the USTR carried out its most sweeping market access investigation involving China. The investigation cited product-specific prohibitions, restrictive import licenses, technical barriers to trade, and a lack of transparency of laws. After negotiations broke down, USTR threatened $3.9 billion in sanctions. Under mutual challenges of sanctions, the United States and China reached an agreement in 1992. By signing the 1992 MOU on Market Access, China agreed to specific measures in return for U.S. support for China’s bid to enter the GATT. Despite tense negotiations in 1993, due to China’s poor implementation of the agreement, and again in 1994, due to China’s anger at the United States for blocking entry to the WTO, the USTR reported in 1994 that China was “substantially in compliance” with the 1992 MOU.

During Congressional testimony in 1996, former USTR Charlene Barshefsky described the nature of China’s compliance and the remaining frustrations for USTR:

> To its credit, China has done much to implement the agreement...While China has removed a substantial number of non-tariff barriers, we are concerned with China’s tendency to give with one hand and take away with the other. In some instances, China had substituted new barriers in the place of those removed... China must live up to its agreements and eliminate those impediments to free trade...If I could pick one area under it where we are dissatisfied, seriously dissatisfied, I would say it is in the agricultural sector.\(^{38}\)

\(^{37}\) Unless otherwise indicated, the following discussion on China’s compliance with past bilateral agreements is drawn from Wayne M. Morrison, “China-U.S. Trade Agreements: Compliance Issues,” Congressional Research Service Report, 1 September 2000.

\(^{38}\) Ibid., 7.
In its 1998 Foreign Trade Barriers report, USTR listed non-tariff barriers, transparency, import substitution laws, and sanitary and phytosanitary issues as the key areas in which China’s compliance was lacking.

**1992 and 1995 MOUs on Intellectual Property Rights (IPR)** – The 1979 Agreement on mutual nondiscriminatory treatment required both countries to provide copyright, patent, and trademark protection equal to that offered in the corresponding country. Despite talks in 1985 and 1987, China made no progress in protecting IPR. After placing China on the “priority watch list” in 1989 and 1990, the USTR listed China as a “priority foreign country” in 1991. After carrying out a Section 301 investigation, the USTR threatened $1.5 billion in sanctions, which China avoided by signing an MOU on IPR on January 16, 1992 in which it promised to strengthen patent, copyright, and trade secret laws and increase protection of U.S. intellectual property.

Although China’s leadership was successful in ratifying the new laws, they failed to enforce them. In 1994, USTR placed China back on the “priority foreign country” list and threatened import tariffs of 100 percent on $1.1 billion worth of Chinese imports. China again avoided such sanctions by signing another MOU on IPR on March 11, 1995. In the 1995 MOU, China pledged to step up enforcement as well as eliminate hidden barriers, which kept U.S. audio-visual products out of the China market and therefore encouraged piracy. But the cycle of failed compliance continued and, in April 1996, USTR again put China on the “priority foreign country” list and threatened $2 billion in sanctions. China again avoided them by signing an accord on June 17, 1996. The accord laid out an action plan towards proper enforcement of IPR law, which has meet with success. In its 2002 National Trade Estimate Report, USTR explained, “China has made substantial progress in some aspects of intellectual property rights protection since it signed agreements in 1992, 1995, and 1996...however, significant problems remain, particularly in the area of enforcement.”

**1997 U.S.-China Textile Agreement** - The United States and China have established quotas under a series of bilateral agreements, the most current of which is the February 1997 MOU that restricts Chinese textile and apparel exports to the U.S. market. By transshipping products through Hong Kong and Macau, among other countries, China has at times bypassed U.S. textile quotas. Estimating that transshipment violations amounted to $2 billion of product annually, the USTR negotiated enforcement provisions into the U.S.-China textile agreements. The provisions allow U.S. officials to inspect factories and impose penalties in the forms of reducing future textile quotas or even fining the Chinese an amount equal to triple the value of the transshipped products. The United States has acted on these provisions on a number of occasions. The 1997 U.S.-China textile agreement contained market access provisions for U.S. textile products. Despite China’s compliance with this agreement, there has been no discernible benefit to U.S. textiles.

China has a mixed record of compliance with its bilateral trade agreements. One consistency has been the repeated need for the USTR to renegotiate agreements to incorporate more specific implementation requirements and to resort to sanctions, or threat of sanctions, to push China to comply.

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40 The U.S. will be forced to abandon this quota system under the WTO in the year 2005.

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Protectionist policies, under-resourced enforcement agencies, corruption, local protectionism, and lack of an effective legal system have contributed to China's problems with compliance. As well, differences between U.S. and Chinese officials over what qualifies as compliance has been a constant point of friction. As a result, USTR has learned to avoid loose agreements with China. Detailing how the WTO accession agreement differs from past bilateral agreements, former USTR Charlene Barshefsky explained:

"China's compliance with tariff changes has always been absolute because that's a known obligation, it is a knowable obligation and compliance can be judged. When we negotiated the WTO accession agreement, it was with that example in mind leading to an agreement, which as you know, doesn't read like an agreement. It reads more like about 150 pages of grid work. So that China in every year at every point knows exactly what the obligation is and we know exactly what our rights are."

However, while the agreement does involve explicit "grid-work" obligations on tariff rates, it also includes numerous commitments designed to reduce trade-distorting practices. A number of witnesses testified that China will simply replace WTO-identified barriers with new ones.

China's accession to the WTO is part of a larger economic reform effort that has been taking place for the past two decades, and the success of WTO implementation largely rests on the success of the reform effort as a whole. There was strong domestic opposition in China to joining the WTO, with many officials outside the central leadership expressing concern about the increased foreign competition it would bring and arguing that China had given in to conditions that benefited the Americans more than the Chinese. This opposition is likely to intensify as China begins the difficult process of implementing its WTO commitments. U.S. and international support for China's economic reforms, and pressure on China to comply with its WTO commitments, may be essential to the reform effort. To this end, some witnesses suggested that the Chinese leadership is counting on U.S. pressure to help further the reform process in domestically painful areas such as the restructuring of SOEs and state-owned banks.

Localism and provincialism may be stronger forces than centralism for the Chinese economy and economic decision-making process. While the central leadership has signed onto the WTO, it remains to be seen whether the provincial and municipal governments will comply. David Bleyle, Consul General of the American Consulate in Chengdu, told the Commission that compliance in the provinces is on "a line of sight from Beijing" basis in which the central leadership exerts paltry influence over provinces' protectionist policies. WTO compliance will therefore largely be a matter of the central leadership's ability to put in place and enforce a strong legal system that will hold up in the face of localism and provincialism. The prospects for legal reform in China are discussed in Chapter 4.

WTO implementation will be a tremendous challenge to China in the social dislocation of expected layoffs and company failures. Chinese companies in the manufacturing and service sectors are still in their formative stages and have little exposure to the competitive market forces.

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43 Overholt, Written Testimony, 12.

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that WTO-entry will unleash. Massive layoffs could bring protests and even violent uprisings, and the provincial governments can be expected to make every effort to protect their home industries.

Initial Areas of Noncompliance

China’s membership in the WTO is only several months old and many of its most far-reaching obligations will not be phased in until later years. Nonetheless, many significant commitments were required to take effect upon accession. To date, there have been a number of areas where China has failed to meet its commitments, including several that have become sources of bilateral trade tensions.44

The Information Technology Agreement (ITA) - Despite its commitment to participate in the ITA agreement upon accession to the WTO, China has denied ITA tariff rates to 15 tariff items unless those products are imported for domestic production. USTR Robert Zoellick stated that the “benefits [China] has accrued from the zero tariffs” of the ITA “will evaporate if it attempts to distort the basic intent of the agreement...We will make this point as often as necessary-and it will have to be made often-to the Chinese.”45 Because of this dispute, the United States blocked China’s application to join the ITA at the February 15, 2002 meeting of the ITA working group in Geneva.

Tariff-rate Quotas (TRQs) - One of China’s early commitments under the WTO is to increase market access for certain agricultural products by granting TRQs to end-users in China. The agricultural products subject to such TRQs are wheat, corn, rice, soybean oil, palm oil, rapeseed oil, sugar, grain rice, wool, and cotton. Although in September of 2001 China promised that it would allocate agricultural TRQs by the end of 2001 or the date of accession, it has delayed issuing TRQ regulations and those they have released have been deemed inadequate by the USTR. Problems with TRQ allocation have also arisen for automobiles and fertilizer. The agricultural product TRQ delays are most likely due to interagency disputes in China between the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), the Ministry of Agriculture, and the State Development Planning Commission.

Genetically Modified Organisms (GMOs) - In January 2002, China released GMO regulations scheduled to take effect on March 20, 2002. The regulations required a lengthy process of inspections, safety assessments, and labeling that could take 9 months to complete. With the regulations threatening all U.S. soybean exports to China (America’s largest agricultural export to China) and with the possibility that the regulations were not WTO-compliant because they were not “science-based”, the U.S. trade officials came close to taking the case to the WTO. By March, China offered an interim proposal to accept U.S. safety certificates as long as U.S. exporters had begun the approval process in China. Despite a temporary hurdle that required interim licenses for U.S. exporters, China began granting these licenses in April. While the dispute has been diffused, USTR has openly stated that it is on the lookout for new hurdles to exporting soybeans to China.

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**Insurance Services** - In November and December of 2001 China issued new insurance regulations covering foreign-invested insurance companies that have caused concern among the U.S. insurance industry. The regulations' deficiencies lay primarily in the areas of branching, transparency, and capital requirements. As well, insurance companies continue to face unnecessary obstacles when pursuing insurance licenses. Chinese officials say that the matter is complex and should be addressed via the WTO's annual transitional review mechanism.

**Courier Services** - China generally agreed that conditions on ownership, operation, and scope for existing foreign courier service providers will not be made more restrictive. Following accession it issued new regulations on courier services which imposed new licensing requirements, anticompetitive pricing restrictions, and weight restrictions on what companies could deliver. All of these regulations restrict market access and therefore are directly in violation of China's WTO commitments. The regulations appear to be protective measures by China as the country attempts to protect the State Postal Bureau (China Post), which is facing severe competition in the profitable express delivery market. Similar to the dispute over insurance regulations, Chinese officials have refused to discuss the problems at the WTO Services Council meeting and insists that the proper forum is the WTO's annual transitional review mechanism.

**Export Subsidies** - China agreed to stop all export subsidies on industrial and agricultural goods upon accession, but U.S. industry and agriculture representatives' state that China has continued subsidizing exports. These subsidies can be difficult to identify and quantify because of their myriad forms in a socialist economy. Subsidies can take the form of shifted assets, credit allocations, low-interest loans, or guaranteed provisions of energy and raw materials. The USTR's 2002 National Trade Estimate Report on Foreign Trade Barriers identifies soda ash, wood products, fiberglass, auto glass, steel, flat glass, cotton, and corn as areas of particular concern.

**Monitoring and Enforcement Mechanisms**

**Monitoring**

The U.S. Government has established an interagency group, coordinated by USTR and overseen by the Bush Administration's Trade Policy Staff Committee (TPSC), to monitor China's progress in implementing its WTO commitments. This China-specific group has a three-tiered system, in which staff and sub-committees comprise the first level, a deputy-level Trade Policy Review Group forms the second level, and the cabinet-level National Economic Council Deputies Committee or the NEC make the third level. The Committee will rely on information gathered and assessed by the Departments of Commerce, State, Agriculture, Treasury, Labor, and the U.S. Patent and Trademark office.

In addition to their involvement on the TPSC, the Commerce and State Departments are also taking the lead in organizing on-the-ground efforts in China. Shaun Donnelly, Acting Assistant Secretary of State, Bureau of Economic Business Affairs, testified:

*Ambassador Randt has made China WTO implementation one of his top priorities for his mission. In Beijing, the Embassy has established a WTO Implementation Coordination Committee chaired by the Embassy Economic Minister to coordinate the efforts of the Departments of State and Commerce and other agencies, Agriculture and Customs attaches. They are responsible for tracking and analyzing the changes in these laws,*

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obviously requiring Chinese language capability and so on. The Embassy has also formed a special IPR working group to monitor China's WTO intellectual property legislation and enforcement. Our consulates in Shanghai, Guangzhou, Chengdu, Shenyang, and Hong Kong, are also key players in WTO compliance efforts.\(^{46}\)

The Commerce Department will take the lead, in coordination with the USTR, in investigating market access and compliance problems as they arise. William Lash, Assistant Secretary of Commerce for Market Access and Compliance, outlined the Department’s five-point "Compliance Plan", the components of which are to (1) concentrate enforcement efforts; (2) help China reform; (3) promptly address market access problems; (4) give U.S. companies a head start; and (5) aggressively monitor trade flows.\(^{47}\) As part of this process, the Commerce Department intends to seek input from a variety of sources, such as the U.S. Chamber of Commerce, the U.S.-China Business Council, and organized labor, and to meet with U.S. small and medium size enterprises to assess whether they are gaining proper market access to China.\(^{48}\)

Separate from the review and monitoring efforts of the U.S. Government, the WTO will conduct an annual review of China's compliance record as part of the Transitional Review Mechanism (TRM) provided for under Article 18 of China's Protocol of Accession. China is the only country in the WTO subject to an annual review, and the TRM process will continue for eight years, after which there will be a final review in the tenth year. Pursuant to the TRM process, the subsidiary bodies of the WTO that have mandates covering China's commitments — e.g., Council for Trade in Goods, Committee on Subsidies and Countervailing Measures, Committee on Antidumping Measures — are to review China's compliance, with China providing relevant information "in advance" of these reviews. The results of these reviews will be reported to the WTO General Council, which will conduct the final review. Annex 1A of China's accession Protocol sets forth a detailed list of specific information China must provide, including economic data in ten fields ranging from foreign exchange to pricing policies, as well as copies of laws and regulations on issues ranging from import licensing to government procurement.

U.S. trade officials recently attempted to have a discussion on TRM procedures placed on the agenda of several WTO committee meetings. China blocked these efforts on the grounds that discussions of this nature go beyond its Article 18 requirements. There now appears to be a process in place to have all the appropriate WTO subsidiary bodies take up TRM matters in October. It remains unclear how far in advance of these discussions China will provide members with documentation, how substantive such documentation will be, and whether China will formally respond to members’ questions regarding the information provided.

During meetings in Geneva with WTO officials, U.S. trade officials, and representatives of various member country delegations, the Commission was told that WTO members are concerned that the TRM process, at least for the first year, may not yield a thorough review of China's compliance if the process is truncated to a limited review period at the end of the year. Some noted that the TRM process, which was an important component of U.S. and other member country support for China's accession package, will only be valuable if it is robust enough to


function as an early warning system of potential trade disputes and thereby encourage China's compliance to avoid such disputes.

As the U.S. Government and the WTO monitor China's compliance with its WTO commitments, it will be important for both to assess China's broader economic practices, as some may effectively circumvent its WTO obligations. For example, the Commission is concerned about reports that China has adopted a policy of granting subsidies to its steel companies that use domestic rather than imported inputs.49

**Enforcement**

The U.S. Government has a variety of means to address Chinese noncompliance with its WTO commitments, including the WTO dispute settlement process, the WTO China-specific safeguards, and U.S. trade law provisions:

**WTO Dispute Settlement Understanding** - By joining the WTO, China has agreed to submit to binding external adjudication of trade disputes, therefore giving the WTO dispute settlement process precedence over its own domestic courts in trade-related matters. The Dispute Settlement Understanding (DSU) requires an initial 60-day consultation period followed by the additional time requirements of establishing a panel and selecting panelists. Although the briefing and hearing phases can be quick, the panel customarily takes several months to make a decision. If the decision is appealed, which is quite common, and the appellate decision can take three or four months. In its entirety, the DSU process generally takes 18 months, and therefore is viewed as a time consuming mechanism for resolving trade disputes.50 In meetings with representatives of various WTO member country delegations, the Commission was told that many countries likely will initially pursue disputes with China through bilateral discussions (or plurilateral discussions as appropriate), then through the TRM process, and lastly through the WTO's formal dispute settlement processes.

**Non-market Economy Antidumping Methodology** - Although application of non-market economy (NME) antidumping has long been a part of U.S. trade law, it has never been a part of WTO law. China's accession agreement includes a provision allowing the U.S. (and any other WTO-member country) to use the NME methodology for assessing China's cost of production in antidumping cases for the 15 years following China's accession.

The ability of WTO members to use NME evaluations of China when prosecuting antidumping cases could be extremely important to the protection of American industries, if strongly enforced by the Commerce Department. Currently the Department has the discretion of determining whether China is a non-market economy.

**Product Specific Safeguard** — The inclusion of Product Specific Safeguards into the Chinese accession agreement will allow WTO members to defend against import surges from China for the next 12 years. These safeguards extend well beyond normal WTO laws because they allow more lenient standards that call for finding of "market disruption" rather than "serious injury", and because they allow WTO members to single out China-specific products as opposed to addressing all imports of a product, regardless of origin. U.S. law already contained such a

50 Bader, Oral Testimony, 17.
remedy against imports from China prior to accession under Section 406 of the Trade Act of 1974, however, it was used sparingly. The new Product Specific Safeguard tracks Section 406 and was agreed to by China in recognition of the numerous areas where immediate compliance was unlikely. The Commission believes that Congressional action under this safeguard is completely appropriate.

**Textile Safeguard** – Under China’s accession agreement, WTO members can impose restrictions on Chinese textile imports using a “market disruption” rather than a “serious injury” standard. This safeguard is available through 2008.

**GATT Article XXI Security Exception** – Article XXI of the GATT, to which all WTO members are subject, provides for national security-related exceptions to a member country’s WTO obligations. The language of Article XXI seeks to define what constitutes a legitimate national security concern and to discourage commercially inspired abuse. The United States has taken the view that Article XXI is self-judging, whereby if a country invokes Article XXI, its actions are not subject to adjudication by a third-party dispute settlement mechanism such as that of the WTO. Either branch of government— the Congress by statute, or the President by executive order - can declare the exemptions.

Article XXI(b) defines what qualifies as a national security interest as follows:

(i) Relating to fissionable materials or the material from which they are derived;
(ii) Relating to the traffic in arms, ammunition and implements of war and to such traffic in other goods and materials as is carried on directly or indirectly for the purpose of supplying a military establishment;
(iii) Taken in time of war or other emergency in international relations.

Because of its broadness, Article XXI has been the subject of much debate among international trade law specialists. However, the WTO has not yet seen a case where the Article XXI exemption is cited before its dispute resolution body. The propriety of its use was raised in 1997 by the European Union with regard to U.S. legislative efforts (the Cuban Liberty and Democratic Solidarity Act and the Iran and Libya Sanctions Act), but the issue was resolved between the United States and EU before proceeding to the WTO.\(^{51}\)

**U.S.-China Bilateral Communications** – Although currently there are many U.S.-China bilateral cooperative programs in place, many initiated by the Carter Administration in 1979, there is no centralized mechanism for coordinating, reporting on, or funding these meetings.\(^{52}\)

Following his summit with President Jiang Zemin this past February, President Bush announced that the United States and China had agreed to increase cooperation and exchanges in areas including trade, energy, science and technology, and law enforcement. They also agreed to continue the annual meetings of the Joint Commission on Commerce and Trade (JCCT), the Joint Economic Committee (JEC), and the Joint Commission on Science and Technology

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Following the April 2002 meeting of the JCCT in Beijing, Undersecretary of Commerce Grant Aldonas announced that he will visit China every six months to consult with the Chinese Ministry of Foreign Trade and Economic Cooperation (MOFTEC) Assistant Minister Ma Xiuhong on China's WTO implementation efforts.

While these meetings are beneficial and productive, the Commission notes that meetings with higher-level Chinese officials would likely be more helpful. In the JCCT the Commerce Secretary meets with Minister of MOFTEC; in the JEC the Treasury Secretary meets with the Minister of Finance. While these annual meetings are commendable and should continue, ministers are not always the functional equivalents of U.S. cabinet secretaries, and U.S. cabinet-level officials could more effectively meet with State Council members, who would have the power to respond to U.S. concerns.

In addition to more frequent meetings between central government officials, the United States would benefit from encouraging the use of existing bilateral mechanisms at the state and municipal levels to promote and monitor WTO compliance. These take place in the form of state government-to-provincial government and city-to-city meetings.

**Technical Assistance**

The Commission heard from numerous witnesses that one of the most effective measures the U.S. Government could employ to promote China's compliance with its WTO obligations is the funding of technical assistance and legal education programs in China. China's development of a functioning commercial legal system is vital to the country's ability to comply with its WTO obligations. Developing such a system is a massive undertaking for which the Chinese Government has asked for international help.

The Commerce Department funds a variety of technical assistance programs in China, in coordination with the U.S. embassy and consulates. The funding levels of these programs have been modest and represent only a fraction of the amounts provided for similar programs in Central and Eastern Europe and the former Soviet republics. Moreover, the U.S. Government’s assistance programs for China are not coordinated with other countries' efforts and are almost exclusively done using a top-down approach of educating government officials (as opposed to the arguably more effective bottom-up approach of educating Chinese students and attorneys). The U.S. Agency for International Development (USAID) is restricted under U.S. law from providing assistance to China.

The EU, the UK, Australia and Japan have also developed capacity-building programs for China. The WTO has been administering some modest programs of technical assistance and capacity building in China to facilitate compliance with its accession commitments and has been participating in similar programs sponsored by member countries. The WTO has begun a long-term project to build a comprehensive database of technical assistance/capacity building programs for developing countries that would encompass international organization, individual government, and private-sector initiatives. The hope is that this database will help better coordinate such programs and avoid overlap and duplication.

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53 Lash, Oral Testimony, 24.

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Most technical assistance programs supplement existing and internally supported PRC-government and think tank programs such as the Shanghai WTO Affairs Consulting Center, which is one of China’s leading WTO research centers. Numerous nongovernmental institutions such as the Ford Foundation, Asia Foundation, Temple University and Harvard University and international financial institutions such as the World Bank and Asian Development Bank also support capacity building.

National Security Implications

China’s accession to the WTO carries high stakes for both the United States and China. While they have some complementary goals for supporting China’s WTO accession – e.g., promoting market-oriented economic growth and reform – they have very different long-term objectives: the United States seeks a democratic and more open China, while the Chinese leadership seeks an economically strengthened nation that continues to be governed by one-party communist rule. The national security implications for the United States of a more economically prosperous China governed by an authoritarian regime are very serious. An economically powerful, non-democratic China may use its wealth and regional influence to enhance its military power projection, bolster its alliances with rogue states, and otherwise undermine U.S. regional, if not global, interests. If China’s WTO membership leads to economic growth and reforms that are accompanied by the development of political and personal freedoms, worker rights, and broadly shared prosperity, China may become a strategic partner for the United States that shares similar long-term objectives. There is no guarantee, however, that a more economically prosperous China will necessarily be a more democratic China.

At the same time, China enters the WTO with a rapidly growing, yet potentially unstable economy burdened with significant fiscal and structural problems. If, as some observers predict, China’s economy stagnates or even collapses under the weight of its WTO commitments, the United States would face a new spectrum of security risks. Consequently, an understanding of the Chinese economy and how the Chinese leadership is handling its important economic challenges should be central to U.S. strategic planning. The U.S. Government needs to prepare for negative contingencies regarding the Chinese economy as a result of WTO accession and have appropriate policy options in place before a crisis occurs. The Commission remains concerned by the limited preparedness of our government for various scenarios.

China’s WTO agreement is unprecedented in terms of its complexity and scope. There is considerable uncertainty at the present time as to whether China has the capacity, or the Chinese leadership has the will, to comply with its broad obligations. China’s success in adhering to its WTO commitments will determine not only whether U.S. firms enjoy enhanced access to the Chinese market for their goods and services, but may also determine whether China is on track to move in a positive direction toward greater economic, and hopefully political, liberalization. Consequently, the U.S. Government should be prepared to provide technical assistance to China where appropriate to facilitate its WTO compliance efforts and to aggressively employ its WTO and U.S. trade law tools to enforce compliance when necessary.

The Commission plans to monitor, through continued hearings, briefings, and research, China’s progress in implementing its WTO commitments, and the health of the Chinese economy. The Commission also plans to use the stated U.S. objectives for supporting China’s accession as benchmarks for assessing the success or failure of U.S.-China policy with respect to China’s economic integration.
Recommendations

- The Commission recommends that the U.S. Government clearly and publicly articulate, in both multilateral and bilateral settings, the importance of China's compliance with its WTO commitments and provide technical assistance to this end. Current technical assistance programs would benefit from greater resources and coordination. Due to the restrictions placed on USAID's involvement in China, the Commission recommends that Congress appropriate and authorize funds directly to technical assistance programs such as the Commerce Department's Commercial Law Development Program (CLDP).

- The Commission recommends that Congress require that the Department of Commerce obtain Congressional approval before implementing any determination that a non-market economy (NME) has achieved market economy status.

- The Commerce Department currently interprets the countervailing duty (CVD) law to be inapplicable to NMEs. The Commission recommends that Congress amend the CVD law to specifically state that it applies to NMEs and thereby can be used to protect U.S. industries from unfair competition from the imports of these economies.

- The Commission recommends that the U.S. Government encourage the use of existing U.S.-China state government-to-provincial government and city-to-city bilateral mechanisms to help promote and monitor WTO compliance.

- Congress currently charges the Commerce Department to submit annually a report on U.S. trade promotion activities in the form of the Trade Promotion Coordination Committee (TPCC) report. In addition, the Secretary of Commerce is charged to testify to Congress on that report. During Secretary Evans’ recent testimony on that report he discussed the importance of China complying with its WTO obligations and noted that a senior Commerce official would travel to China once a month to evaluate China’s compliance efforts. The Commission recommends that Congress request that each annual TPCC report assess China’s WTO compliance progress and recommend any additional resources or other initiatives to facilitate compliance, and that this report include a survey of the market access attained by key U.S. industry sectors in China, including agriculture. The report should compare actual market access results with the initial estimates made by the Executive Branch in support of granting China Permanent Normal Trade Relations status and compare U.S. market access in those key sectors with that gained by the European Union and Japan.

- China's WTO accession agreement includes three important China-specific safeguards: the ability of WTO members to use a non-market economy methodology in anti-dumping cases, a product specific safeguard that allows WTO members to restrain Chinese imports that disrupt their domestic markets, and a textile safeguard. Inclusion of these safeguards was a key component of U.S. support for China's accession as they provide important tools to combat unfair trade practices or import surges. The Commission recommends that USTR and the Commerce Department make aggressive use of these safeguards during the limited time period for which they will be available.

- With regard to the WTO China-specific textile safeguard, the Commission recommends that Congress request the Commerce Department to prepare an annual report on the U.S. textile industry addressing whether “market disruption” is occurring with regard to any products in this industry as a result of imports from China. A determination of “market disruption” would trigger the textile safeguard mechanism.
The Commission recommends that Congress encourage USTR to request consultations at the WTO on China’s noncompliance with its obligations under the TRIPs Agreement, in particular the lack of adequate enforcement to reduce and deter counterfeiting and piracy of U.S. motion pictures and other video products. If China’s noncompliance in this area is not adequately resolved through such consultations, Congress should encourage USTR to request that a WTO dispute settlement panel be convened on this matter.

Congress mandated the Commission to evaluate and make specific recommendations for the U.S. Government to invoke Article XXI of the GATT (relating to security exceptions) as a result of any adverse impact on U.S. national security interests. Current trends indicate that China’s rapid growth as a steel producer may have an adverse impact on the U.S. steel industry. The Commission believes that the steel industry is a likely candidate for using Article XXI, as demonstrated by the Bush Administration’s decision to impose temporary safeguard measures on key steel products and President Bush’s statements on the importance of the U.S. steel industry to our national security. The Commission therefore recommends that Congress consider using Article XXI to ensure the survival of the U.S. steel industry, if the Administration’s current safeguard measures prove ineffective.

The Commission recommends that Congress renew the Super 301 provision of U.S. trade law to address unfair trade practices that have the greatest impact on U.S. export market opportunities in China and elsewhere.

The Commission recommends that Congress examine the tools available to the U.S. Government to address market access-limiting practices by China not covered by its WTO obligations, and direct U.S. trade officials to make full use of these tools to protect U.S. export opportunities.
Chapter 4 - Political and Civil Freedoms

Key Findings

- In the past twenty years there have been some improvements in social and personal freedoms for the Chinese people. However, trade and economic liberalization have not led to the extent of political liberalization much hoped for by U.S. policymakers. The Chinese Government has simultaneously increased trade and aggressively resisted openness in politically sensitive areas such as the exercise of religious, human, and worker rights.

- To facilitate trade and investment, China has instituted numerous legal reforms that deal with foreign direct investment (FDI), financial markets, and private businesses. The development of a legal structure to implement China's World Trade Organization (WTO) commitments faces a host of challenges such as Chinese Communist Party (CCP) control of the courts, a weak judiciary system marked by a lack of trained judges and a flawed judicial appointment system, local and provincial protectionism, and widespread corruption.

- The Chinese Government has implemented limited reforms in administrative law and civil procedures. Nevertheless, its citizens suffer from errant, arbitrary, and sometimes brutal treatment by the government.

- The Chinese Government systematically denies workers the freedom of association, the right to organize and bargain collectively, and the right to strike. Exploitative child labor and forced labor are commonplace. In recent years, workers and union organizers have protested these conditions, but such protests are often defused by payoffs or suppressed by intimidation and brute force, while emergent labor leaders and others have been jailed or sent to mental institutions. The government seems determined to quash any independent workers' organizations.

- The central government seeks to effectively control the free flow of information from the Internet to the traditional media.

Introduction

Successive American administrations have argued that letting Western influences permeate China through trade and investment would erode the legitimacy of the government's one-party, authoritarian rule and foster the development of a rules-based society. Prominent U.S. officials, such as former National Security Advisor Sandy Berger and former U.S. Trade Representative Charlene Barshefsky, have argued that a normal trading relationship with China would lead to a more liberal, more democratic China.¹

In the past two decades Chinese citizens have gained some social and personal freedoms, such as the freedom to travel, to choose their own professions, and to associate with friends of their choice. However, the government has not permitted political liberalization and continues to repress any independent groups. Having fostered a more complex and diverse society where media criticism, popular protest, and religious objection can no longer be wholly monitored or controlled, Beijing now resorts to official intimidation, false propaganda, and brute force to suppress dissent when necessary.

¹ A more detailed discussion of American goals for Chinese economic integration appears in Chapter 3.
The Chinese Government’s flagrant abuse of human rights is not only morally repugnant, but it also concretely damages U.S. interests. China’s export of goods made by prison labor and its suppression of labor rights damage U.S. economic competitiveness. Its disregard for the rule of law hinders proper compliance with WTO commitments. Its efforts to control the media and the Internet, and to sponsor computer "hacker" activism against U.S. institutions are a cause for concern. Its media apparatus promotes disinformation and adverse views about the United States among its citizenry.

Further, China’s policies and actions in other political areas, ranging from suppression of religious freedom, to village elections, to Hong-Kong, suggest that economic liberalization might not lead to political liberalization.

**Legal Reforms**

Since 1979, China has instituted numerous legal reforms to spur foreign investment and economic modernization. In the process, China has facilitated varied commercial activities, recognized new commercial rights and interests, promulgated industry regulations, and legitimized and built the basic infrastructure for an expanding market economy.

The government has begun to reform state-owned enterprises, the banking and tax systems, and the securities markets, in order to create a market economy that will inspire the confidence of foreign investors. To that end, China has set forth and revised criminal and civil law, strengthened institutions to curb administrative arbitrariness, reformed and reconstructed the court system, and resurrected the study of law and the legal profession.²

Nevertheless, an independent, impartial legal system is lacking. The current legal structure is plagued by Party intervention, glaring corruption, and arbitrariness. An expanding and increasingly more expert class of legal professionals has not changed the fact that the judiciary remains subservient to Party interests. These and other problems continue to leave Chinese citizens without adequate legal recourse and vulnerable to the whims of errant government policies.

Legal reforms in China to date have been implemented mainly to further economic growth rather than to promote a genuine rule of law under which the state itself would be subjected and limited by the law. Instead, the Chinese legal system is characterized by the rule by law, where the state employs the law as a vehicle to exercise power when convenient or necessary for its own ends.³

The United States now depends on this flawed legal system, under the influence of the Chinese Communist Party, to enforce China’s WTO commitments.

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Commercial Legal Reform

China will have to comply with three basic legal requirements placed on all WTO members. These are:

1. Transparency of relevant laws, regulations, judicial decisions, and administrative rulings of general application;
2. Uniform, impartial, and reasonable administration of such legal norms; and
3. Institutions that guarantee independent, objective, and impartial review of all relevant administrative actions.

China will have to publish and make easily available all laws, regulations, and administrative rulings; establish an inquiry point within the central government where complaints can be lodged and addressed swiftly, and establish institutions that guarantee objective and impartial review of all relevant administrative actions.

Aside from complying with the general requirements placed on WTO members, China must also bring its domestic laws into compliance with all of its WTO obligations. It must legislate, abolish, or amend literally thousands of laws. To that end, China has already undertaken massive efforts to revise existing laws and regulations relating to trade and investment, technology transfer, banking, insurance, securities, taxation, customs, intellectual property, telecommunications, health and professional services. 4

However, glaring problems stand in the way of China’s commercial legal reforms. For one, the dissemination of new regulations is likely to be a slow process as provincialism and local protectionism deflect or frustrate the central government’s directives at all levels of the administrative and legal structures. The United States Trade Representative (USTR) has on numerous occasions had to renegotiate agreements to include enforcement provisions or “action plans” for the Chinese Government to enforce laws in the localities. Such enforcement problems will likely be the cause of many disputes and will place the onus on Chinese courts to review and rule on administrative action or future inaction.

Weak Judiciary

Legal professionals in China are poorly trained and the legal system is unduly influenced by the CCP. Despite progress made in the training of judges, many remain poorly educated. Today, only about 10 percent of China’s judges have four-year college degrees in law. 5

Judges do not have a limited tenure of office and are, by and large, appointed, promoted, compensated, and removed by the local party and government elite. Moreover, the courts are under the control of the local Party Political-Legal Committee, which oversees the courts as well as the local prosecutor’s office, police and justice department. Over 90 percent of the country’s

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5 U.S.-China Security Review Commission, Hearing on WTO Compliance and Sectoral Issues, Written Testimony of Donald C. Clarke, 18 January 2002, 6. A 1998 study of nine basic-level courts (the lowest level) in a major provincial city revealed that only three percent of the judges had a bachelor's degree in law and that the "great majority" had had other types of jobs in the court administration such as bailiff, clerk, or driver before being promoted to the rank of judge.
approximately 180,000 judges are CCP members. As a result, local protectionism and provincialism thwarts true independence of China's judiciary.

Corruption

Systemic corruption in China today not only plagues almost every aspect of society and hinders overall economic development, but is also a major stumbling block to the creation of an impartial legal system that can enforce China's WTO compliance.

China reportedly has the largest dollar amount of corruption of any other country in the world. Some estimate the cost of corruption to China's economy at 2-3 percent of GDP. Hu Angang, a noted economist at the Chinese Academy of Sciences and Qinghua University in Beijing, estimates that corruption in China from 1999-2001 averaged an annual rate of 14.5-14.9 percent of GDP and that 15-20 percent of public projects funds "leak" into private hands.

The legal system in China is mired in corruption much like the rest of the economy. Judges, who are usually underpaid and treated like other political officials, are easily susceptible to corruption. Lawyers are known to use social or Party connections and bribes to win cases. As a result, the courts in China often do not render judgment based on legal merit but are influenced by payoffs and political manipulation. Even when corrupt government officials are caught, criminal courts sentence only 6.6 percent of them.

Although China's leaders have declared the fight against corruption a central policy objective, they have had little success. Many Chinese scholars have stated that capital flight actually increases proportionately to the degree which the government increases anti-corruption efforts. Some government officials and scholars contend that anti-corruption campaigns in fact have been hijacked by various government officials to advance political interests or wage political fights rather than to make substantive reforms.

Noncommercial Legal Reforms

China has implemented some noncommercial legal reforms in administrative law, criminal law, and the National People's Congress (NPC).

In the area of administrative law, the central leadership has put in place reforms to establish the basis of judicial review of state actions. The 1989 Administrative Litigation Law, an attempt to foster bureaucratic responsibility, permitted affected parties to sue administrative agencies for

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6 Cohen, Written Testimony, 5.
8 Ibid.
10 Cohen, Written Testimony, 5.
13 Ibid.
alleged illegal application of administrative rules. The 1994 State Compensation Law allows citizens to sue the state for a variety of perceived infractions or excesses; the 1996 Administrative Penalties Law limits the power of officials to administer penalties and punishments and lays out principles of transparency, legitimacy and due process for administering such penalties.\textsuperscript{15}

Criminal law and procedure remain the least reformed areas of Chinese law, with arbitrary arrest, detention, and torture still common.\textsuperscript{16} The 1996 revised Criminal Procedure Law outlined a framework for key areas from pre-trial detention to the right to counsel. In practice, police often use loopholes in the law to circumvent a defendant’s right to counsel; criminal defense lawyers frequently have trouble getting access to their clients or collecting evidence; and law enforcement officials threaten and harass lawyers. In addition, there is no right to remain silent, no presumption of innocence, no right against double jeopardy and no law of evidence.\textsuperscript{17}

Traditionally, the NPC has served as a rubber stamp of CCP edicts. Over the past two decades, the NPC has taken a more active role in originating and passing legislation while engaging in more contentious debates on legislative initiatives.\textsuperscript{18} Nevertheless, the NPC today is far from being an independent organ that can provide checks and balances on Party rule.

Rule of Law Initiatives

U.S. nongovernmental organizations, universities and government agencies have been funding rule of law initiatives in China that address important legal infrastructure needs, ranging from legal training to legislation drafting to technical assistance. While rule of law initiatives could help foster legal reform, they may not necessarily lead to democratic change or even political liberalization. As long as the CCP remains above the law, legal reform could be used merely to advance the Party’s interests, such as building up China’s economic power while controlling dissent. An improved commercial rule of law without political reform might help a regime unfriendly to the United States attract trade, investment, and wealth more effectively.

Prison Labor Exports

China operates the largest prison/forced labor camp system in the world; it is known to produce goods destined for the United States and international markets. The import of such products affects not only Chinese citizens but also the U.S. economy, as workers in labor camps make such low wages that American workers simply cannot compete.\textsuperscript{19}

U.S. laws banning the import of prison labor goods seek to protect U.S. businesses, consumers and laborers from unfair foreign competition. Section 1307 of Title 19, U.S. Code (Section 307 of

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\textsuperscript{18} Feinerman, Written Testimony, 59.

the U.S. Tariff Act of 1930) prohibits the importation of prison or forced labor products from any country. Section 1761 of Title 18, U.S. Code, makes it a criminal offense to knowingly import or transport in interstate commerce convict labor goods. As early as 1989, the U.S. Government expressed concerns about the entry of such products into the U.S. market from China. However, U.S. efforts to monitor or stem the influx of these forced labor exports have largely been unsuccessful due to the lack of cooperation from the Chinese Government.

Human rights groups such as the Laogai Research Foundation contend there are over 1,000 labor camps in China and that prison labor goods make up an important part of the Chinese national economy. A study conducted by Dunn & Bradstreet documented 99 such prison labor facilities, which together produce over $800 million in domestic and international sales each year.

Chinese law mandates that prisoners can be required to work up to 12 hours per day. Former prisoners and credible sources, however, have reported that work requirements often exceed those set forth by the law, especially under circumstances where the penal institutions derive economic benefits from prison labor. Those who perform prison labor include not only criminals, but also many political, religious and labor dissidents who are forced to undergo "re-education through labor."

As of August 2001, U.S. Customs had undertaken approximately 84 criminal investigations of prison labor in China and had issued 20 detention orders for goods entering the United States from Chinese facilities that were believed to be prison camps. However, the U.S. Customs Service to date has substantiated only three allegations of forced labor imports from China into the United States. They involved:

- E.W. Bliss Company of Hastings, Michigan, which in 1992 pled guilty to charges of knowingly importing machine presses made with prison labor;
- China Diesel Imports, which imported diesel engines produced by the Yunnan Machinery Company of China, was found to have used prison labor in its manufacturing process; and
- Office Mate International Corporation of Edison, New Jersey, and its sister company Allied International Manufacturing Corporation (AIMCO), of Nanjing China, whose owner was convicted of transporting over a hundred million paper binder clips made from prison labor into the United States. (According to the Laogai Research Foundation, such imports amounted to at least one-third of all binder clips available in the United States.)

The U.S. Customs Service has required a collection of evidence beyond reasonable suspicin to issue a detention order to block forced labor goods from entering the U.S. border or to prosecute a violating importer. Once a detention order is issued, it remains in effect until Customs is able to

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make a clear determination that the facility in question is not utilizing prison labor.\textsuperscript{26} Because detention orders are issued with an eye toward a potential court challenge by the accused, Customs must have the ability to gather strong evidence to support its claim. In the case of China, Customs would like to inspect the alleged forced labor facility to confirm that the barred products were indeed goods produced from forced labor.

To investigate, prevent and stop the importation of forced labor products from China, the United States signed a Memorandum of Understanding on Prohibiting Trade in Prison Labor Products with China in 1992 to gain access to suspect prison facilities, with Chinese permission. A subsequent bilateral agreement, the Statement of Cooperation on the Memorandum, was signed in 1994 to specify the timeline of "visits" requested by Washington.

According to the U.S. Department of State, Chinese cooperation in carrying out the two agreements has been at best "sporadic."\textsuperscript{27} China for the most part has either rejected or left standing U.S. requests to inspect alleged Chinese prison labor facilities. Between 1997 and the end of 2001, Beijing allowed U.S. officials to conduct only one visit to a suspected prison labor facility. As of the end of 2001, eight U.S. requests for prison visits, some dating back to 1992, were pending.\textsuperscript{28}

China has argued that its "re-education through labor" facilities are administrative rather than penal in nature and therefore are not covered by the two bilateral agreements. In instances when the relevant facilities are conceded to be prisons, China has claimed that the products are not exported to the United States.

In 2000, the Chinese Ministry of Justice further indicated its unwillingness to cooperate with the United States in implementing the two bilateral agreements. In a statement, the Ministry recommended that the U.S. Customs Service cease its requests for "visits" to suspect prison labor facilties, claiming that it was the "sovereign right of the Chinese Government to investigate claims of forced labor without U.S. interference."

Without Chinese cooperation, U.S. Customs cannot effectively investigate these alleged forced labor facilities. As China abuses its criminal and political prisoners, it is simultaneously hindering the effective enforcement of bilateral agreements and of domestic U.S. laws. The Commission recommends that Congress implement steps to more effectively prohibit the importation of goods made by prison and forced labor from China. (See appendix for a letter and recommendations the Commission released to Congress in May 2002.)

**Labor Rights**

The existence of free trade unions and advancement of worker rights are essential to the development of a free and liberal society in China. However, the Chinese Government systematically denies workers the freedom of association, the right to organize and bargain collectively, and the right to strike. Horrid working conditions abound, where workers face

\textsuperscript{26} Senate Committee on Foreign Relations, *Hearing on U.S. Implementation of Prison Labor Agreements with China*, Written Testimony of Jeffrey Bader, 105\textsuperscript{th} Cong., 1\textsuperscript{st} sess., 21 May 1997, Committee Print, 18.


\textsuperscript{28} *Ibid.*
depressed wages, long hours, accidental amputations, and death from over-exhaustion. Often, they are also unable to collect fair compensation, or to seek legal redress or grievances. Labor activists who protest or attempt to organize independent trade unions are regularly detained in prisons or psychiatric hospitals. The cheap labor costs have in part contributed to the redirection of American investment and relocation of manufacturing plants, leading to job losses and decreasing economic competitiveness in the American economy.

Although China is a member of the International Labor Organization (ILO), it has largely ignored its commitments to comply with ILO standards regarding the freedom of association. Only one union, the All-China Federation of Trade Unions (ACFTU), whose officials are appointed by and answer to the CCP, operates legally.

Aside from lacking appropriate union representation, Chinese workers also suffer the costs of the nation’s transition from a centrally planned economy to a market economy. In the cities, privatization of ailing state-owned enterprises (SOEs) in the past few years have led to massive layoffs. In an urban workforce of roughly 200 million, 15 million workers are estimated to have lost their jobs as a result of this downsizing. The combination of layoffs and poor working conditions have led to frequent protests by disgruntled or unemployed workers across China. Large-scale protests in northeastern China in early 2002 demonstrate the volatility and seriousness of massive labor discontent in China.

Away from the state-owned sector, most Chinese workers are not even represented by the official union. The ACFTU has had little success in organizing workers in the burgeoning private sector, where union membership in 2001 is estimated to be less than 20 percent. In the countryside, the rural workforce of some 550 million people—along with some 100 million migrants in the “floating population” that leaves the countryside to seek employment in the cities—for the most part do not have union representation.

Without the right to organize and bargain collectively and the right to strike, some workers have attempted to address their grievances in the courts. China has shown a willingness to allow legal aid clinics to take labor and employment law cases and permits private lawyers to represent mistreated workers including those injured in industrial accidents. Existing labor laws do outline standards ranging from compensation to overtime; however, most workers do not know their rights under the law. Those who do and have brought their grievances to the courts are often frustrated by unfair determinations made based on personal and political influence rather than the law.

The American business community in China claims that it contributes greatly to the improvement of social, labor, and environmental conditions by promoting the rule of law, ethical business behavior and new ideas. Labor and human rights communities, however, have accused

30 Ibid.
31 Ibid.
American companies in China of taking advantage of and prolonging human and labor rights abuses by paying subsistence wages and punishing workers who seek to strike or raise grievances.\textsuperscript{34}

Ultimately, the denial of workers' rights and poor working conditions in China has a depressing effect on the wages of American workers, who do not accept the extremely low standards Chinese workers tolerate.\textsuperscript{35} In part because of low labor costs, artificially depressed by the deprivation of workers' rights, China has managed to become competitive in various industries at U.S. expense. For instance, China today produces more steel than any other country in the world despite the poor quality of its products and the low productivity of its workforce.\textsuperscript{36}

**Free Flow of Information**

The development and liberalization of information-based industries such as the Internet and the media has been widely expected to facilitate the influx of foreign ideas and information sources, and even encourage citizens to demand rule of law and democracy. Hopes for political liberalization, however, have yet to be realized.

**Internet**

The Internet industry has served as a powerful engine of growth for the Chinese economy since 1998. The information technology sector has grown at three times the rate of the overall Chinese economy as of early 2001.\textsuperscript{37} Much of this growth has been driven by the burgeoning Chinese Internet population, which doubled every six months for much of the last few years and ballooned from 2.1 million at the beginning of 1999 to 33.7 million in December 2001.\textsuperscript{38} China has approved the momentous breakup of monopoly giant China Telecommunications, encouraged Internet growth by slashing telecom rates for online access, and built a vast fiber-optic network to improve national connectivity.

Beijing has also aggressively clamped down on what it considers to be online subversive thought as well as efforts by dissident groups such as the banned Falun Gong spiritual sect and the China Democratic Party to communicate and organize via the web.

Via its firewall controls, Beijing blocks access to Chinese and Western websites it finds disagreeable. Internet users often manage to access many blocked sites via proxy servers and alternative networks, sometimes using software and solutions offered by foreign entities. The government is aggressively battling the influence of such technologies and persistently tries to debilitate the overseas servers that help Chinese citizens access the World Wide Web.\textsuperscript{39}


\textsuperscript{37} Nina Hachigian, "China's Cyber-Strategy," *Foreign Affairs* 80 (March/April 2001): 118.

\textsuperscript{38} “Ninth Comprehensive Survey,” *China Internet Network Information Center (CNNIC)*, January 2002.

In addition, press reports indicate that Beijing is relying on products from Western IT companies to help rein in what Beijing considers as subversion on the web. Such reports allege that companies have provided technologies that, while legal under the existing U.S. export regulations, have nevertheless aided the Chinese Government in sensitive areas such as remote surveillance, online censorship, and virus acquisition.\textsuperscript{40}

To complement controlling the web via technology, Beijing has also passed sweeping Internet regulations in the past two years prohibiting non-state sanctioned news and commentary. Internet content and service providers are required to maintain detailed records about their users, install software to record email messages sent and received, and send copies of any emails that violate PRC regulations to the relevant government agencies. Internet cafes have been forced to install filtering software that blocks or deletes sensitive web-content. Individuals seeking to spread democracy on the web have been arrested; websites that publish news and commentary that criticize the government have been fined or closed; internet cafes that do not properly catch their users’ online activities or filter out inappropriate sites have been warned or shut down.

Public security organs in the past two years have reportedly engaged in a massive recruiting effort for computer technicians to enhance the Internet police force, which has become the most important police branch inside the public security system in China.\textsuperscript{41} In April 2002, Beijing reaffirmed its resolve for Internet control when top public security officials declared that it was key to national security and social stability and that public security organs at all levels should carry out an "Internet struggle" to control the web.\textsuperscript{42}

Beijing has successfully convinced some American Internet companies such as Yahoo! to comply with its regulations and aid online censorship.\textsuperscript{43} America Online, in a joint venture with China's Legend Computers to develop a web portal, has not eliminated the option of turning over the names, emails or records of political dissidents if the Chinese Government demands them.\textsuperscript{44}

Even as China increases its control of the web with regulations and Western vendors' assistance, its efforts are largely implemented by self-censorship.\textsuperscript{45} Because all commercial websites must seek government licenses for business operation, cooperation with the authorities is crucial. Most major content providers dutifully self-censor content by deleting messages, warning users and blocking entry points to more sensitive sites. Websites that fail to comply may face punishment ranging from extraordinary fines to business closure.\textsuperscript{46}


\textsuperscript{41} "PRC Public Security Ministry Calls For Strict Control Over Internet," \textit{Hong Kong Ming Pao (Internet version)}, 13 April 2002, B14; translated in FBIS.

\textsuperscript{42} Vivien Fik-Kwan Chan, "Internet Crackdown Intensifies," \textit{South China Morning Post}, 17 April 2002.

\textsuperscript{43} Gutmann, "Who Lost China's Internet," 24.


\textsuperscript{45} Michael Chase and James Mulvenon, "You've Got Dissent! Chinese Dissident Use of the Internet and Beijing's Counter-Strategies," Rand Corporation (March 2002): xiii.

\textsuperscript{46} Gutmann, "Who Lost China's Internet," 24.
Chinese entrepreneurs view government censorship as only a necessary nuisance, stressing that censorship is a fact of life. Without their willful collaboration, it would be impossible for the government to monitor the multitude of information available on today's Chinese web. As one Chinese Internet executive put it, "The point is to make profits, not political statements."\(^{47}\)

While keen to control online content, the Chinese Government is also eager to develop Internet strategies and technologies that could be used in information warfare against the United States. Chinese hackers, encouraged or at least not discouraged by the government, have made no pretense about their interest in debilitating the U.S. financial, business or government networks.\(^{48}\) Other Internet users, much to the embarrassment of the government, have used the Internet medium to spread anti-American vitriol, as they did immediately after September 11.

**Traditional Media**

The state media has experienced further openness due to commercialization and the growth of advertising in the past two decades.\(^{49}\) Non-official books, television stations and newspapers have proliferated throughout the country.\(^{50}\) The sheer volume of available materials makes official censorship difficult, especially for smaller regional and provincial publications. In addition, many publishing houses and media sources, though still state owned, have adopted a more market-oriented approach to shaping public opinions.

However, Beijing continues to enforce its censorship guidelines by incentives for self-censorship and official intimidation. While repression may have decreased over the last decade, its methods and repressive nature have remained.\(^{51}\) Editors and journalists are still evaluated for promotions and given fringe benefits according to how well they adhere to the Party line.\(^{52}\) Scholars and writers operate under a "dui, well-entrenched leeriness" of censorship, grimly aware that politically incorrect speech might result in punishments such as the loss of employment, imprisonment, torture, or estrangement from family.\(^{53}\)

Where self-censorship fails, the government takes action against dissenting authors or liberal media sources with a high profile. Popular publications regularly face temporary shutdowns, forced dismissal of editors, and closure of online chat rooms due to criticisms of the government.

Beijing attempts to thwart new ways of greater media access. For instance, the spread of home satellite dishes in the 1990s has allowed many Chinese households to view alternative television programs. Earlier this year, the State Administration of Film, Radio and Television (SARFT) attempted to limit the reception of satellite television programs and ordered the dismantling of satellite dishes in Beijing and other major cities where the dishes have been erected without

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\(^{47}\) Chase and Mulvenon, "You've Got Dissent!," xlii.
\(^{50}\) Rowen, "The Growth of Freedoms in China," 20. China today has over 1,000 television stations and 2,000 newspapers. As of 1998, over 130,000 book titles were published, with 7.24 billion copies in print.
\(^{53}\) Perry Link, "The Anaconda and the Chandelier".

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official authorization.\textsuperscript{54} The SARFT is currently planning to create a uniform satellite platform, from which all foreign satellite programs will be broadcast from a Chinese controlled satellite to a Chinese audience that has been authorized to receive foreign television programs.\textsuperscript{55}

While China wants to control the media for propaganda purposes, it also has economic motives. The commercialization of the media has made it a lucrative business, and the government is eager to take advantage of rising advertising revenues. For instance, China Central Television (CCTV) garnered some US$662 million in advertising revenue in 2000, far outstripping the $3.6 million that the government contributed to CCTV.\textsuperscript{56} Refusal to liberalize the media industry then serves as a means to protect potential profits. Foreign investments in the Chinese media industry must leave the controlling stake to the state and abide by the government’s regulations on content examination.

In late 2001, Beijing presented an appearance of openness when it granted News Corp., AOL Time Warner and Hong Kong-based Phoenix TV limited permission to transmit programming into Guangdong Province. Critics have argued that this sign of openness has little substantive value, as many residents already receive signals to foreign programming from nearby Hong Kong. In addition, AOL Time Warner and News Corp. promised to ensure U.S. access for the state-run English language channel CCTV-9, and may in the end give Chinese Government propaganda a much-desired audience overseas.\textsuperscript{57}

Despite the commercialization and diversification of traditional media in China, it remains a vehicle of propaganda for the central government. Beijing’s efforts to control the free flow of information reflect its broader approach to maintain political stability while modernizing the overall economy. The Internet and the media, both of which have tremendous potential to further social and political openness, instead have been employed to suppress political dissidence and when convenient, to criticize the United States. (See Chapter 1 for further discussion of the Chinese media.)

\textbf{Other Civil and Political Freedoms}

China’s actions in the legal, labor, Internet, and media realms are all the more troubling in light of the regime’s harsh treatment of its own citizens across the board. For instance, China abuses ethnic minorities in Tibet and Xinjiang, enforces coerced abortions on women to carry out the one-child policy, and persecutes religious believers and political dissidents.

Most notably, the nation-wide crackdown on the pseudo-Buddhist sect Falun Gong since 1999 has revealed to the world the ugly, authoritarian side of the Chinese Government that remains unchanged after two decades of economic reform. The central government has dismissed, imprisoned, convicted, sent to reeducation-through-labor camps, confined to mental hospitals, and/or brain washed a vast majority of the Falun Gong believers.\textsuperscript{58} Detained believers have been

\begin{footnotesize}
\textsuperscript{54} Uren, Written Testimony.
\textsuperscript{55} Ibid.
\textsuperscript{56} Ibid.
\end{footnotesize}
subjected to regular beatings and extreme torture. According to various sources, approximately 200 Falun Gong members have died in police custody since the crackdown began.\textsuperscript{59}

Although Chinese citizens can and do worship in various state-sanctioned facilities and institutions, Beijing has regularly unleashed its security apparatus on other religious believers, such as Protestants who meet in house churches not directly under government control, Roman Catholics who pledge their allegiance to the Pope, Tibetan Buddhists, and Muslim Uighurs who are considered to be advocating independence for their respective autonomous regions. The government has systematically planned and implemented measures that would suppress religious dissent and have even advocated more clandestine methods for suppression because outright crackdowns prove to be cumbersome and not always effective.\textsuperscript{60}

Chinese citizens can do little about the abuses they face, especially since they do not enjoy the right to vote out their political leaders. When China began experimenting with village elections in 1987, it raised hopes in the West that the country was on a path toward democracy. In 1998, the National People's Congress even passed the Organic Law on Village Elections, which requires that village chairmen and village committees be chosen by direct, competitive elections in all of the country's approximately 1 million villages.\textsuperscript{61}

Though a majority of the provinces have carried out village elections, many of the elections suffer from serious procedural flaws. While Party members have been defeated at some elections, the CCP still dominates the local electoral process. Roughly 60 percent of the members elected to the village committees are Party members.\textsuperscript{62}

While there are efforts to introduce elections on the township level, they are not necessarily a precursor for democracy in China. The elections, as currently instituted, do not undermine the power of the Communist Party or limit its draconian policies.\textsuperscript{63}

When Hong Kong reverted to Chinese rule in 1997, many had hoped that mainland China would be positively influenced by Hong Kong's liberal society based on a rule of law. Though Hong Kong today remains one of the freest cities in Asia, disturbing signs of Beijing's attempt to interfere in its internal affairs regularly emerge. Some of the most notable incidents have included: the National People's Congress' overruling of the Court of Final Appeals (CFA), Hong Kong's highest court, in its first major constitutional decision under Chinese rule in June 1999; warning from the Mainland's top official in Hong Kong to the local media to refrain from broadcasting views and speeches about Taiwan independence as normal news items in March 2000; warning from another mainland official not to trade with Taiwanese businessmen who advocate independence in May 2000; and the re-election in 2002 of Chief Executive C.H. Tung,

\textsuperscript{59} Ibid.
\textsuperscript{63} Ibid.
who was backed by Beijing and was confirmed by an 800-member committee that answers to China.\textsuperscript{64} China today remains a place where freedom does not prevail.

**National Security Implications**

China's systemic, draconian suppression of political, labor and religious dissent in recent years reveals that the blossoming of trade has not deterred the government from maintaining its authoritarian grip on power. Instruments that could be used to promote liberalization, like the Internet and the media, are being used by the government to promote the interests of the Party.

**Recommendations:**

- Enforcement against the import of prison labor goods from China should be improved by shifting the burden of proof from the U.S. Government to companies that import such goods into the United States. Such companies would be required to certify, based on good faith efforts, that the products they are importing are not made by forced or prison labor. The Commission made recommendations to Congress on this issue in a May 2002 letter. (See the appendix for the letter to Congress and the accompanying recommendations.)

- The Commission recommends that Congress establish a corporate code of conduct for U.S. businesses operating in China. Aside from addressing traditional human rights and labor issues, the code should also mandate corporate responsibility in categories of special concern, such as the suppression of personal freedoms. Companies that fail to comply with the code of conduct should be afforded less favorable terms on Ex-Im Bank or OPIC-supported transactions or on other U.S. Government financial assistance.

- The Commission recommends that Congress request Voice of America, Radio Free Asia and other relevant government entities to seek ways to help Chinese Internet users access banned information sources.

- The Commission recommends that Congress request that the President direct the Department of Commerce and other relevant agencies to conduct a review of export administration regulations to determine whether to control the export of U.S. technologies that permit the Chinese government to surveil its own people or censor free speech.

Chapter 5 - China’s Growth as a Regional Economic Power

Key Findings

Cross-Strait Economic Relations

- Trade and investment between the Mainland and Taiwan have grown dramatically in recent years. Estimates of the cumulative level of investment by Taiwan firms in China are as high as $70 billion (far in excess of officially reported levels).

- The level of cross-strait business linkages is particularly significant in the computer electronics sector, with Taiwan manufacturers increasingly transferring production to the Mainland to remain competitive in the global supply chain. There is an ongoing debate within the Taiwan Government regarding whether to loosen existing restrictions on investment and technology transfers to the Mainland in its flagship semiconductor industry.

- Cross-strait economic linkages are likely to accelerate in the future now that both China and Taiwan are members of the WTO, and over time could help ameliorate political tensions between the two.

- The growing reliance of Taiwan firms on the Mainland as a manufacturing center raises concerns about Taiwan’s vulnerability to Chinese economic leverage, and correspondingly to U.S. dependence on items made in China for its computer electronics and other high-technology sectors.

Regional Impact

- China received nearly 40 percent of the foreign direct investment (FDI) inflows into Asia from 1995 – 2000. Cumulative U.S. FDI into China during this time period exceeded U.S. investment into any other Asian destination, except Japan, Hong Kong, and Singapore. Hong Kong reinvests a significant portion of its inward FDI in the Mainland.

- China far outpaced most of its Asian neighbors in terms of export growth over the past decade. Among Asian countries, China led the region in terms of export growth to the United States and now ranks second behind Japan as a source of U.S. imports.

- In addition to Taiwan, other developed countries in Asia, most notably Japan, are relocating significant manufacturing and research and development (R&D) capacity to China to take advantage of lower production costs.

- China’s enhanced economic standing in Asia has given it new political influence in the region as its trade with neighboring countries has increased rapidly in recent years.

- WTO accession may accelerate all of the above trends, enhancing China’s attractiveness as a destination for FDI, stimulating export production, and expanding intra-Asian trade.

Introduction

China’s rise as a global economic power has significant implications for its neighbors in Asia and for U.S. interests in the region. The trends that have already begun in this regard appear likely to accelerate as a result of China’s accession to the WTO. The intra-Asia balance of power, and
U.S.-Asia relations will be a focal point of U.S. economic and military strategic planning for the foreseeable future. Accordingly, it is essential that U.S. policymakers accurately assess how China's emergence as a major player in the global economy will impact the region as a whole.

Subsumed in this topic, but in many regards a separate issue from a U.S. strategic planning perspective, is the developing nature of cross-strait economic relations. The China-Taiwan economic relationship is undergoing fundamental change. Economic linkages are proliferating despite the ongoing political and military tensions. Moreover, both entities are now members of the WTO, a development that introduces a new structure to their economic relationship. Given the United States' direct stake in cross-strait relations, any new dynamic in the China-Taiwan relationship must be carefully monitored and planned for by U.S. strategic planners. The state of military frictions between the two sides, and the corresponding implications for U.S. national security, is the subject of Chapter 8.

Cross-Strait Economic Relations

Growing Cross-Strait Economic Integration

Cross-strait economic linkages, in both investment and trade, have expanded dramatically over the past decade. Despite ebbs and flows in the political relations between the two sides over that time, their economic relationship has grown steadily.

China today stands as Taiwan's third largest trading market, with total two-way trade valued at over $30 billion.¹ As reflected in Figure 5.1, Taiwan exports to China — which the Taiwan Government calculates as a composite of its direct exports to China plus 70 percent of its exports to Hong Kong — have increased from around $6 billion in 1990 to over $26 billion in 2000, while Taiwan's imports from China have expanded from approximately $342 million in 1990 to $6.2 billion in 2000, resulting in significant trade surpluses for Taiwan.

Figure 5.1
Taiwan's Trade With China

![Diagram showing Taiwan's trade with China from 1990 to 2001.](image)

Note: Export figures include direct exports to China plus 70 percent of exports to Hong Kong.

Source: U.S.-Taiwan Business Council/Taiwan Board of Foreign Trade

On the investment side, there is a great disparity between official and unofficial estimates of Taiwan investment in the Mainland. The Taiwan Government places significant restrictions on such investment, but Taiwan businesses have proven adept at circumventing them by, for example, investing in the Mainland via Hong Kong, the Cayman Islands and other third-party countries. While official Taiwan Government figures place Taiwan firms’ investment in the Mainland at $17 billion at the end of 2000, Taiwan officials readily admit that actual investment could be as high as $60-70 billion, which would account for 40 percent of Taiwan’s outward investment.\(^2\) Mainland investment in Taiwan is negligible as a result of Taiwan’s strict prohibitions on such investment.\(^3\)

**Figure 5.2**
Taiwan’s Pledged Cumulative Investments into China

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<tr>
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<td>6.32</td>
<td>16.29</td>
<td>22.68</td>
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<td>37.42</td>
<td>40.40</td>
<td>43.77</td>
<td>50</td>
</tr>
</tbody>
</table>

Source: U.S.-Taiwan Business Council/Taiwan Board of Foreign Trade

The most significant sector for cross-strait trade is computer electronics. Taiwan has been a dominant player in this industry for the past decade and its success has been one of the key drivers of its economic growth and development. More than half of Taiwan’s top ten manufacturing firms in 2000 were computer electronics manufacturing firms and Taiwan now supplies 60 percent of the world’s motherboards and is the world’s leading supplier of notebook computers, monitors, mice, keyboards, video cards, sound cards, on-off switches, LAN cards, graphic cards, scanners, and laser disk drives.\(^4\)

To maintain its competitive position in the computer electronics industry, Taiwan has increasingly looked to the Mainland as a low-cost manufacturing center. The degree of cross-strait integration in this sector is striking. As Meritt Todd Cooke of the American Institute in Taiwan testified:

> *The Taipei Computer Association reported in the same month [Feb. 2001] that 30 percent of Taiwan’s 411 high technology companies had established major investments in Mainland China and that fully 90 percent of those 411 companies planned to be invested*

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\(^2\) Ibid.


in China by the end of 2001. Lastly, China edged out Taiwan in 2000 for the first time for the number three slot in world IT [information technology] production value. China came in behind the US and Japan with $25.5 billion of production value against Taiwan in fourth place with $23 billion. The key point to note, however, is that Taiwanese companies generated fully 70% of that $25.5 production value in Mainland China.\(^5\)

Another significant element of cross-strait economic linkages is the growing number of Taiwan businessman residing and traveling to the Mainland. During its trip to China this past November, the Commission visited Kunshan, a city near Shanghai that has become an enclave of Taiwan-invested businesses, including high-tech manufacturers producing circuit boards, computers, and telecommunications equipment. The Commission members were told that 32 of the top 100 Taiwan firms had invested in Kunshan, which has attracted around $11 billion in foreign investment in the three pillar industries of precision machinery, chemicals, and information technology. During the Commission's visit to Taiwan in January, we were informed that some 400,000 to 700,000 Taiwan nationals live and work on the Mainland (representing 7-10 percent of Taiwan's entire labor force), concentrated in the high technology and high economic growth areas of Shanghai and Shenzhen.

**New Developments**

**Accession to the WTO**

Taiwan followed China into the WTO by officially becoming a member of the organization on January 1, 2002, three weeks after China's formal admission. Although Taiwan's accession negotiations generally had been concluded ahead of China's, Taiwan's formal admission was delayed until after China formally joined due to political considerations within the WTO. The Chinese Government ultimately did not contest Taiwan’s separate WTO membership on the grounds that this membership only recognized Taiwan as a separate trading entity, like Hong Kong, rather than a separate sovereign entity. Taiwan officially joined the WTO under the designation of the "Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu," also referred to as "Chinese Taipei".

During these early days of China's and Taiwan's membership in the WTO, there is a sense of optimism that it will improve cross-strait relations by increasing economic linkages and providing a forum for dialogue. This hopeful outlook was recently articulated by Dr. Ing-wen Tsai, Chairwoman of the Mainland Affairs Council of the Executive Yuan of the Republic of China (Taiwan):

> I would see the accession to the WTO as presenting a great opportunity for both sides to interact in a more structured and systematic manner, which is very much needed after more than a decade of exchanges between the two sides in trade, investment, and tourism. It would also help stabilize bilateral relations, which is very much needed for both sides to engage in their respective internal reforms. What is more significant, hopefully, is the possibility of both sides to use the WTO as a venue to open bilateral discussions on WTO issues and a bridge for discussions on a wider spectrum of issues in a separate context.\(^6\)

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6 Tsai, "A New Era in Cross-Strait Relations," 62.
At the same time, however, WTO membership creates new possibilities for bilateral tensions. As noted, China’s acceptance of Taiwan’s membership did not signal a new position by the Mainland on the political status of Taiwan. For example, if China refuses to recognize a formal trade dispute initiated by Taiwan or to otherwise accord Taiwan’s representatives to the WTO equal treatment with other members, this could become a new source of conflict.

The WTO membership of China and Taiwan in the WTO will likely accelerate the growing levels of Taiwan investment into China. While increasing economic linkages between the two could help ameliorate political tensions, it also has the potential to increase Taiwan’s economic dependence on China, and the security implications that go along with that dependence.

Easing of Restrictions on Cross-Strait Investment

To counter concerns about Taiwan’s growing economic integration with China, the Taiwan Government in 1996 instituted a “no haste, be patient” policy regarding investment in the Mainland, which, among other things, restricted investment in certain industries, including high-tech and infrastructure projects, and required special approval for individual investments greater than $50 million. The goal was to limit investment in the Mainland and thereby minimize Beijing’s ability to exert economic leverage. However, this policy did not effectively stem the flow of investment as Taiwan businesses found numerous ways to circumvent the restrictions.

In August 2001, the Economic Development Advisory Conference (EDAC), an influential group of Taiwan business, academic, and government leaders convened by the Taiwan Government, recommended relaxing the “no haste, be patient” policy in favor of one characterized as “vigorous liberalization and effective management” (also referred to as “active opening, effective management”), which would allow greater flexibility for investments in the Mainland. The EDAC further recommended opening up the “three links” across the Strait — trade, transportation, and communications. Taiwan President Chen Shui-bian promptly endorsed the Conference’s recommendations. The main drivers of this shifting approach to cross-strait economic relations appear to be pressure from Taiwan’s business community and the need to address the island’s current economic slowdown. Taiwan businesses, particularly in the information technology sector, see expansion of their operations in China as vital to remaining competitive in international markets. This is compounded by Taiwan’s current economic downturn, its worst in decades.

It is presently unclear how these new policies will be implemented in practice and what impact they ultimately will have on cross-strait investment. Taiwan’s political leaders likely will try to strike a balance between their country’s need for China as a production and export market and the security concerns raised by this economic integration. This is reflected in statements from Taiwan officials, such as Mainland Affairs Council Chairwoman Ing-wen Tsai:

On investment, we have developed a new investment review system that is transparent and flexible — a system to suit the needs of businesses and emphasizing macro rather than micro aspects of the investment flows. At the same time, we stress partnership

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8 Ibid.
between the government and business in managing risks associated with investment in China, which despite the opportunities offered, is still highly risky for investors and their home countries.\textsuperscript{10}

As Taiwan Government officials wrestle with the challenges of cross-strait economic ties, new business relationships are developing apace. In the past year, numerous new ventures were announced, including several in the strategically important energy and semiconductor sectors. The following are some of the most significant:

- **Chinese Petroleum Corp. (Taiwan) – China National Offshore Oil Corp. (China)** - These two state-owned firms controlled by their respective governments signed an agreement in May 2002 to set up a $25 million joint venture to conduct oil and gas exploration in the Taiwan Strait. Executives of the two companies have expressed an interest in expanding the venture to conduct joint oil and gas development in the future.\textsuperscript{11}

- **China Airlines (Taiwan) – China Eastern Airlines (China)** - China Airlines, Taiwan's flagship carrier, negotiated to buy a 25-percent stake in China Eastern Airlines' cargo subsidiary (China Cargo). China Eastern is one of the Mainland's largest domestic passenger carriers.\textsuperscript{12}

- **Sampo Group (Taiwan) – Haier Group (China)** - The biggest consumer appliance makers in Taiwan and China have formed an alliance to sell each other's products. Sampo will sell Haier-made refrigerators, television sets and washing machines under its own brand name in Taiwan, while Haier will sell Sampo DVD machines and flat-screen TV sets in China. Sampo may eventually manufacture products for Haier on a contract basis in its mainland factory.\textsuperscript{13}

- **Taiwan Power Co.** - Taipower signed one-year contracts for the purchase of 1.2 million tons of mainland coal – roughly 10 percent of the company's total demand. Taipower has also been in touch with mainland authorities on storing low-level waste from Taiwan's three nuclear power plants.\textsuperscript{14}

- **Taiwan Semiconductor Manufacturing Co. and United Microelectronics Corp.** - Taiwan's two largest semiconductor manufacturers have both indicated intent to build plants on the Mainland to produce eight-inch wafers if the Taiwan Government loosens current cross-strait investment restrictions in this sector (see discussion below).\textsuperscript{15} Former United Microelectronics Corp. executives have reportedly been involved in the establishment of a semiconductor plant that broke ground on the Mainland earlier this year.\textsuperscript{16}

- **Grace Semiconductor Manufacturing and Semiconductor Manufacturing International Co.** - These two firms, which have Taiwan investors, have already set up shop on the Mainland to produce eight-inch wafers. Grace is a joint venture between Winston Wang, son of a powerful Taiwan industrialist, and Jiang Mianheng, son of PRC President Jiang Zemin.\textsuperscript{17}

\textsuperscript{10} Tsai, "A New Era in Cross-Strait Relations," 63.
\textsuperscript{11} Jason Dean, "Oil Firms From China, Taiwan Sign Joint Exploration Deal," *Asian Wall Street Journal*, 17 May 2002, A3.
\textsuperscript{12} Eric Ng, "Cross-strait pact takes off," *South China Morning Post*, 30 August 2001; Joseph Lo, "China Air buys stake in Eastern Cargo," *South China Morning Post*, 7 September 2001.
\textsuperscript{17} Landler, "From Taiwan, A Fear of China Technology," sec. C, p. 1; Luh, "Taiwan Strait just Wafer-Thin."
The semiconductor industry has been the pride of Taiwan’s high-technology sector and Taipei’s deliberations over how to address mainland investment in this industry illustrate the conflicting pressures facing Taiwan in its ongoing efforts to manage cross-strait economic relations. Taiwan semiconductor manufacturers are pushing for a loosening of constraints on their ability to set up manufacturing facilities on the Mainland, while there are conflicting concerns that this would lead to a “hollowing out” of Taiwan’s manufacturing capabilities in this industry and would give the Chinese access to cutting-edge technology that could pose a security risk. During the Commission’s trip to Taiwan this past January, Morris Chang, President of Taiwan Semiconductor Manufacturing Company (TSMC), told the delegation that his interest was to produce only older generation 8-inch wafers on the Mainland, and not any of the advanced 12-inch wafers.

On March 29, 2002, Taiwan Premier Yu Shyi-kun announced a new policy regarding investment by Taiwan firms in semiconductor manufacturing facilities on the Mainland. The new policy would allow up to three Taiwan firms to set up 8-inch wafer plants on the Mainland by 2005 provided they transfer only second-hand equipment to these plants and only if they have constructed more advanced 12-inch wafer foundries in Taiwan that have reached “stable levels of basic production.” This policy has not been finalized and reportedly is still being hotly debated within the Taiwan Government.

**National Security Implications**

The expansion of cross-strait economic linkages is a dynamic that may operate to minimize the prospects for hostilities by developing commercial relationships that give both sides a vested interest in peaceful relations and by opening new channels for dialogue. But this dynamic raises corresponding concerns about economic dependence and the possible leverage this may give China over Taiwan. The future direction of cross-strait economic relations is of enormous significance to U.S. national security given that the state of cross-strait relations is a potential flashpoint in the U.S.-China relationship. Moreover, given the growing integration between China and Taiwan in the global supply chain for high-technology goods, the state of their relations has a direct impact on an industry key to U.S. economic health.

The following are key indicators the Commission will continue to examine to assess the impact of cross-strait economic integration on U.S. national security:

**Taiwan’s Economic Dependence on the Mainland**

By all accounts, Taiwan sees trade and investment with the Mainland as a key to its future economic growth, particularly with regard to high-technology goods. China offers Taiwan a low-cost production center for manufactured goods, an increasingly essential need in order for Taiwan companies to stay internationally competitive in this sector, as well as an enormous potential market for these goods.

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But this economic strategy comes with risk, as it links Taiwan’s economic well-being to the shifting currents of cross-strait relations. Deterioration in these relations could lead China to exercise economic leverage over Taiwan by threatening to restrict or cut off Taiwan’s trade and investment with the Mainland. China might even take (or threaten to take) the provocative step of seizing Taiwan assets located on the Mainland. It is more likely, however, that China will seek to exercise its economic leverage in indirect ways, including attempting to influence the Taiwan business community (which wields substantial political clout in Taipei). To this end, the Commission has learned of instances where China has exerted pressure on Taiwan businessmen operating, or seeking to operate, on the Mainland to support pro-Beijing policies.20

The presence of hundreds of thousands of Taiwan businessmen resident on the Mainland presents another security risk for Taiwan as these individuals might be at risk in the event cross-strait relations took a turn for the worse. Further, if the community of Taiwan businessmen on the Mainland was forced by the Chinese Government (or otherwise felt compelled) to return home, Taiwan could face a significant employment crisis.

**China’s Economic Dependence on Taiwan**

China reaps substantial economic benefits from its trade and investment relationship with Taiwan. As noted above, Taiwan’s cumulative investment into China is estimated to be around $70 billion and it is increasingly focused on the production of high-technology goods. The Commission again notes the testimony it received that 70 percent of China’s $25.5 billion in information technology production value in 2000 was attributable to Taiwan-invested firms. Further, Taiwan officials estimate that Taiwan investment on the Mainland has contributed to the creation of at least 3 million jobs.21 It seems clear that an increasing number of Chinese businesses are becoming vested in the cross-strait economic relationship, creating a growing force within China for moderating tensions with Taiwan. The extent to which these economic benefits factor into China’s posture toward Taiwan may be modest at present, but may become an increasingly important component of Beijing's political calculations should the economic relationship continue to grow.

**U.S.-China-Taiwan Triangular Relationship**

The integration between Taiwan and China in the high-technology goods supply chain creates a triangular relationship with the United States that presents both economic benefits as well as strategic challenges. In terms of economic efficiency, this triangular relationship allows the three parties to maximize the efficient use of their resources: U.S. research and development, Taiwan manufacturing, management and marketing know-how, and Chinese low-cost labor and production. High-technology goods and services have been a key driver of the U.S. economy over the past decade or more, with the United States leading the way in the innovation and development of these items. During this same time period, Taiwan established itself as a preeminent manufacturer of semiconductors and other high-technology products. The latest development has been the outsourcing of production by Taiwan businesses of these products to the Mainland.

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21 Tsai, "A New Era in Cross-Strait Relations," 63.
Through this triangular relationship, the U.S. high-technology industry is becoming increasingly reliant on mainland production, heightening the economic stakes of any cross-strait hostilities. Any disruption in this supply chain could reverberate through the U.S. economy via a slump in the technology sector. To illustrate this point, Merritt Cooke of the AIT told the Commission that when a severe earthquake hit Taiwan in September 1999, the tech markets in New York dropped more in percentage terms than in Taipei.\(^{22}\) Tellingly, news reports indicate that representatives of Dell Computer, a U.S. firm that is the largest buyer of laptop computers from Taiwan companies, have been pressuring Taiwan officials to establish direct trade and transportation ties with the Mainland.\(^{23}\) This may be indicative of a larger trend of U.S. businesses joining many in the Taiwan business community in pressuring Taiwan’s leaders toward more economic integration with the Mainland.

The WTO accession of China and Taiwan and the expected expansion of economic linkages between the two might well make the U.S. economy even more vested in peaceful cross-strait relations. Rupert Hammond-Chambers, President of the U.S.-Taiwan Business Council, testified:

The opening of cross-strait trade and the accession of Taiwan and China to the WTO will highlight this trend and further strengthen the economic inter-dependency between them and with the United States, but that will make the U.S. that much more reliant on an improvement in cross-strait relations for its own economic well-being as American technology products are increasingly produced in one of the world’s most potentially dangerous areas.\(^{24}\)

China and Taiwan in the WTO

The entry of both China and Taiwan into the WTO provides a new forum for dialogue as well as disputes between these parties. At the outset, there have been some positive indications about how the two may interact within the organization. As discussed above, the GATT/WTO made a decision to allow China to formally enter the organization ahead of Taiwan, regardless of the status of their respective accession negotiations. Some observers feared that China would use this sequential accession to block or otherwise hold up Taiwan’s accession. In the end, China took no such action and Taiwan formally joined the WTO three weeks after China. Another positive sign was that neither side chose to invoke WTO Article XIII, a provision allowing a member to opt out of the WTO agreement with regard to another member. Nonetheless, China and Taiwan are likely to have an uneasy coexistence in the organization, particularly during the early years of their membership.

WTO accession likely will accelerate cross-strait economic linkages as trade barriers between the two sides are reduced. Trade disputes inevitably will arise that will test their relationship within the organization. If China engages Taiwan in a formal dispute, thereby recognizing Taiwan as an independent member of the organization, China would be demonstrating a willingness to separate its political conflict with Taiwan from its economic relationship. However, China may refuse to formally recognize disputes initiated by Taiwan or work to prevent such disputes from reaching formal dispute settlement in order to avoid such engagement.

\(^{22}\) Cooke, Written Testimony, 1.
\(^{24}\) Hammond-Chambers, Oral Testimony, 241.

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The WTO offers China and Taiwan a forum for dialogue outside of the formal government-to-government arena. Under the umbrella of a discussion between two "trading partners" rather than two governments, the two sides may be able to make positive progress on both trade and, potentially, non-trade matters.

Based on discussions the Commission had in Geneva with WTO officials and representatives of various member country delegations, the Commission understands that there have been some initial tensions between China and Taiwan in the early months of their WTO membership. China has apparently admonished WTO officials for inadvertently referring to Taiwan's representative to the organization as "ambassador" and is protesting Taiwan's use of the term "ministries" to reference its governmental entities in documents it submitted to join the WTO's Government Procurement Agreement.

The United States has a national security interest in a stable cross-strait relationship. The growing economic linkages between China and Taiwan may help to achieve this goal. Nonetheless, if China attempts to exercise its considerable economic leverage over Taiwan in an aggressive manner, the result will likely be a heightening of tensions between the two. The Commission will continue to closely monitor the nature and status of cross-strait economic integration and to assess its implications on broader cross-strait relations.

**Future of Hong Kong**

For decades, Hong Kong played the role of gateway to the mainland market, a role many believed might expand following its transfer to mainland control in 1997 as a Special Administrative Region. The past few years, however, have seen the rise of Shanghai as an important business center and with that concerns about Hong Kong's long-term role. The Commission believes it is important to monitor the economic future of Hong Kong as a barometer of the Mainland's development as a sophisticated business and financial center and as an indicator of the success or failure of the "one country, two systems" policy governing its integration into the Mainland.

Hong Kong remains an important flow-through point for mainland trade and investment. According to Hong Kong data, nearly 90 percent of Hong Kong's exports to China during the past few years (1998-2000) were "re-exports" (i.e., goods that were imported by Hong Kong and then exported to the Mainland, often after receiving some additional processing in Hong Kong).25 More significantly, while specific data is unavailable, it is believed that the vast majority of China's exports to Hong Kong are "re-exported" by Hong Kong to other countries after packaging or further processing since the bulk of these imports are electrical and other machinery, toys, sporting equipment, apparel, and footwear.26

Hong Kong's inward FDI flows increased dramatically in 1999 and 2000, surpassing the amount going into China by more than $20 billion in 2000.27 Chinese statistics indicate that over the past several years around 40 percent of China's inward FDI came from Hong Kong, suggesting that a

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26 Ibid., 4.
significant portion of that FDI likely was destined for the Mainland from the outset. This mechanism is used by Taiwan businesses to circumvent Taiwan’s mainland investment restrictions, by Chinese investors “round tripping” their money to obtain the favorable treatment available on the Mainland for foreign investment, and by investors in other countries who may be seeking to conceal that the Mainland is their actual investment destination.

Many observers see the expansion of direct trade and investment flows to the mainland market, with no bypass through Hong Kong, as a sign that its role as a gateway may be diminishing. Moreover, the Chinese leadership has made it a priority to develop Shanghai into a preeminent Asian business and financial center, as witnessed by the development of the Pudong financial district. China’s leaders have made no secret of their desire to see Shanghai overtake Hong Kong as the key financial hub for Greater China. In fact, Premier Zhu Rongji told reporters in 1999 that he saw Shanghai as China’s New York and Hong Kong as its Toronto.

Hong Kong’s status as a Special Administrative Region of China and the dynamic of the “one country, two systems” structure has allowed the city to remain for the most part an independent economic entity that is still ranked by some as the world’s “freest economy.” Nonetheless, as Hong Kong’s economy stagnates in the wake of the Asian financial crisis and the current global economic slowdown, it has been seeking greater integration with the Mainland, including preferential treatment for its firms over other “foreign” competitors, through the establishment of a free-trade arrangement with the Mainland – the so-called Closer Economic Partnership Agreement (CEPA).

The future role Hong Kong will play in a Greater China and in Asia is still uncertain. The Commission will continue to monitor economic developments in Hong Kong and assess the implications for U.S.-China trade relations and for the region as a whole.

Impact on Asian Region

Asia is a region of vital importance to U.S. national security as it is home to key U.S. allies and trading partners. One of the stated U.S. goals for supporting China’s WTO accession was that it would enhance regional economic prosperity and foster peaceful intra-Asia relations. The Commission intends to test this assumption, as there have been some indications that China’s growing economic dominance in the region could have negative implications for neighboring economies.

Several key questions must be examined to assess China’s economic impact on its neighbors. First, to what degree is China attracting needed capital and export markets away from other Asian economies and how have U.S. investment and import patterns in Asia changed over the last decade? Second, will China grow to the point where it becomes a major investor and trade partner for its neighbors? In other words, the Commission will examine whether the growth of China as an economic power represents a zero sum game for other Asian nations in terms of their own economic growth or an economic engine that adds to the region’s economic prosperity.

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29 "Clouds over Hong Kong," The Economist, 14 August 2001, 57.


If China becomes a more significant trade and investment partner with the Association of Southeast Asian Nations (ASEAN) and other Asian nations, the dominant role the United States and Japan have played in this regard may diminish, which may lessen their political influence in the region as well.

In beginning to examine these questions, it is helpful to look at some of the basic trends that have emerged over the past decade. Figure 5.3 below indicates that China received nearly 40 percent of total FDI inflows into Asia ($245.1 billion out of $643.3 billion) from 1995-2000. China and Hong Kong together received nearly 60 percent of total FDI inflows into Asia during that period. China’s significant levels of inward foreign investment have in part been driven by investment from Hong Kong, which, as discussed above, accounts for around 40 percent of China’s annual inward FDI (thereby making any summing of China’s and Hong Kong’s inward FDI levels involve a certain measure of double-counting). FDI inflows into China increased to $46.8 billion in 2001, and are expected to grow significantly in future years in the wake of its accession to the WTO.

**Figure 5.3**

*World FDI Inflows into Asia, 1995-2000 (Billions of U.S. Dollars)*

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<td>3.3</td>
<td>12.7</td>
<td>8.2</td>
<td>27.6</td>
</tr>
<tr>
<td>Indonesia</td>
<td>4.3</td>
<td>6.2</td>
<td>4.7</td>
<td>(0.4)</td>
<td>(2.7)</td>
<td>(4.6)</td>
<td>7.5</td>
</tr>
<tr>
<td>Korea, Rep. of</td>
<td>1.8</td>
<td>2.3</td>
<td>2.8</td>
<td>5.4</td>
<td>10.6</td>
<td>10.2</td>
<td>33.1</td>
</tr>
<tr>
<td>Malaysia</td>
<td>5.8</td>
<td>7.3</td>
<td>6.5</td>
<td>2.7</td>
<td>3.5</td>
<td>5.5</td>
<td>31.3</td>
</tr>
<tr>
<td>Philippines</td>
<td>1.5</td>
<td>1.5</td>
<td>1.2</td>
<td>1.8</td>
<td>0.7</td>
<td>1.5</td>
<td>8.2</td>
</tr>
<tr>
<td>Singapore</td>
<td>8.8</td>
<td>10.4</td>
<td>13.0</td>
<td>6.3</td>
<td>7.2</td>
<td>6.4</td>
<td>52.1</td>
</tr>
<tr>
<td>Taiwan</td>
<td>1.6</td>
<td>1.9</td>
<td>2.2</td>
<td>0.2</td>
<td>2.9</td>
<td>4.9</td>
<td>13.7</td>
</tr>
<tr>
<td>Vietnam</td>
<td>2.3</td>
<td>2.5</td>
<td>2.8</td>
<td>2.3</td>
<td>2.0</td>
<td>2.1</td>
<td>14.0</td>
</tr>
</tbody>
</table>

Source: World Investment Reports, UNCTAD, 2001

As shown in Figure 5.4, cumulative U.S. FDI flows into China of $6.8 billion for the period from 1995 through 2000 exceed U.S. FDI flows into other Asian markets, with the exception of Japan, Hong Kong, and Singapore. Combined U.S. FDI into China and Hong Kong exceeded U.S. FDI into any of China’s neighbors, with the exception of Japan. Notably, these figures suggest that U.S. investment in China remained fairly steady through the Asian financial crisis in 1997-98, while it dropped off in those years to some of the ASEAN nations, particularly Indonesia, Malaysia, and Thailand.
China’s growth in merchandise exports over the past decade far exceeded most of its neighbors, with the exception of the Philippines and Vietnam (whose export values were only a fraction of China’s total). Changes in export value and growth rates for the Asian economies are shown in Figure 5.5.

As indicated in Figure 5.6, China led the Asian region in terms of growth in merchandise exports to the U.S. market over the past decade, with such exports growing more than six-fold (Vietnam grew by a higher percentage, but is not yet a significant trading partner of the United States). Japan began and ended the time period as the leading Asian source of U.S. merchandise imports; however China’s rapid growth in exports to the United States during that period allowed it to significantly close the gap.
Figure 5.6
Growth in U.S. Merchandise Imports from Asia, 1990-2000 (Billions of U.S. Dollars)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>15.2</td>
<td>45.6</td>
<td>199%</td>
<td>100.1</td>
<td>557%</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>9.5</td>
<td>10.3</td>
<td>8%</td>
<td>11.5</td>
<td>21%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>3.3</td>
<td>7.4</td>
<td>122%</td>
<td>10.4</td>
<td>211%</td>
</tr>
<tr>
<td>Japan</td>
<td>90.4</td>
<td>123.6</td>
<td>37%</td>
<td>146.6</td>
<td>62%</td>
</tr>
<tr>
<td>Korea, Rep. of</td>
<td>18.5</td>
<td>24.2</td>
<td>31%</td>
<td>40.3</td>
<td>118%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>5.3</td>
<td>17.5</td>
<td>232%</td>
<td>25.6</td>
<td>385%</td>
</tr>
<tr>
<td>Philippines</td>
<td>3.4</td>
<td>7.0</td>
<td>107%</td>
<td>13.9</td>
<td>312%</td>
</tr>
<tr>
<td>Singapore</td>
<td>9.8</td>
<td>18.6</td>
<td>89%</td>
<td>19.2</td>
<td>95%</td>
</tr>
<tr>
<td>Taiwan</td>
<td>22.7</td>
<td>29.0</td>
<td>28%</td>
<td>40.5</td>
<td>79%</td>
</tr>
<tr>
<td>Thailand</td>
<td>5.3</td>
<td>11.4</td>
<td>114%</td>
<td>16.4</td>
<td>210%</td>
</tr>
<tr>
<td>Vietnam</td>
<td>0.0</td>
<td>0.2</td>
<td>---</td>
<td>0.8</td>
<td>---</td>
</tr>
</tbody>
</table>

Source: USITC Databank

The implications of China’s emergence as a regional trade and investment powerhouse are well understood by its neighbors. In a recent speech, Singapore Trade and Industry Minister George Yeo explained that “[i]n 1990, China accounted for less than 20% of total foreign investments in developing Asia, while Southeast Asia took 60%. Today, the numbers are reversed.” 32 Jin Nyum, South Korea’s Economic and Finance Minister, remarked that China is becoming a “juggernaut in the global economy, turning itself into the world’s manufacturing plant, which will suck all manufacturing facilities into it like a black hole.” 33 South Korea’s Trade Minister, Hwang Doo-yun, noted that “[w]e are losing competitiveness (to China) in areas of light manufacturing industries that are at the lower end of the market, and they (China) are also very rapidly coming up in areas that are technology-intensive. That is a serious problem.” 34

In addition to seemingly drawing investment dollars and export markets away from its Asian neighbors, China is drawing jobs as well. Taiwan’s transfers of manufacturing facilities to the Mainland were discussed above. Japan is also shifting segments of its manufacturing industry to China to take advantage of China’s lower production costs and market potential. Japanese electronics manufacturers, including Toshiba, Sony, Matsushita Electric Industrial, and Canon have all announced plans to expand manufacturing operations in China. 35 In many instances research and development activities are following to access China’s growing pool of low-cost engineering talent. According to news reports, Matsushita has opened a research and development laboratory for household appliances in Suzhou, the Nomura Research Institute has begun outsourcing software projects to China, and Toshiba is planning a tenfold increase in the number of engineers at its chip development center in Shanghai. 36 Hitachi, Sony Pioneer,

Fujitsu, and NEC reportedly are among other major Japanese firms that have announced plans to establish research and development units in China as well.\textsuperscript{37}

While there are indications that China may be diverting trade and investment away from some of its neighbors, there are also indications that China is expanding its own trade with many of these countries. According to a report issued by the Singapore Government, bilateral trade between China and the ASEAN-5 (Singapore, Indonesia, Thailand, Malaysia, and the Philippines) has expanded at an average rate of 16 percent per year, growing from $7.1 billion in 1990 to $29.6 billion in 2000, with ASEAN-5 imports from China generally running only modestly ahead of exports.\textsuperscript{38} The report further noted that while China has not been a significant investor to date in the ASEAN region, "[w]ith the PRC continuing its economic reform and its transition to a market economy, it will play an increasingly important part as a key exporter of capital to Asia."\textsuperscript{39} In January 2002, CNOC, China's state-owned offshore oil company, reportedly paid $585 million to a Spanish firm to acquire its assets in a major Indonesian oil company.\textsuperscript{40}

In addition to its WTO entry, China is expanding its economic integration with its Asian neighbors through other arrangements. At the ASEAN summit in November 2001, ASEAN leaders endorsed a proposal to create a free-trade area with China over the next 10 years.\textsuperscript{41} This arrangement suggests both a desire by the ASEAN countries to take advantage of China's economic growth through expanded market access and a strategy by China to prevent its Asian trading partners from throwing up protective barriers. A report prepared by an ASEAN-China joint experts group predicts that an ASEAN-China free-trade agreement would increase ASEAN's exports to China by 48 percent and China's exports to ASEAN by 55 percent, and would increase ASEAN GDP by 0.9 percent and China's GDP by 0.3 percent.\textsuperscript{42} Such an arrangement would establish China as the leader of an economically powerful Asian trading block, one that can be expanded to cover a broader area of Asia in the future.

National Security Implications

Loss of Trade and Investment

There are a number of reasons that the leading Asian economies are presently undergoing economic slowdowns and experiencing financial instability. Many of these economies have never fully recovered from the Asian financial crisis of the late 1990s and are still struggling to implement necessary structural economic reforms. Compounding these problems is the global economic slowdown, particularly in the United States, which is impeding their ability to export their way back to financial health.

It is clear, however, that these countries are becoming increasingly concerned about how their economies are being impacted by China's emergence as a regional economic power. China is

\textsuperscript{37} Ibid.
\textsuperscript{38} "China's Rising Investment In Southeast Asia: How ASEAN And Singapore Can Benefit?" Singapore Ministry of Trade and Industry, 2001 Annual Report, 99.\textsuperscript{43}
\textsuperscript{39} Ibid., 100.
\textsuperscript{40} Sadanand Dhume and Susan V. Lawrence, "Buying Fast into Southeast Asia," \textit{Far East Economic Review}, 28 March 2002.
\textsuperscript{42} "ASEAN Secretary-General Calls For ASEAN Economic Integration To Compete With China" ASEAN Press Release, 7 March 2002 <http://www.aseansec.org/%5Cnewdata%5Casean_compete.htm> (17 June 2002).
garnering levels of FDI well in excess of its neighbors and its export growth is ahead of most as well. In addition, many Asian economies can no longer compete against China as a low-cost manufacturing center and their manufacturers consequently are moving significant facilities there. While continued analysis is needed to assess the extent to which China's increasing FDI and export production levels are displacing trade and investment in other Asian countries, it seems evident that China's emergence as a major trading nation has to some degree been at the expense of its neighbors.

China's WTO entry likely will accelerate these current trends. China's attractiveness as a destination for FDI should be enhanced post-accession. Moreover, as trade barriers to Chinese goods are lowered by WTO members, China's export production may surge as well, displacing exports from its neighbors and potentially lowering world market prices for many of these items. At the same time, however, a more open Chinese market may create new export opportunities for its neighbors and China's economic growth may lead it to become a significant source of investment capital for its neighbors.

China's entry into the WTO will not impact all of its neighbors equally. Those countries whose economies are the most dependent on labor-intensive exports (e.g., textiles, electronic goods) can be expected to be the most negatively impacted as they compete directly with Chinese exports, while countries that produce higher-end goods, or produce exports for which China is a significant importer (e.g., certain electrical components, mineral/natural resource products), are more likely to be positively impacted.

The United States has a clear strategic interest in the financial stability and continued economic development of its key Asian allies. Promoting Asian economic integration was a stated goal of U.S. support for China's WTO membership. However, as the foregoing discussion highlights, it is not clear whether China's WTO accession will have positive or negative economic implications for its Asian neighbors over the long-term. If China's future economic growth comes at the expense of its neighbors, the consequences could include a more severe Asian financial crisis coupled with social and political instability in the region.

Growing Regional Influence

China's influence in Asia has been enhanced as a result of its growing economic clout. Many of the Asian economies that have traditionally seen the United States as their major trading partner are now looking to strengthen their trade ties with China. The decision by ASEAN leaders last November to pursue a free-trade area with China demonstrates this trend. At the ASEAN summit where the proposal was approved, Singapore Prime Minister Goh Chok Tong noted that "[w]e depend on the U.S. alone as a market for growth for east Asia will be much more difficult in the future, because the U.S. economy is going to slow down."

Japan has become increasingly wary of China's growing influence in the region and reportedly was shocked when it learned of the proposed China-ASEAN free-trade area. During Japanese Prime Minister Koizumi's trip to the ASEAN region in January, he floated the concept of establishing a broad-based Asian "economic community," that would include China, perhaps to counter China's attempts to forge its own regional free-trade relationships.

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The United States has a critical interest in China's economic integration in Asia because it gives all parties a vested interest in avoiding hostilities. At the same time, China's economic integration with its neighbors raises the prospect of an Asia economic area dominated or significantly influenced by China. If so, the United States may find that its leverage and influence in the region, even with its traditional Asian allies, may wane to some degree, particularly with regard to economic and trade matters.

**Recommendation**

- The Commission recommends that the Congress should encourage the Administration to initiate consultations with other Asian countries to assess and make recommendations on the impact of the "hollowing-out" phenomenon with respect to China on regional economies and on U.S. economic relations with the region.
Chapter 6 - China's Presence in U.S. Capital Markets

Key Findings

- Foreign investment, in the form of foreign direct investment (FDI) and debt and equity offerings in overseas capital markets, has played an important role in meeting China's capital requirements to date, and likely will continue to play an important role in the future.

- The Chinese Government (through sovereign bond offerings) and Chinese state-owned and other enterprises have raised significant funds in overseas capital markets in recent years, including the U.S. capital markets. By some estimates, Chinese entities have raised more than $40 billion in international equity markets over the past decade, with more than $14 billion raised through initial public offerings in the U.S. capital markets in the past three years. Chinese issuers have raised an estimated $20 billion over the past decade from international bond offerings denominated in U.S. dollars.

- Chinese firms raising capital or otherwise trading their securities in the U.S. markets have predominantly been major state-owned enterprises, some of which have ties to China's military, defense industry, or intelligence services. There is also concern that some Chinese firms accessing the U.S. capital markets may be assisting in the proliferation of weapons of mass destruction or ballistic missile delivery systems. The Chinese Government's bond offerings, which have been purchased by U.S. institutional and other investors, provide scant detail on the use of the proceeds raised from such offerings.

- The U.S. Government lacks adequate institutional mechanisms to monitor national security concerns raised by Chinese and other foreign entities seeking to raise capital or otherwise trade their securities in the U.S. debt and equity markets. Moreover, Securities and Exchange Commission (SEC) reporting requirements for foreign registrants provide insufficient disclosure to the investing public of the national security risks related to certain foreign entities' global business activities, including the material risks associated with entities that do business in terrorist-sponsoring states.

Introduction

As a component of the Commission's statutorily mandated assessment of the trade and capital flows between the United States and the People's Republic of China, the Commission examined the national security implications of the significant presence of Chinese entities in the U.S. capital markets. China's economic growth and development has been powered to a large extent by foreign investment. While the bulk of this investment has been in the form of FDI, an important element in recent years has been foreign investment accumulated through the debt and equity offerings of Chinese entities in overseas capital markets, particularly in the U.S. markets.

The past few years have seen numerous Chinese companies, including some of China's largest state-owned enterprises (SOEs), enter the U.S. capital markets and raise impressive sums of money. Moreover, Chinese U.S. dollar-denominated bond offerings have netted substantial sums as well. Given China's projected capital needs over the coming decade, as discussed in Chapter 3, it appears likely that the Chinese Government and Chinese SOEs will continue to look to the U.S. capital markets as a key source of financing.
The presence of Chinese debt and equity offerings in the U.S. capital markets raises U.S. national security concerns that have not been adequately examined to date. The Commission is concerned about the identities and nature of the Chinese companies accessing the U.S. capital markets. Specifically, the extent to which they have ties to the People's Liberation Army (PLA) or components of China's defense industry, intelligence services, or are assisting in the proliferation of weapons of mass destruction or ballistic missile delivery systems. The Commission is also concerned with those entities operating in U.S.-sanctioned countries, or are otherwise engaged in activities inimical to U.S. interests. Second, the important role the U.S. capital markets play as a source of funding for Chinese entities suggests an area of leverage for the U.S. in its relationship with China that should be assessed as a potential sanctions tool for combating China's proliferation activities and other actions inimical to U.S. security interests.

The Commission devoted particular attention over the past year to examining these issues in an effort to raise awareness of this emerging national security concern. The Commission held a full-day hearing on this topic on December 6, 2001, receiving testimony from a broad spectrum of witnesses including Senator Fred Thompson, U.S. intelligence officials, experts on the Chinese economy, investment analysts, major institutional investors, and Wall Street representatives. Additionally, the Commission contracted with outside researchers to provide detailed assessments of China’s capital needs and the scope of its activities in U.S. and other international capital markets.¹

Chinese Debt and Equity Offerings in International Capital Markets

According to an analysis done by Morgan Stanley Dean Witter and the Wall Street Journal, reprinted in Figure 6.1, Chinese firms raised approximately $41 billion through initial public offerings (IPOs) and placements in international equity markets from 1993 through 2000, $21 billion in 2000 alone. This analysis did not cover 2001, but other sources indicate that there was a significant drop-off last year due to the global economic downturn.

Figure 6.1
Chinese Equity Fundraising: Domestic and International Markets

Source: Morgan Stanley Dean Witter/Wall St. Journal

Figure 6.1 also shows the comparative amounts raised on domestic and overseas markets. The amounts raised domestically have historically exceeded the amounts raised on overseas markets, often by a significant margin. In 2000, overseas equity fundraising by Chinese entities overtook domestic equity fundraising for the first time. Given the curtailment in Chinese overseas offerings in 2001, it can be expected that the amount generated on domestic markets last year again exceeded overseas fundraising.

China has also raised significant sums internationally through its sovereign and corporate bond offerings. As shown in Figure 6.2, Chinese sovereign bonds garnered $8.5 billion and corporate bonds raised $26 billion from 1986 through 2001. With regard to the corporate bond offerings, only certain types of state-controlled entities – international trade and investment corporations (ITICs), state-owned banks and enterprises, and Hong Kong-based SOEs - have raised capital through international bond sales. The bulk has been raised by the ITICs, a class of Chinese financial institution, under the control of the central or a provincial or municipal government, that nominally raises foreign capital for infrastructure development but often invests instead in real estate or the stock market. When the Guangdong ITIC (known as GITIC) defaulted on payments to its creditors in 1996-97, and the central government did not step in to pay off the debts, the ITIC lost its credibility as a vehicle for raising capital. The problems with the ITICs, coupled with the Asian financial crisis, led to a significant reduction in Chinese international bond fundraising beginning in 1998.
Figure 6.2
Chinese International Bond Offerings: Grouped by Issuer Type

Source: Bloomberg Professional Service (data compiled by USCC staff)

As Figure 6.3 indicates, Chinese entities have historically preferred to issue debt in the international bond markets in either Japanese yen (mostly through so-called Samurai bonds) or US dollars, raising approximately $20 billion in dollar-denominated bonds in the past decade. The Chinese Government typically has issued sovereign debt in U.S. dollar-denominated paper, but in 2001 the Government made its first Euro-denominated sale and raised $600 million.

Figure 6.3
Chinese International Bond Offerings: Grouped by Currency

Source: Bloomberg Professional Service (data compiled by USCC staff)
Role of Hong Kong

Hong Kong has historically played a significant role as a gateway for mainland Chinese companies to access the world’s capital markets. Before economic reforms in the Mainland progressed to the point where firms were able to directly raise capital through financial markets, many Chinese companies seeking access to international capital markets set up Hong Kong subsidiaries and raised capital as Hong Kong firms. Although several high-profile Chinese offerings in the U.S. capital markets have been made by Hong Kong subsidiaries of mainland firms – China Mobile, China Unicom, China National Offshore Oil Corporation – the majority of Chinese offerings in the United States have been made by mainland-incorporated firms.

The Hong Kong Stock Exchange (HKSE) is considered one of Asia’s largest and most respected financial markets. But its disclosure requirements, capitalization requirements and securities regulation environment are less stringent than those in the United States. There are two types of mainland Chinese companies in the Hong Kong market: “H-shares,” which are companies that are floated on the HKSE but incorporated in the Mainland, and “Red Chips,” which are Hong Kong-incorporated companies that usually are subsidiaries or otherwise affiliated with larger mainland SOEs or government ministries.

The Chinese Government has historically conducted the sale of its sovereign bonds in Tokyo, New York or London. The Hong Kong Government reportedly has approached the Beijing leadership about using Hong Kong as the base for the sale of China’s sovereign bonds, including U.S. dollar-denominated bonds. News reports characterized the move as “the latest attempt by Hong Kong Government officials to lobby the Mainland to use the SAR as a fund-raising center to boost its capital markets.”

Presence in U.S. Capital Markets

Chinese companies access the U.S. equity markets, both to raise capital or otherwise trade their securities, primarily through the issuance of American depositary receipts (ADRs), including Level I, II, and III ADRs and Rule 144A and Regulation S offerings. The Bank of New York’s ADR directory listed 38 Chinese ADRs as of May 31, 2002: 12 Level I, 1 Level II, 15 Level III, 7 Rule 144A and 3 Regulation S. This list is reprinted in Appendix A.

The precise amount that Chinese entities have raised in the U.S. capital markets is difficult to pinpoint, however the range of estimates presented to the Commission by various sources give

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2 Enouch Yiu, “Hong Kong seeks role in debt sale,” South China Morning Post, 20 November 2001, 1.
3 ADRs are a negotiable security issued by a U.S. depositary bank (e.g., The Bank of New York) that represents the shares of a non-U.S. company which have been purchased by a broker and deposited with a local U.S. custodian bank. There are several types of ADRs, differing in their listing requirements and their ability to raise capital. Level I ADRs are traded in the U.S. over-the-counter (OTC) market and are subject to only minimal Securities and Exchange Commission registration and reporting requirements. Level II ADRs can be listed and traded on U.S. securities exchanges but cannot be used to raise new capital. Level III ADRs can be listed and used to raise capital. Level II and Level III ADRs are subject to more extensive SEC registration and reporting requirements than Level I ADRs. In addition to these three types of ADRs, non-U.S. companies can also tap U.S. investors through Rule 144A and Regulation S offerings. Rule 144A offerings allow non-U.S. companies to raise capital through the private placement of ADRs with sophisticated U.S. institutional investors (referred to as “Qualified Institutional Buyers”). Regulation S offerings allow companies to raise capital by placing depositary receipts offshore to non-U.S. investors, which can then be marketed to U.S. investors following a waiting period. Neither Rule 144A nor Regulation S offerings are subject to full SEC registration requirements.
4 Bank of New York ADR directory can be found at www.bankofny.com.
an idea of the scope involved. Marc Lackritz, President of the Securities Industry Association, testified that Chinese entities had raised $48.3 billion in equity capital overseas from 1991-2000, and that about 7 percent of this amount – or $3.4 billion – had been raised through targeted U.S. offerings. He further indicated that Chinese issuers of debt raised around $9.7 billion in the U.S. markets during that time period. Paul Wolansky, Managing Director of New China Management Corporation, testified that Chinese companies raised approximately $10.5 billion through listings in U.S. equity markets since 1999.

A report prepared for the Commission on China’s fundraising activities in the U.S. equity markets concludes that Chinese firms raised approximately $14.6 billion through IPOs in U.S. capital markets from 1999-2001, representing 73 percent of the $20 billion Chinese firms raised in total through overseas IPOs during that time period. The report’s findings are indicated in Figure 6.4.

Figure 6.4
Amounts Raised in Initial Public Offerings in the U.S. Markets, 1999-2001 (Billions of US Dollars)

[Graph showing amounts raised in 1999, 2000, and 2001 in billions of US dollars.]

Source: China Securities and Futures Statistical Yearbook (various years); websites of various stock exchanges; Bloomberg

The most significant Chinese equity offerings in the U.S. markets – by both mainland firms and Hong Kong subsidiaries of mainland firms – have been listed on the New York Stock Exchange (NYSE) and predominantly have been state-owned enterprises (SOEs) from the energy, telecommunications, and transportation sectors. The Chinese companies listing on the NASDAQ generally have been smaller, Internet and technology-related firms that have “private” management but SOEs as strategic investors. The NASDAQ’s lower capitalization requirements make it attractive to smaller Chinese firms seeking access to U.S. capital.

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6 Ibid.
Key Issuances In U.S. Capital Markets and Expected Pipeline

The most significant Chinese IPOs in the U.S. market to date have all involved companies in the telecommunications and energy sectors. Below is a brief description of the largest offerings over the past three years, all of which involve SOEs listing on the NYSE. In some cases the listed entity is a Hong Kong subsidiary of a mainland firm. In all cases, the PRC remained the majority shareholder after the IPO.


- **China Petroleum and Chemical Corporation (Sinopec) (NYSE: SNP)** - Raised $3.5 billion in an October 2000 IPO. Sinopec is China's largest refiner and petrochemical producer with former operations in Sudan and a current development contract in Iran that exceeds the limits outlined in the Iran and Libya Sanctions Act.

- **PetroChina Company Limited (NYSE: PTR)** - In 2000, PetroChina set out to raise $10 billion in its first U.S. IPO, which would have made it the largest international IPO in NYSE history. Largely due to public opposition from a broad coalition of non-governmental groups in the U.S. protesting PetroChina's parent company's holdings in Sudan, the offering ultimately raised only $2.9 billion on the NYSE in April 2000. PetroChina produces two-thirds of China's oil and gas.

- **China National Offshore Oil Corporation (CNOOC) Limited (NYSE: CEO)** - Raised $1.3 billion with its February 2001 IPO. CNOOC Limited runs China's offshore oil and gas exploration and production activities in partnership with international oil and gas firms.

China delayed many IPOs in 2001 due to unfavorable market conditions, but several are scheduled for 2002. The major IPOs in the pipeline again involve SOEs in the telecommunications and energy sectors as China continues to list the offshoots of what were once large monopolies. Among the notable expected IPOs are China Telecom, Bank of China, China Power, and Baosteel. The Bank of China IPO would be the first in China's banking sector. A recent wave of scandals at the Bank of China, including its agreement to pay $10 million in fines to the U.S. Office of the Comptroller of the Currency for misconduct at the bank's New York branch, reportedly has played a role in delaying its planned listing on the NYSE.

On the debt side, Chinese companies may be entering an era of increased fundraising via bond offerings. CNOOC, which raised significant funds through its listing on the NYSE, recently offered a $500 million, 10-year bond issue. The demand for this issue reached $4.2 billion when the books closed, about 20 percent of which came from U.S. investors. Chinese corporate bond issues had been sparse in recent years — most notable have been China Mobile's $600

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9 The figures cited for funds raised through IPOs on the NYSE are based on data compiled for the Commission by Gordon Chang. *Ibid.,* Appendix 4.
10 The Iran and Libya Sanctions Act of 1996 (LSA), Public Law 104-172, 104th Cong., 2d Sess., 5 August 1996, sanctions foreign companies that provide new investments over $40 million for the development of petroleum resources in Iran or Libya.
12 Eric Ng, "Market Flocks to CNOOC Bond," *South China Morning Post,* 2 March 2002, p. 3.
million issue in 1999 and Citic Pacific's $450 million issue last year. Some market analysts believe that the success of the CNOOC issue will encourage other SOEs to tap the international bond markets, possibly in lieu of the equity markets.

**Linkages Between U.S.-Listed Firms and Chinese Military and Weapons Proliferation Activities**

There has been an increasing concern in recent years about the identities and nature of certain Chinese companies raising money or otherwise trading their securities in the U.S. capital markets and their affiliations with the PLA or components of China's defense industry or intelligence services. In addition, concerns have been raised about whether any Chinese entities listed in the U.S. capital markets may be assisting in the proliferation of weapons of mass destruction or ballistic missile delivery systems. This issue has direct implications for U.S. national security and raises questions about whether the U.S. intelligence community is sufficiently focused on this potential source of funding for China's military and weapons proliferators, as well as whether U.S. investors are sufficiently informed about the activities and affiliations of the Chinese companies in which they invest.

Senator Fred Thompson voiced his concerns about U.S. investors funding, through portfolio investment, Chinese companies linked to the PLA or weapons proliferation in testimony before the Commission:

> It is extremely disturbing to think that we are financing China's military development and the proliferation of weapons of mass destruction to rogue nations. But plenty of evidence exists that we are directly investing in companies and programs that may one day be the agents of our own destruction. The California Public Employees' Retirement System (or CalPERS) has invested millions of dollars of employee pension funds in companies with close ties to the Chinese government and the Chinese People's Liberation Army. CalPERS has invested in four companies linked to the Chinese military or Chinese espionage: Cosco Pacific, China Resources Enterprise, Citic Pacific, and Citic Ka Wah Bank. The Teachers' Retirement System of Texas was also invested in Cosco Pacific, but it divested its shares of Cosco Pacific less than a month after receiving a congressional letter discussing Cosco's links to the Chinese military.

The Chinese companies cited in Senator Thompson's testimony all sold their shares to U.S. investors through listings in Hong Kong. A report prepared for the Commission by Adam Pener of the William J. Casey Institute provides background on these and other publicly listed Chinese companies that reportedly have connections with China's military establishment. These examples highlight the reality that U.S. investors, including sophisticated pension and mutual funds, may be unknowingly funding Chinese companies that pose a security risk to the United States through their purchases of overseas listed securities. While this security risk is of concern to the Commission, the Commission decided to focus initially on the extent to which Chinese firms directly trading their securities in the U.S. capital markets may present a similar risk, and the extent to which the U.S. Government and investment community are alert to this challenge. The flow of U.S. portfolio investment into Chinese securities listed outside the U.S. capital markets,

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13 Ibid.
15 Casey Institute Report, 19-23.
particularly by public pension funds and other large institutional investors, is an issue the Commission will explore in future years.

The Commission notes the findings of two other bipartisan federal commissions that expressed concern about the presence of certain Chinese and other foreign registrants in the U.S. capital markets. The report of the Committee on U.S. National Security and Military/Commercial Concerns with the People’s Republic of China (the “Cox Commission”) concluded that:

[The PRC is using U.S. capital markets as a source of central government funding for military and commercial development and as a means of cloaking U.S. technology acquisition efforts by its front companies with a patina of regularity and respectability.]^{16}

The Commission to Assess the Organization of the Federal Government to Combat the Proliferation of Weapons of Mass Destruction (the “Deutch Commission”) found that:

[Known proliferators may be raising funds in U.S. capital markets. . . . Because there is currently no national-security based review of entities seeking to gain access to our capital markets, investors are unlikely to know that they may be assisting in the proliferation of weapons of mass destruction by providing funds to known proliferators.]^{17}

Among its recommendations, the Deutch Commission concluded that appropriate U.S. Government officials should “assess options for denying proliferators access to U.S. markets” and further advised that “[a]ccess to U.S. capital markets . . . [is] among the wide range of economic levers that could be used as carrots or sticks as part of an overall strategy to combat proliferation.”^{18} This suggests that denying access to U.S. capital markets could be used as an economic sanction against governments that fail to adequately curtail their proliferation activities.

The PLA was at one point heavily involved in commercial business enterprises, with some of its companies, such as Poly Group and China Carrie, securing listings on the Hong Kong Stock Exchange.^{19} China Aviation Industry Corp II (AVIC II), a state-owned aviation company under the direct control of the State Commission of Science Technology and Industry for National Defense, reportedly is planning to list in Hong Kong in the near future, and will be followed to the market by China’s other key military business conglomerates.^{20} While the level of PLA involvement in the commercial sector has apparently decreased in recent years as a result of China’s campaign to divest the PLA from its business holdings, there continue to be relationships between the PLA and commercial enterprises. The full extent of relationships between the PLA and other organs of the Chinese military-industrial complex and Chinese firms raising funds in the U.S. capital markets merits further study.

Overlaying these specific concerns is the issue of Chinese sovereign debt issuances. Since China’s bond prospectuses generally provide little detail as to how the proceeds will be spent, the

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^{18} Deutch Commission Report, 77-78.

^{19} Tai Ming Cheung, “Can PLA Inc. be Tamed?,” Institutional Investor, July 1996, 47.

significant monies raised by these offerings could be finding their way into military spending and other activities that are harmful to U.S. security interests. Because money is fungible, funds raised by China from its general-purpose bonds are just as useful for military and other security-related purposes as funds raised by a PLA-affiliated company.

At the request of Senator Thompson, the U.S. General Accounting Office (GAO) recently investigated whether any Chinese or Russian companies associated with the proliferation of weapons of mass destruction have been raising funds in the U.S. capital markets and to what extent the U.S. Government monitors access to the markets by such firms. The Commission was briefed by the GAO on the findings of its investigation on April 26, 2002. Due to their classified nature, the Commission will address those findings that are pertinent to its examination of this issue in the classified annex to this Report.

National Security Implications

Funding of Chinese Military and Weapons Proliferation Activities

The Commission is concerned about the use of the U.S. capital markets as a source of funding for the Chinese military and intelligence services and for Chinese companies assisting in the proliferation of weapons of mass destruction or ballistic missile delivery systems. This activity not only poses direct security concerns, but raises issues regarding investor transparency and material risk as well. Given this dynamic, the Commission is troubled that neither the U.S. Government nor the U.S. investment community is adequately evaluating security-related risks related to China's fundraising in the U.S. capital markets.

As U.S. policymakers struggle to develop new approaches to more effectively curtail weapons proliferation, the substantial role the U.S. capital markets may play in funding companies that assist in proliferation should be evaluated more closely. Any comprehensive approach to combating proliferation should address all sources of financing. It would seem to make little sense for the U.S. Government to sanction trade with Chinese companies that assist in proliferation, while allowing these same companies to fund themselves in the U.S. capital markets.

The presence of PLA and other Chinese military-linked or intelligence-linked companies in the U.S. capital markets is also troublesome. The Commission recognizes that military and commercial production in China are often intertwined and that it is difficult to ascertain when monies raised by Chinese SOEs in the U.S. markets may ultimately be used for military purposes. Further complicating this issue is the fact that funds raised by China through sovereign bond offerings are not tied to specific governmental purposes, so the proceeds of these bonds may also be going into military programs. However, at a minimum, U.S. investors should be made aware of any materially relevant ties between the Chinese military and intelligence services and Chinese companies listing in the U.S. markets so they can make informed investment decisions. U.S. investors should also be made aware of such ties with regard to overseas-listed securities offered for sale through U.S. brokerages.

In this regard, the Commission notes the SEC's decision last year to incorporate national security concerns into its interpretation of "material" information that should be disclosed to investors. On May 8, 2001, in a letter from then-Acting SEC Chairman Laura Unger to Representative Frank Wolf, the SEC announced guidelines to increase the transparency of certain foreign registrants.
seeking access to U.S. markets. The SEC indicated that it will (i) require foreign companies to file their registration statements electronically, (ii) actively review all registration statements filed by foreign firms that have business dealings in countries subject to U.S. economic sanctions, (iii) seek information from foreign registrants about any material business they conduct with U.S.-sanctioned countries, and (iv) share information on foreign registrants’ business in sanctioned countries with the Treasury Department’s Office of Foreign Assets Control (OFAC). The SEC now believes that “the fact that a foreign company is doing material business with a country, government, or entity on OFAC’s sanctions list is . . . substantially likely to be significant to a reasonable investor’s decision about whether to invest in that company.” As a result, the SEC “will seek information from registrants about material business in, or with, countries, governments, or entities with which U.S. companies would be prohibited from doing business under economic sanctions administered by OFAC,” and make this information available to the investing public.

The Commission also notes the House of Representatives’ approval last year, by an overwhelming vote of 422-2, of the Sudan Peace Act (H.R. 2052). This legislation would prohibit any entity engaged in the development of oil or gas in Sudan from “raising capital in the United States” or “trading its securities (or depositary receipts with respect to its securities) in any capital market in the United States.” This legislation and the SEC guidelines discussed above demonstrate growing recognition by the Congress and Executive Branch that access to the U.S. capital markets by certain foreign registrants, including those of Chinese origin, raises national security concerns.

The Commission acknowledges the important role of the U.S. capital markets as a preeminent source of capital for both domestic and foreign enterprises, and the negative consequences to the U.S. and world economy that could result if access to our markets became unduly restricted. Nonetheless, the Commission believes that access to our capital markets should not be wholly divorced from national security concerns, and that appropriate measures should be put in place to mitigate the potential national security risks arising from the presence of certain Chinese and other foreign registrants in our markets. In egregious cases, denying certain foreign entities access to our markets may be warranted. At a minimum, U.S. investors should be fully informed of the true identities and global activities of foreign registrants that could pose a threat to U.S. security interests. The Commission will continue to examine whether any Chinese companies assisting in proliferation, or engaged in other activities inimical to U.S. security interests (e.g., material dealings with terrorist-sponsoring governments, arms smuggling, technology theft) are raising money in the U.S. capital markets and will report its findings in its public and classified reports, as appropriate.

Source of Economic Leverage

The U.S. capital markets have become a significant source of capital for Chinese firms. While smaller in scope than the influx in funds from FDI, the U.S. capital markets have provided significant amounts of capital for some of China’s most important SOEs and the Chinese Government itself, and this trend is likely to continue.

This investment dynamic presents the United States with a potential tool of influence and leverage in the U.S.-China economic relationship. The Deutch Commission noted the possibility of using access to the U.S. capital markets as an “economic lever” that could be utilized as part of the U.S. strategy to combat proliferation. This lever could be applied in other circumstances as
well, particularly where trade sanctions are contemplated (and may prove to be more effective than trade sanctions).

Critics of capital market sanctions argue that if companies are shut out of the U.S. capital markets for any reason they will simply make their offerings in other markets. However, the Commission believes that this assertion underestimates the global importance of the U.S. capital markets. The market capitalization of the other major capital markets is well below that of the U.S. markets, reflecting the much deeper pool of capital available for securities offerings. As a result, major overseas exchanges may well "max out" over time with regard to their capacity to absorb large-scale offerings if the U.S. markets are unavailable. In addition, a decision by the U.S. Government to deny a Chinese or other foreign firm access to the U.S. capital markets would likely taint that entity's offerings in other markets, raise its risk profile and cost of funds, and ultimately diminish its value to investors. Finally, a foreign firm's inability to access the U.S. "demand side" for its debt and equity offerings, including U.S. public pension funds, mutual funds and other large institutional investors, would likely substantially narrow the market for its securities.

The Commission also notes that virtually all the fundraising by Chinese firms in the U.S. capital markets has been conducted by SOEs. China's nascent private sector firms, which need capital to develop into true competitors of the state sector, have not had the ability to access this source of capital in any meaningful way. U.S. policymakers should consider whether this source of support for Chinese SOEs is counterproductive to U.S. support for the growth and development of a vibrant Chinese private sector.

**Recommendations**

- The Commission recommends that Congress codify in legislation the disclosure guidelines outlined by the SEC in its May 8, 2001 correspondence to Representative Frank Wolf. These guidelines require the SEC to solicit from foreign registrants and disclose to investors information regarding a foreign registrant’s material business operations in a country, or with an entity, subject to U.S. economic sanctions administered by the Treasury Department's Office of Foreign Assets Control. These guidelines recognize that a foreign registrant’s material business operations in terrorist-sponsoring and other U.S.-sanctioned countries or with sanctioned entities – countries and entities with which U.S. companies cannot do business – pose a material risk to investors.\(^\text{21}\)

- The Commission recommends that Congress request the Treasury Department, in coordination with the Executive Branch agencies tasked with identifying and monitoring Chinese and other foreign entities associated with the proliferation of weapons of mass destruction or ballistic missile delivery systems, to assess whether any such entities are accessing, or seeking to access, the U.S. capital markets. If the Treasury Department determines that any such entities are accessing, or seeking to access, the U.S. capital markets, this information should be provided to the SEC and made available to investors including state public pension systems and other institutional investors.

- The Commission recommends that Congress prohibit debt or equity securities offerings in the U.S. capital markets by any Chinese or other foreign entity where the State Department

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\(^{21}\) The Commission made this recommendation in a letter dated March 15, 2002 to the Chairman and Ranking Members of the Senate Banking, Housing and Urban Affairs Committee and House Financial Services Committee, with copies to the Senate and House leadership. The text of this correspondence can be obtained on the Commission’s website <http://www.uscc.gov/>. 

Chapter 6 - China's Presence in U.S. Capital Markets
has imposed sanctions on that entity for engaging in the proliferation of weapons of mass
destruction or ballistic missile delivery systems.

- The Commission recommends that Congress enhance reporting requirements for Level I
  ADRs and Rule 144A and Regulation S offerings. None of these types of offerings is now
  subject to full SEC reporting and registration requirements. As a result, foreign entities can
  trade their securities in the U.S. markets without the need to disclose detailed aspects of
  their business operations, including overseas activities that may be harmful to U.S. security
  interests and pose a material risk to investors.

- Consistent with recommendations in Chapter 1, the Commission recommends that
  Congress provide additional resources to strengthen the U.S. intelligence community's
  collection and analysis concerning the national security dimensions of Chinese and other
  foreign fundraising in the U.S. capital markets, as well as of Chinese and other foreign
  entities selling their securities to American investors from exchanges overseas.

- The Commission urges the Treasury Department to follow-up on the recommendation made
  by the Deutch Commission that the Department lead an interagency review of current and
  potential mechanisms for exercising financial/economic leverage to combat proliferation,
  including denying proliferators access to the U.S. capital markets.
# Appendix A

## American Depositary Receipts Issued By Chinese Firms

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<tr>
<th>ISSUE</th>
<th>SYMBOL</th>
<th>EXCHANGE</th>
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<td>PORTAL</td>
<td>Transportation</td>
<td>BNY</td>
<td>1994.11.01</td>
<td>144A</td>
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<tr>
<td>China Shipping Development Company Limited</td>
<td>CSDXY</td>
<td>OTC</td>
<td>Transportation</td>
<td>BNY</td>
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<td>China Southern Airlines Co., Ltd.</td>
<td>ZNH</td>
<td>NYSE</td>
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<td>NYSE</td>
<td>Transportation</td>
<td>MGT</td>
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<td>Guangzhou Shipyard International Company Limited</td>
<td>GSHY</td>
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<td>Harbin Power Equipment Company Ltd. 144A</td>
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<td>SINOPEC SHANGHAI PETROCHEMICAL COMPANY LIMITED</td>
<td>SHI</td>
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<td>TINGYI (CAMAYAN ISLANDS) HOLDINGS CORP.</td>
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<td>YANZHOU COAL MINING COMPANY LIMITED</td>
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Source: Bank of New York (www.bankofny.com)

BNY = Bank of New York
MGT = J.P. Morgan Chase
CIT = Citibank

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Chapter 7 - Proliferation and Chinese Relations with Terrorist-Sponsoring States

Key Findings

- China provides technology and components for weapons of mass destruction and their delivery systems to terrorist-sponsoring states such as North Korea, Iran, Iraq, Syria, Libya and Sudan. This arms trafficking to these regimes presents an increasing threat to U.S. security interests, in the Middle East and Asia in particular.

- China’s cooperation with terrorist-sponsoring states is helping to create a new tier of nations with the capability to produce weapons of mass destruction and ballistic missiles.

- The Chinese Government has made numerous multilateral and bilateral promises to stop proliferation originating in China, but despite repeated promises has not kept its word. This situation was a major item at the summit meeting between Presidents Bush and Jiang in February 2002, but no progress has been made since that meeting.

- Since September 11th, Beijing has expressed support for and implemented a working relationship with the United States on some aspects of anti-terrorist efforts. But Chinese proliferation and cooperation with terrorist-sponsoring states have continued unabated. These relationships enhance Beijing’s political and military influence and help ensure a diversified source of energy to meet its growing energy needs.

- The current U.S. sanctions policies to deter and reform Chinese proliferation practices have failed and need immediate review and overhaul.

Introduction

China is one of the world’s leading sources for missile-related technologies and nuclear materials for terrorist-sponsoring nations such as Iran, Iraq, Syria, Libya, Sudan, and North Korea.1 (Figure 7.2) The proliferation of weapons of mass destruction and their delivery systems to these regimes present an increasing threat to U.S. security interests, in the Middle East and Asia in particular.

Had weapons of mass destruction been accessible to the September 11th terrorists, the outcome could have been far more devastating. CIA Director George Tenet recently testified that we now face a “convergence of threats” -- the connection between terrorists and weapons of mass destruction. “The proliferation of ICBM and cruise missile designs and technology has raised the threat to the United States from WMD delivery systems to a critical threshold...the U.S. most likely will face ICBM threats from North Korea and Iran, and possibly from Iraq.”2 These countries are all recipients of Chinese assistance. In addition, within ten years land attack cruise missiles may “pose a serious threat to not only our deployed forces, but possibly even the U.S. mainland.”3

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1 The Secretary of State has designated these countries as state sponsors of terrorism. U.S. Department of State, Patterns of Global Terrorism 2001, (Washington, DC: U.S. Department of State 2001)
3 Ibid.
In July, 1999, the Commission to Assess the Organization of the Federal Government to Combat the Proliferation of Weapons of Mass Destruction (The Deutch Commission) warned that,

Every American should understand that weapons of mass destruction (WMD)—nuclear, biological, and chemical weapons and their means of delivery—pose a grave threat to the United States and to our military forces and our vital interests abroad.⁴

Why China Proliferates

Beijing’s relationships with terrorist-sponsoring regimes provide China with leverage against the U.S., enhance China’s political and military influence, and provide the PRC with foreign exchange and access to energy resources. China has particularly cultivated relationships with oil-rich terrorist-sponsoring states in order to provide Beijing with long-term economic and strategic benefits and extend China’s reach. In the words of a former U.S. Army attaché in Beijing, “China’s proliferation ... takes these rogue nations and gives them influence, while increasing China’s prestige.”⁵

The United States has worked hard to convince China to sign various arms control and non-proliferation agreements, but Beijing’s compliance record is poor. The PRC has made non-proliferation commitments under the Missile Technology Control Regime (MTCR), the Nuclear Non-Proliferation Treaty (NPT), and the Chemical Weapons Convention (CWC), as well as under various bilateral agreements with the U.S., such as the agreement of November 2000 to implement an effective missile-related export control system. At a meeting of the International Conference on Disarmament in April 2002, Chinese Foreign Minister Tang Jiaxuan urged a multilateral approach to strengthen existing efforts to stem the proliferation of weapons of mass destruction, citing the threat of terrorist organizations and other non-state actors.⁶

Some experts suggest that some of China’s exports may not reflect official intentions. China’s export control policy is weak and poorly enforced and companies and individuals may be able to export WMD-related materials without direct government authorization. In November 2000, Beijing made an explicit bilateral commitment to the United States to develop and implement an export control regime, but this has yet to materialize. Beijing asserts that it is often ignorant of the activities of individual companies. Other experts argue that “all important arms sales must have the approval of the top leadership,” although it is possible that dual-use products may be exported without government approval.⁷ Whatever the explanation, the result is the same: ongoing exports of lethal technology to terrorist-sponsoring states that oppose American national interests and their supporters who target Americans.

All branches of the U.S. Government agree that China’s proliferation is dangerous and is unlikely to subside quickly. The CIA remains “concerned that [China] may try to circumvent the CW-related export controls that Beijing has promulgated since acceding to the CWC and the Nuclear

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⁶ Tang Jiaxuan, Speech delivered at International Conference on Disarmament, 2 April 2002.
Nonproliferation Treaty." The Department of Defense, in its annual report on proliferation, states that for strategic and economic reasons, China most likely will "continue to take advantage of ambiguities in its proliferation pledges." 

Proliferation is not unique to China; the United States itself is sometimes guilty of this practice. Although the United States tries to restrict the export of critical technologies, it is nearly impossible to stem such technology flows. At best, the United States can slow the process. Consequently, "The U.S. has been and is today a major, albeit unintentional, contributor to the proliferation of ballistic missiles and associated weapons of mass destruction." This is partially the result of "foreign student training in the U.S., by wide dissemination of technical information, by the illegal acquisition of U.S. designs and equipment and by the relaxation of U.S. export control policies." During the 1990's, for example, the United States liberalized commercial export controls to include high performance computers, in effect allowing the PRC, and other countries, to legally obtain computers that could help them increase their military capabilities.

However, there is a difference between American and Chinese policies: the United States strains to limit the export of technologies to make WMD proliferation, especially to terrorist states, while China does not do the same.

**Cooperation Among Terrorist-Sponsoring States**

In addition to the direct linkages between China and the states to which it proliferates, there are also indirect relationships, so that technology exports destined for one country may circulate through several terrorist-sponsoring states.

In 1998, the Rumsfeld Commission examined the relationships between countries such as Iraq, Iran, and North Korea and the degree to which they were cooperating with one another in developing their weapons programs. The Commission found that, given their access to advanced technology from China, Russia, the United States and other sources in the West, these countries can provide each other with the capabilities to develop long-range ballistic missiles.

This cooperation between terrorist states and other countries increases a country's offensive capability in various ways. "For example, if Iran were to deploy missiles in Libya, it could reduce the range required to threaten the U.S. as well as Europe." Furthermore, "long-range ballistic missile systems could be transferred from one nation to another, just as China transferred operational CSS-2s to Saudi Arabia in 1988. Such missiles could be equipped with weapons of mass destruction."

There are many examples of the spread of lethal technologies from one terrorist-sponsoring state to another. "Iran has established solid and liquid propellant capabilities and already is beginning

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8 Tenet, Armed Services, 9/11, Written Testimony.
11 Ibid.
12 Ibid.
13 Ibid.
to proliferate missile production technologies to Syria,"¹⁴ according to the Director of the Defense Intelligence Agency (DIA). The Pentagon reported that North Korea supplied Syria with 10 intermediate-range ballistic missiles. According to an unclassified CIA report, North Korea is sourcing material and components for its ballistic missile programs through North Korean firms based in China. The report further states that North Korea has the capability to launch chemical and possibly biological agents.¹⁵

In January 2002, Chinese entities were sanctioned under U.S. law for transfers to Iran of what is believed to be dual-use equipment for chemical and biological weapons.¹⁶ As mentioned earlier, in response to U.S. pressure, including sanctions on satellite exports to China, Beijing has promised to tighten up its export control regime. Chinese proliferation behavior may have improved somewhat with respect to its 1997 pledge to end any kind of "new nuclear cooperation" with Iran although this did not come without a quid pro quo for China: an agreement to allow American companies to engage in China’s nuclear energy industry.¹⁷ In this case, the CIA has expressed some reservations about Beijing's compliance with its promise.¹⁸

During President Bush's February 21, 2002 summit with President Jiang, the President urged the Chinese to implement the terms of the November 2000 agreement on proliferation in which Beijing pledged not to assist countries seeking to develop nuclear-capable ballistic missiles. The President pressed China to develop a comprehensive missile-related export control regime and to agree that prior contracts will not be grandfathered. He also expressed great concern over Iranian aggressive overtures to revitalize nuclear cooperation with China, and asked China to rebuff them. The Chinese Government has yet to implement these prudent suggestions.

**Dual-Use Technology**

Some legal U.S. exports of dual-use technology may also present a serious security problem for the United States. The extent to which foreign technology may be finding its way into Chinese military exports is worrisome. This is largely the result of the relaxation of Western export controls, the growing number of dual-use technologies, and the illegal re-transfer of these technologies.

CIA Director Tenet has observed that proliferating countries are "taking advantage of both foreign assistance and the dual-use nature of WMD and missile-related technologies" to establish advanced production capabilities and "to conduct WMD and missile-related research under the guise of legitimate commercial or scientific activity."¹⁹

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¹⁷ Defense Department, Threat and Response, 17.

¹⁸ CIA, *WMD Report*.


Chapter 7 - Proliferation and Chinese Relations with Terrorist-Sponsoring States.
Chinese firms have provided dual-use missile-related items, raw materials, and/or assistance to Iran, North Korea, and Libya. China has provided Iran with dual-use chemicals that can be used to produce chemical weapons and the technology to manufacture chemical weapons.20

Since dual-use technologies have both civilian and military uses, it is often difficult to determine when restrictions are appropriate; nonetheless, the West has been exceedingly permissive in its sales to China. The Commission heard testimony that United States and European companies have exported substantial amounts of fiber-optic cable, repeaters, systems and switches that China has used to upgrade its military communications. Digital fiber optic cables are of concern to the intelligence community because it is nearly impossible to monitor the cables through conventional surveillance systems.21

While it is generally recognized that Beijing ignores its non-proliferation commitments, many experts and policy makers believe that China takes its U.N. commitments more seriously. However, as recently as January 2001, it was reported that a Chinese front company, Shandong Arts and Crafts Co., was involved in selling "missile related guidance and test equipment" to Iraq,22 violating United Nations sanctions. China reportedly agreed to comply with the sanctions after U.S. protests.23

In March 2001, CNN reported that the Pentagon privately accused China of improving communications for Baghdad's aircraft target capability in violation of U.N. sanctions against Iraq.24 A Chinese firm, Huawei Technologies, assisted Iraq with fiber optics to improve its air defense system, enhancing Iraq's ability to shoot down U.S. military aircraft patrolling the no-fly zones. China reportedly acknowledged that it had violated the U.N. sanctions, though it denied the work was linked to Iraq's air defenses.25 In February 2001 the United States bombed an Iraqi air defense site supplied by Huawei Technologies. Huawei was founded by a former PLA officer and is a major competitor of Cisco and Lucent.

Energy Security

A key driver in China's relations with terrorist-sponsoring governments is its dependence on foreign oil to fuel its economic development. This dependency is expected to increase over the coming decade.

China is expected to double its need for foreign oil between now and 2010. After being a net oil exporter during the 1970's and 80's, China became a net oil importer in 1993.

Chinese oil imports reached $20.6 billion in 2000. As a result of lower world-wide oil prices, 2001 imports decreased in value, but actually increased in volume 5.9 percent. China is increasingly

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20 Defense Department, "Threat & Response," 18.
25 Gersham, "Arms Sales to Taiwan: A Flashpoint Issue."
dependent on foreign oil for stable economic growth with continuing budget deficits reflecting the rising level of its oil imports.\textsuperscript{26}

Figure 7.1
PRC Oil Consumption and Projections thru 2020


Chinese leaders believe that the United States seeks to contain China and is therefore a major threat to China's energy security. "China considers the United States the key obstacle to entering the free oil market. They suspect that the United States seeks to dominate the [Gulf] region in order to exercise control over the Gulf's energy resources."\textsuperscript{27} Consequently, China believes it is essential to diversify its energy sources.

Between 1994-1996, China's state-owned oil companies were elevated to the ministerial level and given a mandate to pursue oil opportunities overseas. "At a relatively rapid pace they purchased small to medium oilfields in Canada and Peru and bid on projects in India, Indonesia, Papua New Guinea, Russia and Venezuela...CNPC [China National Petroleum Company] entered a joint venture with an American partner and bought 98 oil wells in Texas...China announced that it was arranging large-scale oilfield development deals with Kazakhstan, Venezuela and Iraq totaling $5.6 billion.\textsuperscript{28}" China also signed on for projects with Japan.

China's strategy to secure adequate energy resources overseas is part of its overall policy to counter U.S. power and minimize U.S. influence.\textsuperscript{29} Fundamental to this strategy are China's relations with the Middle East, particularly Iran, Iraq, and Sudan. "Arms sales provide a wedge

\textsuperscript{28} Ibid.
for China into the Gulf, a region of global geopolitical importance and of growing significance to China itself where the United States is the preeminent power.\textsuperscript{30}

Chinese companies have entered into oil deals with Iraq, Sudan, and Iran, countries that are off limits to U.S. companies. A prime example involves the case of the China National Petroleum Company (CNPC) and the Sudanese government. CNPC has invested heavily in developing Sudan’s oil industry, reportedly “at virtually no profit, in exchange for the drilling rights to more than 40,000 square kilometers in Southern Sudan.”\textsuperscript{31} Sudan is on the U.S. State Department’s list of terrorist-sponsoring states and was sanctioned by the Clinton Administration. The U.S. State Department reports that last year,

\begin{quote}
a number of international terrorist groups including al-Qaeda, the Egyptian Islamic Jihad, Egyptian al-Gama’a al-Islamyya, the Palestine Islamic Jihad and HAMAS continued to use Sudan as a safehaven, primarily for conducting logistics and other support activities.\textsuperscript{32}
\end{quote}

China’s partnership with Sudan has earned millions of dollars for Khartoum, which, in addition to harboring terrorist organizations, also engages in a consistent policy of genocide and slavery against its own people.\textsuperscript{33}

\begin{quote}
Of the weapons sold by China to the Gulf countries, ballistic missiles are among its highest money earners. These weapons—especially if equipped with biological, chemical or nuclear warheads—have the greatest potential to destabilize the region.\textsuperscript{34}
\end{quote}

\begin{quote}
Of particular concern are China’s sales to Iran of C-801 and C-802 anti-ship cruise missiles, which pose a threat to oil tanker traffic and American naval vessels in the Persian Gulf. Some Western analysts have speculated that despite China’s September 1997 and January 1998 commitments to the United States to halt the export of antiship cruise missiles to Iran, arms-for-oil barter arrangements could still appeal to the Chinese government.\textsuperscript{35}
\end{quote}

In order to ensure that its future energy needs will be met, China uses various diplomatic instruments in its “interaction with its ‘energy-related’ partners. These instruments include general political and diplomatic support of countries such as Iraq and Iran... China uses its position and influence in international organizations to lobby for the interests of such states.”\textsuperscript{36}


\textsuperscript{32} U.S. Department of State, “Patterns of Global Terrorism 2001,” May 2002, 68.


\textsuperscript{34} Calabrese, “Energy Security,” 363.


\textsuperscript{36} Troush, “Oil Strategy.”
"China, with its U.N. seat and desire to reduce U.S. hegemony, was one of the few major powers willing to maintain strong and cordial relations with Tehran during the more radical days of the revolutionary regime."\textsuperscript{37} During the Iranian hostage crisis of 1979-1980, "China abstained in the United Nations Security Council vote to sanction Iran for the hostage-taking."\textsuperscript{38} During the Gulf War, China supported U.N. resolutions sanctioning Iraq, but did not vote for the use of force against Iraq. "Beijing's role in the United Nations Security Council and also its position in the U.N. bodies dealing with sanctions, were of exceptional importance to progress in its energy deals with Iraq."\textsuperscript{39}

China holds development rights to an Iraqi oil field which it cannot develop until U.N. sanctions against Iraq are lifted. "China will most probably continue to use its membership in the U.N. Security Council, as well as its position in other U.N. bodies and subcommittees, to counter U.S. policy on Iraq."\textsuperscript{40}

Various forms of cooperation with Iran and Iraq may help ensure a continuous energy supply in both peacetime and during crises. Sino-Iranian civil cooperation, for example, is important to the development of a rail link passing through Iran, Turkmenistan and western China, in effect a revival of the "Silk Road."\textsuperscript{41} Recently, China announced that it is ready to strengthen its ties with Iran through a Memorandum of Understanding, which includes cooperation in subway, port and airport construction,\textsuperscript{42} all of which potentially enhance Iran’s defensive and offensive capabilities. Reportedly intelligence sources have concluded that the China National Electronics Import and Export Corporation has been assisting Iran in the development of an integrated tracking and missile-interceptor system.\textsuperscript{43} "Having only limited options in terms of power projection to the area, Beijing views its arms sales to Iran as a critical element of its regional policy. These arms sales, including elements of sophisticated nuclear and other ‘dual-use’ technology, give China an opportunity to gain a foothold in the region and build up a long term strategic link to secure its growing energy interests."\textsuperscript{44}

We do not know precisely the extent to which proliferation relates to China’s need for energy; but if its record is a valid indicator, China is likely to continue to meet requests for proliferation-related goods and services in exchange for access to energy in oil-producing countries. Although China is banking on oil development projects with Kazakhstan to meet a significant amount of its future oil needs, Beijing most likely will continue to nurture its relations with oil-producing states, especially Iran and Iraq, as an insurance policy.\textsuperscript{45}

\textsuperscript{37} Byman, “China’s Arms Sales,” \textit{12}.
\textsuperscript{39} Troush, “Oil Strategy.”
\textsuperscript{40} Ibid.
\textsuperscript{42} "Iran: Chinese Minister Notes Trade With Iran Tops $3.3 billion in 2001," \textit{Tehran IRNA} (FBIS Transcribed Text), 04 April 2002.
\textsuperscript{44} Troush, “Oil Strategy.”
\textsuperscript{45} Ibid.

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Sanctions

U.S. sanctions imposed on the PRC following the 1989 Tiananmen Square crackdown are still in effect. One result of the sanctions was the suspension of satellite export licenses for Chinese launches. Sanctions also exist under the 1990 Missile Technology Control Act that relate to M-11 missile technology and equipment transfers to Pakistan; under the Iran Nonproliferation Act of 2000, which pertains to Chinese assistance to Iran’s chemical and biological weapons programs; and under the Chemical and Biological Weapons Control and Warfare Act of 1991.

Several Chinese companies now are under sanction for violations of U.S. law. In 2001 the U.S. imposed sanctions on a Chinese company for aiding Iran’s chemical weapons program.46 In the same year the China Metallurgical Equipment Corporation (CMEC) was sanctioned for providing missile technology to Pakistan.47 In January 2002, two Chinese companies and one individual were sanctioned for the transfer to Iran of equipment and technology for production of chemical and biological weapons. In May 2002, sanctions were imposed on seven companies (two of which were already under the January 2002 sanction) for aiding Iran’s WMD program. Also sanctioned for the third time is an individual, Q.C. Chen, long involved in these transfers.

These sanctions provide that for two years, U.S. Government agencies are prohibited from procuring or entering into contracts for the procurement of goods, technology, or services from a Chinese enterprise associated with proliferation activities. No department or agency of the U.S. Government may provide any assistance to the sanctioned entities, and they shall not be eligible to participate in any assistance program of the U.S. Government. Prohibited are items on the U.S. Munitions list and sales of any defense articles, defense services or design and construction services controlled under the Arms Export Control Act. New licenses are denied, and existing licenses suspended for the transfer to these entities of items controlled under the Export Administration Act.

As the sanctioned companies are not engaged in activities with the U.S. Government, sanctions can have little or no deterrent effect on them. Furthermore the President can waive any sanctions if he deems it to be in the national interest. Throughout the 1990’s this waiver authority was often exercised to permit China to launch U.S. satellites. Presidential waivers continued to be issued, even as the PRC transferred M-11 missile technology to Pakistan.

Although the President has a variety of sanctions available to respond to China’s proliferation activities, these sanctions are case-specific and relate to designated activities with a narrow set of options available on a case-by-case basis.

For example, the Iran Nonproliferation Act (PL 106-178) prohibits U.S. Government procurement of goods and services from the sanctioned entity and denies export licenses for the transfer of controlled items to the sanctioned entity. None of these laws provides for economic sanctions (trade, investment, and capital flows) against the offending country or government. Missile technology sanctions (PL 101-510) provide for the denial of U.S. Government contracts relating to missile equipment or technology and denial of export licenses for missile equipment or technology. The President can also deny licenses for the transfer of munitions list items and prohibit the importation into the United States of products produced by the foreign entity or

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47 Ibid., 5.
entities. Once again, the law does not provide for economic sanctions against the offending country or government. Similarly, chemical and biological weapons sanctions (PL 102-182) provide the President the authority to deny U.S. Government contracts and to deny importation into the United States of products produced by the sanctioned entity, but the law does not provide for economic sanctions against the offending country or government.

The President have sufficient authority to select from the full range of economic and security related sanctions under the International Economic Emergency Powers Act (IEEPA). But its implementation is an unlikely remedy, since the IEEPA is to be invoked only in the event of a national economic emergency.

Finally, so many waivers have been granted during the last decade that U.S. sanctions and threats of sanctions appear to be more of an irritant to China than a credible obstacle. Moreover, their utility must be weighed against their impact on our own economic interests, including American jobs, and often pose a dilemma for U.S. trade officials.

In most cases, U.S. business interests have successfully argued that sanctions harm U.S. industry and the U.S. economy, particularly when the same or similar goods are available from other countries.

For example, Huawei Technologies, which helped Iraq improve its air defense capability in violation of U.N. sanctions, is an important player for many U.S. firms who want to access the Chinese telecom and data communications market, which is growing at a rate second only to that of the United States.\(^\text{46}\)

The issue of U.S. satellite launches from China has dominated the sanctions debate for the past decade. Many have argued against lifting restrictions on U.S. satellite exports to China based on national security concerns, i.e., if you improve satellite-launching missiles, you automatically improve missiles that can deliver more dangerous things. Others argue that in addition to the near term impact on U.S. industry of denying satellite exports, over the long term, U.S. industry’s ability to remain internationally competitive could suffer. Because European satellites contain components subject to U.S. restrictions, they, too, are in effect prohibited from launching on Chinese vehicles. These restrictions, some here argued, may encourage European manufacturers to develop indigenous capabilities in order to eliminate any dependency on the United States.

The various issues that surround sanctions policy reflect the broader factors involving globalization and the interdependence between U.S. economic and security issues.

One prime example is the U.S. military’s increasing reliance on private sector innovation to remain on the cutting edge. The extent to which private sector companies remain competitive has overriding importance for U.S. national interests and the ability to assure technical superiority in weapons systems.

**Anti-Terrorism**

China promised to cooperate with the United States in the war on terrorism, largely through intelligence sharing. Pan-Islamic fundamentalism threatens China’s control over its majority

\(^{46}\) Gershman, “Arms Sales to Taiwan: A Flashpoint Issue.”
Muslim western province, Xinjiang, which is rich in natural resources. China's cooperation, however, has been minimal. Just after September 11th, Chinese President Jiang Zemin reportedly expressed reservations to the British Prime Minister over the U.S. war on terrorism and U.S. military action.\footnote{Shirley Kan and Kerry Dumbaugh, *Terrorism Briefing Book* (Washington, D.C.: Congressional Research Service, 22 March 2002).} Prior to his retirement in May 2002, the U.S. Commander in Chief of the Pacific Command Admiral Dennis C. Blair complained that China’s intelligence sharing efforts were lacking in detailed information needed in the war on terrorism.\footnote{Dirk Beveridge, "U.S.: China Could Help War on Terror," *Associated Press*, 18 April 2002, <http://www.washingtonpost.com> (22 May 2002).}

According to CIA Director Tenet, "September 11th changed the context of China's approach to us, but it did not change the fundamentals. China is developing an increasingly competitive economy and building a modern military force with the ultimate objective of asserting itself as a great power in East Asia."\footnote{Tenet, Armed Services, 9/11, Written Testimony, 19.}

Although the warming of U.S.-Pakistan relations and the U.S. military presence in central Asia present strategic concerns for Beijing, the U.S. war on terrorism benefits Beijing. U.S. military actions and intelligence sharing help deter threats along China's borders. Intelligence sharing also enhances the regime's international prestige, demonstrating that China can be a partner with the United States.

Although China has publicly stated its support for international efforts to stem terrorism and approved the establishment of an FBI Legal Attaché in Beijing, Chinese counterterrorism efforts appear to be aimed at maintaining domestic security. Thus its pronouncements on cooperation with the U.S. war on terrorism may be motivated by China's desire to lend legitimacy to its actions against its own population.

Beijing’s definition of terrorism includes any group or individual it perceives to be a threat to the regime. This includes Muslim separatists, Tibetans, Falun Gong, and political and religious dissenters. According to the State Department's 2001 report on Global Terrorism, as part of its efforts "to improve its counterterrorism posture and domestic security" the Chinese government is "increasing its vigilance in Xinjiang, western China...and is increasing the readiness levels of its military and police units in the region."\footnote{Name, Armed Services, 9/11, Written Testimony, 19.}

Moreover, China's working relations with state sponsors of terrorism have continued without change. As the United States wages war on terrorism, China continues to proliferate to those states that harbor the terrorist networks. Beijing's foreign policy is consistent with its overall objectives. Some have argued that China’s cooperation with Iran, Iraq, Syria, Sudan and Libya are based, in part, on promises from these countries that outside Muslim extremist elements will be restrained from fomenting rebellion within China's borders. Presumably, the SA-7 missiles it allegedly supplied the Taliban in Afghanistan just a week after September 11th,\footnote{State Department, *Patterns of Global Terrorism*, 16.} were meant to help secure China's borders against dissidents in the western provinces.

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\footnote{Bill Gertz and Rowan Scarborough, "China-al Qaeda nexus," *The Washington Times*, 21 December 2001.}
Economic Reforms and WTO Accession

The World Trade Organization (WTO) provides no mechanism through which China may be forced to limit exports of WMD and related assistance.

Under certain circumstances, the economic reforms and decentralization that China's accession to WTO is expected to generate may lead to increased proliferation activity. As Chinese entities are forced to compete internationally under WTO implementation, economic dislocation could motivate companies to export illegally in order to survive the impacts of market opening. In testimony before the Commission, several witnesses stated they did not expect China's proliferation activity to cease despite WTO accession, in part because continued economic reform and decentralization would make dual-use technologies even harder to control. Decentralization could encourage a company to skirt official export policy and allow the government to turn a blind eye.  

National Security Implications

Because the United States is limited in its ability to prevent China from proliferating WMD to terrorist-supporting states, the United States "must prepare for the possibility of future conflict with regional adversaries, such as Iran, who are armed with longer-range ballistic missiles and perhaps even nuclear or chemical weapons." 55 A scenario in which Iran, Iraq and Syria armed with any combination of nuclear, biological, or chemical weapons enter into a future Middle East conflict would be very threatening to the United States.

China remains one of the world's key suppliers of missile technology. 56 The wide array of transfers during the last twenty years has serious implications for U.S. national security. While patterns of activity may have shifted with respect to composition, i.e. nuclear vs. non-nuclear, dual-use, or qualitative as opposed to quantitative transfers, China has proven to be an active proliferator.

As a result of extensive and continuing proliferation of WMD and related materiel, the United States must now be prepared to allocate significant resources to counter newly emerging and unpredictable nuclear, biological and chemical threats.

55 Byman and Cliff, "China's Arms Sales: Motivations and Implications," xii.
56 Defense Department, "Threat and Response," 18.
Recommendations

The President should have a full range of economic sanctions as tools to be used against foreign nations for violating proliferation commitments or agreements, and to deter further acts of proliferation.

- The Commission recommends that Congress should create new authorization to broaden and harmonize proliferation sanctions. The new legislation would amend all current statutes that pertain to proliferation in order to include a new section authorizing the President to invoke economic sanctions against foreign nations that proliferate WMD and technologies associated with weapons of mass destruction and their delivery systems. This would authorize the President to invoke and implement economic sanctions including import and export limitations, restrictions on access of foreign entities to American capital markets, restrictions on direct foreign investments into an offending country, restrictions on transfers by the U.S. Government of economic resources, and restrictions on science and technology cooperation or transfers. The new authority should require the President to report to the Congress the rationale and proposed duration of the sanctions within 72 hours of imposing them. They should remain in place for as long as is necessary to ensure non-proliferation goals are met.

- The Commission recommends that Congress maintain the Tiananmen sanctions that restrict U.S. export licenses for satellite launches in China until such time as the PRC effectively implements its commitment under the November 2000 agreement to put into place an appropriate export control system and the publication of a comprehensive missile-related export control list and regulations.

- Consistent with the recommendations in Chapter 6, the Congress should consider use of financial sanctions that include denial of access to U.S. capital markets to Chinese and other foreign firms found to be involved in proliferation. Unlike trade sanctions, financial restrictions would minimize "collateral damage" to U.S. exports and U.S. jobs.

- The Commission recommends that the United States work through the United Nations Security Council to formulate an effective framework enforced by sanctions to counter the proliferation of weapons of mass destruction and their delivery systems.

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The primary statutes include:

Prohibition on assistance to countries that provide military equipment to terrorist states (PL 104-132) of the Foreign Assistance Act 1961),

Prohibition on assistance to countries that aid terrorist states (PL 104-132),

Chemical Weapons Convention Implementation Act of 1998 (PL 105-277),

Sanctions against the use of CBWs (22 USC 5605, enacted by PL 102-182),

Sanctions against certain foreign persons for CBW proliferation (PL 102-182),

Nuclear Proliferation Prevention Act of 1994 (PL 103-236),

Transfers of missile equipment or technology by Foreign persons (PL101-510 et al),

Iran Nonproliferation Act of 2000 (PL 108-178),

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<tr>
<th>COUNTRY</th>
<th>TYPE OF ASSISTANCE</th>
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<tr>
<td>ALGERIA</td>
<td><strong>Research Reactor</strong></td>
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<tr>
<td></td>
<td>• 15 MWt pressurized heavy water research reactor; possible provisions of heavy water for the reactor; construction began around 1988; placed under IAEA safeguards in 1992</td>
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<td></td>
<td>• Designs for construction of third stage of Algeria’s Center for Nuclear Energy</td>
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<tr>
<td>ARGENTINA</td>
<td><strong>Low Enriched Uranium</strong></td>
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<tr>
<td></td>
<td>• 20 percent enriched, sold in 1980s, no safeguards</td>
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<tr>
<td></td>
<td><strong>Heavy Water</strong></td>
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<td></td>
<td>• 50-60 metric tons (1981-1985); no safeguards</td>
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<tr>
<td></td>
<td><strong>Uranium Concentrate (U3O8)</strong></td>
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<td></td>
<td>• 1981-1985, no safeguards</td>
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<td></td>
<td><strong>Uranium Hexafluoride Gas (UF6)</strong></td>
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<tr>
<td></td>
<td>• Early 1980s, 30 metric tons; no safeguards</td>
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<tr>
<td>BRAZIL</td>
<td><strong>Enriched Uranium</strong></td>
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<td></td>
<td>• 3 percent, 7 percent, 20 percent enriched; 200 kg total</td>
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<td></td>
<td>• 1984, no safeguards</td>
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<tr>
<td>INDIA</td>
<td><strong>Heavy water</strong></td>
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<td></td>
<td>• 1982-1987; 130-150 metric tons</td>
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<td></td>
<td>• No IAEA safeguards</td>
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<td></td>
<td><strong>Low-Enriched Uranium</strong></td>
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<td></td>
<td>• 1995, for India’s Tarapur reactors</td>
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<td></td>
<td>• Supplied under IAEA safeguards</td>
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<tr>
<td>IRAN</td>
<td><strong>Research Reactors</strong></td>
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<td></td>
<td>• 27kW subcritical, neutron source reactor; provided in 1985; currently under IAEA safeguards</td>
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<tr>
<td></td>
<td>• Zero-power reactor; commercial contract signed in 1991; currently under IAEA safeguards</td>
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<tr>
<td></td>
<td>• HT-6B Tokamak nuclear fusion reactor, located at Azan University</td>
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<td></td>
<td>• 20 MWt reactor; contract signed in 1992 but the deal was canceled due to U.S. pressure</td>
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<tr>
<td></td>
<td><strong>Power Reactors</strong>: two 300 MWe reactors</td>
</tr>
<tr>
<td></td>
<td>• Deal suspended in 1995 and canceled in 1997</td>
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<td></td>
<td>• CIA verified project cancellation</td>
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<tr>
<td></td>
<td><strong>Calutrons (electromagnetic isotope separators, EMIS)</strong></td>
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<tr>
<td></td>
<td>• For Karaj and Isfahan facilities; commercial</td>
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<tr>
<td>IRAQ</td>
<td>Ring Magnets</td>
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<tr>
<td></td>
<td>- Exports of samarium-cobalt magnets for gas centrifuges, 1989-1990</td>
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<td>- Project canceled in October 1997</td>
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<td>- CIA verified cancellation of deal</td>
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<td>- China possibly provided blueprints for facility</td>
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<th>Zirconium Tube Production Facility</th>
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<td>- Assistance continuing</td>
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contract signed in 1989; under safeguards
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<th><strong>PAKISTAN</strong></th>
<th><strong>NUCLEAR WEAPON-RELATED ASSISTANCE</strong></th>
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<tr>
<td><strong>Nuclear Weapon Design</strong></td>
<td>• Basic, Hiroshima sized weapon</td>
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<td><strong>Nuclear Weapon Testing</strong></td>
<td>• Possible inclusion of Pakistani observers at China’s Lop Nur test facility (1989)</td>
</tr>
<tr>
<td><strong>Possible Provision of Tritium Gas</strong></td>
<td>• 1986, no safeguards</td>
</tr>
<tr>
<td><strong>Uranium Enrichment</strong></td>
<td>• Assistance to unsafeguarded Kahuta enrichment facility</td>
</tr>
<tr>
<td></td>
<td>• This assistance was mutually beneficial</td>
</tr>
<tr>
<td><strong>Ring Magnets</strong></td>
<td>• About 5,000 to unsafeguarded A.Q. Khan Research Laboratory in Kahuta (1995)</td>
</tr>
<tr>
<td><strong>Weapons-Grade Uranium for Two Devices</strong></td>
<td>• Early 1980s, supplied without safeguards</td>
</tr>
<tr>
<td><strong>Plutonium Production Reactor at KhU.S.hab</strong></td>
<td>• 50-70 MW heavy water reactor (unsafeguarded)</td>
</tr>
<tr>
<td></td>
<td>• Construction assistance</td>
</tr>
<tr>
<td></td>
<td>• Provided special industrial furnace and high-tech diagnostic equipment (1994-1995)</td>
</tr>
<tr>
<td><strong>Reprocessing Facility at Chashma</strong></td>
<td>• Possible assistance constructing unsafeguarded facility</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>CIVILIAN NUCLEAR ASSISTANCE</strong></th>
<th><strong>Power Reactor:</strong> Chashma-1 (CHASNUPP), 300 MWe</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Build by CNNC, deal signed in late 1995.</td>
</tr>
<tr>
<td></td>
<td>• Began operating in November 1999</td>
</tr>
<tr>
<td></td>
<td>• Under IAEA safeguards (INFCIRC/418)</td>
</tr>
<tr>
<td><strong>Research Reactors</strong></td>
<td>• Miniature Neutron Source Reactor (MNSR); supplied under IAEA safeguards (INFCIRC/393) in 1991</td>
</tr>
<tr>
<td></td>
<td>• Helped construct PARR-2 research reactor, safeguarded</td>
</tr>
<tr>
<td><strong>Heavy water (D2O)</strong></td>
<td>• Up to 5 MT/year for safeguarded PHWR [Kanupp] research reactor</td>
</tr>
<tr>
<td></td>
<td>• Possibly diverted by Pakistan to the Khushab research reactor against Chinese wishes</td>
</tr>
</tbody>
</table>

**Fuel Fabrication Services**

Source: Monterey Institute of International Studies, EANP/CNS
### Figure 7.3 Continued China’s Missile Technology Exports: In The 1980s And 1990s

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>TYPE OF ASSISTANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>IRAN</strong></td>
<td><strong>Ballistic Missiles</strong>&lt;br&gt;- 8610/CSS-8&lt;br&gt;- M-9/DF-15 (China cancelled the sale under U.S. pressure)</td>
</tr>
<tr>
<td><strong>Iraq</strong></td>
<td><strong>Cruise Missiles (1980s)</strong>&lt;br&gt;- HY-2 (Silkworm)&lt;br&gt;- C-601&lt;br&gt;- YJ-1/C-801</td>
</tr>
<tr>
<td><strong>Libya</strong></td>
<td><strong>Missile Fuel</strong>&lt;br&gt;- Lithium hydride</td>
</tr>
</tbody>
</table>

**Assistance to Iran’s Indigenous Missile Programs**
- Extensive production assistance for the 8610/CSS-8 missile
- Extensive production infrastructure for HY-2, C-801 and C-802 missiles (production assistance halted in 1997)
- Possible assistance to the Shahab-3 ballistic missile
- FL-10 air-launched cruise missile

**Missile Fuel**
- Various propellant ingredients
- Ammonium perchlorate

**Missile Guidance and Control Technology**
- Guidance kits (mid-1990s)
- Gyroscopes (mid-1990s)
- Accelerometers (mid-1990s)
- Test equipment for ballistic missiles (mid-1990s)
<table>
<thead>
<tr>
<th>PAKISTAN</th>
<th>Ballistic Missiles and Launchers</th>
</tr>
</thead>
<tbody>
<tr>
<td>• 34 M-11/DF-11 missiles; stored at Pakistan's Sargodha Air Force Base near Lahore; delivered in November 1992</td>
<td></td>
</tr>
<tr>
<td>• M-11 transporter-erector-launchers (TELs)</td>
<td></td>
</tr>
<tr>
<td>Possible Assistance to Indigenous Missile Programs</td>
<td></td>
</tr>
<tr>
<td>• Hatf-1, Hatf-2 and Hatf-3 ballistic missiles</td>
<td></td>
</tr>
<tr>
<td>Missile Fuel</td>
<td></td>
</tr>
<tr>
<td>• Ammonium perchlorate, 10 tons seized in Hong Kong in 1996; Pakistan's SUPARCO was caught attempting to import the ammonium perchlorate from a company in Xian, China</td>
<td></td>
</tr>
<tr>
<td>Missile Guidance</td>
<td></td>
</tr>
<tr>
<td>• Gyroscopes</td>
<td></td>
</tr>
<tr>
<td>• Accelerometers</td>
<td></td>
</tr>
<tr>
<td>• On-board computers</td>
<td></td>
</tr>
<tr>
<td>Assistance to Missile Production Factory</td>
<td></td>
</tr>
<tr>
<td>• Rawalpindi, 40 km west of Islamabad</td>
<td></td>
</tr>
<tr>
<td>• Likely producing Pakistani version of M-11 missile</td>
<td></td>
</tr>
<tr>
<td>• Blueprints and construction equipment, possibly ongoing</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>SAUDI ARABIA</th>
<th>Ballistic Missiles</th>
</tr>
</thead>
<tbody>
<tr>
<td>• 30+ DF-3 (CSS-2) missiles; deliveries began in 1988; and included construction of launch complex, training, and post-sale systems maintenance</td>
<td></td>
</tr>
<tr>
<td>• In 1997, Saudi Arabia requested from China possible replacements for the aging DF-3 missiles; China did not provide any replacements</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>SYRIA</th>
<th>Ballistic Missiles</th>
</tr>
</thead>
<tbody>
<tr>
<td>• DF-15/M-9 missiles, Syria provided advance payments</td>
<td></td>
</tr>
<tr>
<td>• Cancelled under U.S. pressure in 1991; Syria possibly received test missile</td>
<td></td>
</tr>
<tr>
<td>Assistance with Indigenous Programs</td>
<td></td>
</tr>
<tr>
<td>• 30 tons of ammonium perchlorate in 1992</td>
<td></td>
</tr>
<tr>
<td>• Technical exchanges</td>
<td></td>
</tr>
</tbody>
</table>

Source: Monterey Institute of International Studies, EANP/CNS
<table>
<thead>
<tr>
<th>ACT</th>
<th>SANCTIONED PARTY(IES)</th>
<th>SANCTION</th>
<th>REASON FOR SANCTION</th>
<th>DATE OF SANCTION</th>
<th>DATE SANCTION WAIVED</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990 Missile Technology Control Act</td>
<td>• China Precision Machinery Import-Export Corp. and China Great Wall Industry Corp.  • China’s Ministry of Aerospace Industry  • China Metallurgical Equipment Corporation</td>
<td>• Prohibition of the export of missile-related computer technology and satellites  • Prohibition of the export of Missile Technology Control Regime (MTCR) items and U.S. Government contracts  • Prohibition of U.S. exports of MTCR Annex items to the sanctioned entity</td>
<td>• PRC transferred missile related technology to Pakistan  • PRC shipped M-11 related equipment to Pakistan  • Proliferation of missile technology to Pakistan</td>
<td>• 1991</td>
<td>• 1992 (Presidential Waiver)</td>
</tr>
</tbody>
</table>
| Iran Nonproliferation Act of 2000 | • Liyang Chemical Equipment, China Machinery and Electric Equipment Import and Export Company (aka China National Machinery and Electric Equipment Import and Export Company), and a Chinese individual
  • Jiangsu Yongli Chemicals and Technology Import and Export Corporation
  • Liyang Chemical Equipment Company, Zibo Chemical Equipment Plant (aka Chemet Global Ltd.), China National Machinery and Electric Equipment Import and Export Company, Wha Cheong Tai Company, China Shipbuilding Trading Company, China Precision Machinery Import/Export Corporation, China National Aero-Technology Import and Export Corporation, and one Chinese individual | • Prohibition of U.S. Government procurement of goods and services from the sanctioned entities. No new individual licenses shall be granted for the transfer to these foreign entities controlled items.
• Prohibition of U.S. Government procurement of goods and services from the sanctioned entity. No new individual licenses shall be granted for the transfer to these foreign entities controlled items.
• Prohibition of U.S. Government procurement of goods and services from the sanctioned entity. No new individual licenses shall be granted for the transfer to these foreign entities controlled items. | • Supplying Iran with materials used in the manufacture of chemical and biological weapons
• Reports indicate company was involved in export of dual-use items covered in the Australia Group
• Aiding Iran's weapons-of-mass destruction programs | • January 2002 (Duration of a minimum of 2 years)
• 2001 (Duration of a minimum of 2 years)
• May 2002 (Duration of a minimum of 2 years) |
| Chemical and Biological Weapons Control and Warfare Act of 1991 | • Nanjing Chemical Industries Group (PRC), Jiangsu Yongli Chemical Engineering and Technology Import/Export Co. (aka Jiangsu Yongli Chemicals and Technology Import and Export Corporation) (PRC), Cheong Yee Limited (Hong Kong), and five Chinese individuals | • Prohibition of U.S. Government procurement of goods or services from the sanctioned entities or persons. Prohibition of importation into the United States of products produced by the sanctioned entities. | • Contributed to Iran's chemical weapons program | • 1997 | • In effect |
Chapter 8 - Cross-Strait Security Issues

Key Findings

- The stated policy of the United States Government is to support Taiwan's security and democracy.

- Taiwan recently has undergone a remarkable political transition, rejecting authoritarian government in favor of free elections and a multi-party parliamentary democracy.

- China is increasing at the rate of roughly 50 per year the number of ballistic missiles it has deployed opposite Taiwan and could have 600 missiles within five years.

- China is enhancing its capability to carry out attacks across the Taiwan Strait with its special operations forces, air forces, and navy and missile forces with little notice.

- It appears the Chinese buildup is designed to forestall pro-independence political movements in Taiwan and help bring about an eventual end to the Island's continued separate status.

- Executive-Congressional consultations regarding Taiwan's security up until the most recent period have not been in conformity with the clear expectation of the Taiwan Relations Act (TRA). The Commission feels strongly that such consensus building is crucial given the clear security risks of this situation. In the last two years the Executive-Congressional consultations in this area have improved.

Introduction

The Taiwan issue is the most dangerous flashpoint in U.S.-China relations. This chapter continues the discussion of cross-strait issues begun in Chapter 5 and provides a discussion of the military and security relationship. Prospects for maintaining peace and security in the region and in the Taiwan Strait depend on how Beijing and Taipei manage their significant political differences. While cross-strait economic interactions have flourished since the 1990's, the two sides remain locked in an uneasy standoff. The United States, with significant interests at stake in its relations with both parties and in the region, cannot stand aside. China's political and military strategy is designed to remind U.S. leaders of the significantly increased direct costs to America and its regional relationships should our military forces intervene to challenge Chinese interests. Even though China retains substantial incentives to collaborate with the United States in future years, the situation remains volatile over the medium and long terms. The real possibility that tensions could erupt into major crisis must be factored into U.S. policy and planning.

A military defense for an island of 23 million people, facing a nation of 1.3 billion people, is complicated and difficult. While recognizing that Taiwan's security depends on more than just military means, this chapter concentrates on the military dimension of the impasse between the two sides. Taiwan has made significant progress in its transition to democracy, a multi-party parliamentary system of government, and to a successful open-market economy. This chapter will examine China's position on the use of force to resolve Taiwan's status and its capabilities for exercising that option and will briefly look at the issues that Taiwan's defense planners are facing and conclude with a discussion of U.S. strategy.
China's Intentions and the Threat of Force

Chinese officials have long maintained that they cannot and will not rule out the use of force against Taiwan under certain conditions. These conditions include a formal declaration of independence by Taipei, internal unrest there, or even indefinite delays in the resumption of cross-strait dialogue.1 The government has published two white papers concerning the "One-China Principle and Taiwan". These papers plus supporting reports and official statements set forth what Chinese officials perceive to be a viable foundation on which unification talks can proceed. The first white paper was released in 1993, which was then followed by President Jiang's Eight-Point Offer to Taiwan on January 30, 1995. The second white paper followed on February 21, 2000. The basic premise of the One-China Principle and the key points are2:

- China will do its best to achieve peaceful reunification, but will not commit itself to rule out the use of force;
- Will actively promote people-to-people and economic and cultural exchanges between the two sides;
- Start direct trade, postal, air and shipping services as soon as possible;
- Achieve reunification through peaceful negotiations; and
- Any matter can be negotiated on the premise of One-China.

Recent statements by China's leaders indicate that the use of force remains an option in dealing with Taiwan:

_The Hong Kong Paper Tai Yang Pao_ reported last year that President Jiang expressed concern over the then deterioration in Sino-US relations. He is reported to have said that if the United States puts pressure on the Mainland through arms sales to Taiwan and blocks cross-strait reunification, China would be forced into a war between powers.3

_Chi Haotian, vice-chairman of the CPC Central Military Commission and the Minister of National Defense has stated that the Taiwan problem is the most serious and urgent problem for China's security. He added that the PLA must continue promoting the peaceful unification of the motherland, and must never allow any force to sever Taiwan from China by any means._4

Recent evidence also suggests that China's leadership is serious in its efforts to pursue unification. In the late 1990's, China made a critical decision to make its force deployment credible in order for the leadership to enhance its options in dealing with pro-independence forces in Taiwan. It is believed that the PRC military has been directed to have viable options ready by 2005-07. Late last year, there was a leak to the Hong Kong newspaper _Insight_, of what purports to be an August 1999, Central Military

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3 Wen Jen, "Jiang Reportedly Threatens War with US over Taiwan," _Hong Kong Tai Yang Pao_, 26 March 2001; translated in FBIS.
4 "PLA NPC Delegates Stress Need for Expeditious Resolution of Taiwan Problem," _Beijing Zhongguo Xinwen She_, 9 March 2001; Meng Yan, "PRC's Chi Haotian: Any Attempt to Sever Reunification of Motherland Will Be Futile," _Beijing China Daily_, 1 August 2001; translated in FBIS.
Commission (CMC) document discussing the plans for military action against Taiwan. On orders from Beijing, *Insight's* offices were subsequently closed for two weeks and the publication withdrawn from circulation. Analysis of the 2001 PLA Dongshan Island exercises of last year indicates the exercises focused on joint operations with the goal of taking Taiwan. The PLA exercised all elements of a potential war plan from the use of its Second Artillery Corps ballistic missiles, from information warfare to joint landings and potential anti-carrier naval operations at sea.

**Assessing China’s Capabilities**

Chinese authorities are apparently considering several broad classes of military contingencies available to impose their will on Taiwan:

- An invasion of Taiwan (or an offshore island), using amphibious or other sea or air-transported forces.
- Air or missile strikes on its industrial infrastructure or commercial assets.
- A blockade.

Associated with each of these contingencies is some strategy for avoiding, discouraging, or defending against possible third-party intervention, that is, against a determined U.S. response. China’s most formidable challenge would be to withstand international condemnation and the imposition of global economic sanctions.

**Launching an Invasion**

Beijing has increasingly focused on advanced training methods to demonstrate joint-service war-fighting skills that are steadily altering the balance of power with Taiwan. Over the past several years PLA exercises have shifted from intimidating Taiwan to a more serious effort to prepare its military forces to invade. Last year’s Dongshan Island exercises illustrated an increasing level of sophistication in war-fighting tactics and interoperability. The PLA is radically overhauling its training regime and introducing more realistic exercises including night maneuvers, combined operations training, long-distance deployments and live-fire exercises.

In keeping with its recent efforts to implement a strategy based on “high-tech limited wars,” the PLA’s tactical goal would be to strike fast and hard in the event of a cross-strait attack. Planning for U.S. involvement compels the PLA’s war-fighting plan towards a quick, decisive neutralization of Taiwan and the degradation of its ability to defend itself. The strategy is to present the United States with a significant political decision. Assuming the strategy was successful, rather than assisting in Taiwan’s defense the United States would then be required to expel a Chinese occupational force.

The PLA is making wide-ranging advances in the size and sophistication of its forces arrayed along the strait. The combination of advanced surveillance, large numbers of ballistic and cruise missiles, and the element of surprise is a serious threat to the region’s stability.

China has stationed some 75 Russian SU-27 fighters with advanced air-to-air missiles opposite Taiwan, and it will assemble another 125 fighters with Russian help. China also has purchased 40 SU-30 fighters, each of which can provide radar targeting through a data link to four SU-27s. The PLAAF’s SU-27s and
SU-30s are highly capable planes. Of particular concern is the massive numbers of less capable fighters possessed by the PLA/AF. These aircraft can overcome by attrition the technologically superior planes of Taiwan’s air force.

China poses an increasing threat to the region with its acquisition of Russian Kilo-class submarines and the indigenously produced Song-class submarines. The Song-class is the first Chinese submarine equipped with a submerged-launch anti-ship cruise missile. The Kilos are among the quietest conventional submarines in the world, and coupled with the Song-class submarines, provide a generational leap in China’s conventional submarine technology.

China’s has also purchased Russian Sovremenny-class destroyers. The SS-N-22/Sunburn/Moskit anti-ship missile on these destroyers is designed specifically to attack U.S. aircraft carrier battle groups and to defeat the U.S. Navy’s Aegis air-defense system. The SU-30 fighter can also carry the air-launched version of the "Moskit" anti-ship missile as well as advanced air-to-air missiles that can travel farther than the 100 miles across the strait.

These actions are seriously affecting the region’s balance of power. Within ten or fifteen years China will have the ability to project its forces and will probably possess sufficient air and sea capabilities to enforce her expanding perimeters. Even now at considerable cost and with substantial losses, the PLA Air Force could establish the air and sea superiority needed for a successful invasion.

Mounting a Missile Attack

An extensive increase in the number of operationally deployed short-and intermediate-range missiles is clearly in progress with many of the missiles positioned at bases near the strait. The significance that PLA strategists attach to ballistic missiles was evident in the 1996 Taiwan Strait crisis, when the effectiveness of China’s forces was fundamentally challenged by the deployment of two U.S. aircraft carriers. There are significant political costs associated with this buildup; the deployments radically increase the potential for miscalculation and decrease the time to make those decisions by both governments. Missile strikes are incalculably risky; once launched, the Chinese leadership cannot afford to fail. The initiative will have to be prosecuted until Taiwan surrenders.

Chinese leaders understand the inherent political risks to its survival should an attack fail. Failure would strip the regime of its domestic legitimacy and threaten its continuation in power. Failure would likely also mean de facto independence on Taiwan. This must give the leadership pause.

Admiral Dennis Blair, Commander-in-Chief, U.S. Pacific Command, stated that China had recently increased its deployment of short-range ballistic missiles against Taiwan. Another assessment of these missiles concludes that:

_They cannot make a decisive military difference yet, but if they continue to increase in number and accuracy there will come a time when they threaten the sufficient defense of Taiwan._

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Of concern, however, is the limited information we actually have on missile deployments, given their growing importance to PLA war strategy. The PLA could be increasing its current production well beyond current assumptions. Taiwan’s national defense report published in August of 2000 indicated the PLA had approximately 400 ballistic missiles of different kinds covering Taiwan and estimated that this could increase to 600 in five years. Ballistic missile batteries could easily be hidden in the rough terrain along the mainland’s coastline. It is not just the numbers that are increasing; China is increasing the accuracy of its short-range ballistic missiles and Taiwan lacks an effective response to this threat.

Taiwan forces, however, would not be the only ones facing the missiles. The PLA, in anticipation of U.S. intervention, has indicated a willingness to use accurate short-range and medium-range ballistic and cruise missiles against U.S. forces, including bases in Japan and aircraft carriers operating in the Western Pacific. All PLA missiles capable of hitting bases in Japan from China’s territory are nuclear-tipped.

PLA strategists understand that modern battlefields will be nonlinear requiring a modern integrated force to be successful. Thus, the operational strategy of using air strikes or missiles to carry out accurate attacks on rear targets has been given particular emphasis. In terms of an emerging strategy, ballistic missile attacks will probably announce a PLA offensive operation against Taiwan. To be successful the PLA will need to disrupt, degrade, or destroy Taiwan’s overall combat capability. PLA strategists have written on the need for missile attacks in the opening phase of combat in order to splinter Taiwan’s fully integrated and developed air defense network. These strategists insist that the key parts of Taiwan’s air defense system, such as airfields, ground-based radar stations, and command, control, communications, and intelligence centers become the first targets. Taiwan is virtually defenseless against a ballistic missile attack. Taiwan’s missile defense forces are vulnerable and China’s ever-strengthening ballistic missile capability can cause severe destruction. Although expressing doubt that the PLA could coordinate simultaneous missile and military operations, the Defense Department’s annual military report on China says that these weapons would be most effective when used in high-volume, precision strikes. Taiwan’s resources and population centers are concentrated, and missiles pose a very serious problem for electric power production, oil storage and processing facilities, communications, ports, airports, railroads, and factories. A few ballistic missiles would be enough to destroy most of Taiwan’s civilian oil reserves stored in the event of war.

As long ago as October 1998, a Defense Intelligence Agency report outlined a major buildup of short-range ballistic missiles opposite Taiwan. Up until 1998 the missile deployment had been modest and was limited to a garrison of CSS-6 weapons. The Chinese plan to have in place a total of 600 missiles by 2005, by deploying about 50 new missiles a year.

\footnote{National Defense Minister, Tang Fei Interview, "Tang Fei: In the Face of War Threats, We Cannot Suffer and not Hit Back", \textit{Lien Ho Pao (in Taipei)}, 28 December 1999 pg.2; translated in FBIS.}
Missile strikes have the advantage of speed: targets would be destroyed with little or no warning. If attack plans were implemented covertly over a period of time, a quick-strike missile attack would minimize the possibility of third-party intervention. Because of the speed of the missiles and the short distance across the strait, Taiwan would have very little time to prepare its defenses. A barrage even of hundreds of Chinese ballistic and cruise missiles fired against Taiwan, however, would actually do limited (or at least not permanently devastating) damage, unless China resorted to chemical, biological or nuclear warheads or the missile strike is coordinated with other concurrent military operations such as air and maritime engagements.

**Threatening a Blockade**

Because Taiwan will continue to maintain significant qualitative and technological advantages against Chinese forces over the near term, the issue of a Chinese blockade will be the most important defense issue in the coming decade. The primary objective of a blockade would be to cripple Taiwan economically and isolate it internationally. A review of available Chinese military literature indicates that China’s leaders apparently believe a blockade would be less likely to provoke outside intervention than other actions. Beijing would probably initiate a blockade in steadily increasing steps. Escalating at will, Beijing could deploy successively more severe responses, beginning with stopping Taiwan-flagged merchant vessels operating in the strait and ending with mining harbors and ports and deploying submarines and surface ships.\(^{10}\)

Chinese naval forces currently have a numerical superiority in submarines and large surface ships and possess the capability to blockade Taiwan’s major ports. In implementing a blockade, Chinese forces could bring to bear a mix of military ships, submarines, aircraft, commercial ships, fishing ships, and other civilian-use craft. All could do double duty as mine-laying craft, intelligence boats, and amphibious troop carriers.

Barring third-party intervention, the PLA Navy’s quantitative advantage over Taiwan’s Navy in surface and sub-surface assets would probably prove decisive. Taiwan’s military forces probably would not be able keep the island’s key ports and sea-lanes of communication open in the face of concerted Chinese military action. Taiwan’s small surface fleet and four submarines are numerically insufficient to counter China’s major surface combatant force and its anti-submarine warfare assets. The PLA Naval Air Forces’ B-6D bombers armed with C-601 anti-ship cruise missiles would place Taipei’s merchant ships and combatants at serious risk.

A blockade, while not risk-free, would be far less costly and dangerous to the PLA. The disadvantage of a blockade is that it takes a long time to succeed and the strait is an important and busy waterway used by commercial shipping of many countries: closing it would harm their economies as well as Taiwan’s. If successful, it would cripple Taiwan economically without destroying its infrastructure or killing many people. Taiwan is dependent on the freedom of sea cargo transport, which accounts for almost 99

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percent of its total cargo transport. Ministry of National Defense (MND) officials estimate that Taiwan would only be able to endure a blockade for 120 days before needing a resupply of essential materials.

**Taiwan’s Defense Strategy**

Taiwan’s current military doctrine seeks to address three operational requirements.

- Maintaining air superiority over the strait and the contiguous waters;
- Conducting effective counter-blockade operations;
- Defeating an amphibious and aerial assault on Taiwan.

To meet these objectives Taiwan must maintain a technologically superior qualitative edge over PLA assets. For the past decade, Taiwan’s military has been transforming its operational forces by acquiring modern weapons systems and associated equipment in order to deter Chinese aggression. Billions of dollars have been spent on developing both domestic programs like the Indigenous Defense Fighter (IDF) and the *Tien Kung* air defense system, as well as on foreign purchases such as F-16 fighters and French-built Lafayette-class frigates.

However, the current organizational structure of Taiwan’s armed forces hinder force modernization. Additionally, Taiwan’s defense purchases often appear to be made for political reasons rather than as part of an overall strategy to effectively defend the island from attack. To overcome these definite deficiencies, Taiwan is engaged in a ten-year (2001-2010) modernization, reform, and restructuring plan.

On January 5, 2000, the Legislative Yuan passed the National Defense Law and the Organic Law of the Ministry of National Defense (MND). The main goal of the legislation is to effect greater control over the military services and to better coordinate weapons acquisitions programs. This is being implemented by bringing the operation of the military under one unified system led by a single defense minister. The laws require Taiwan’s defense establishment to reorganize the national defense systems and unify its military administration and military command structure. In effect, it mandates requirements necessary for a modern, professional armed force. Taiwan’s military services are now under pressure to demonstrate better coordination between competing, independent operating branches and units.

With the exception of some recent systems from Russia, the most modern Chinese conventional weapons are inferior one-for-one with the Western-built equipment in Taiwan. The Chinese military is impressive in size, but lacking in technological sophistication. Taiwan’s F-16s and Mirage 2000s, for example, could counter China’s SU-27s with Taiwan’s pilots better trained than their Chinese counterparts. Taiwan still has a technological edge over the Mainland militarily, but this will disappear without U.S. support. Taiwan’s advanced weapons are not being used to their fullest extent.

The most pressing needs of Taiwan’s military include improved defenses against cyber attack and incoming missiles, better anti-submarine warfare capabilities, expanded military training programs, and a restructuring that would emphasize naval and air power rather than ground forces.

Officials of the Defense Ministry believe Taiwan will be forced to fight an island defensive war, with little to no early warning time, shallow depth, and a quickly moving field of battle and is modernizing its armed forces to meet those needs. An invasion would run headlong into Taiwan’s strong suit of layered shore-based coastal defense, an effective air force and the Asian region’s third most powerful navy. For
example Taiwan has begun to invest increasing amounts of time and money in developing its own offensive Information Warfare (IW) capabilities but they are believed to be limited. Taiwan's armed forces have also decided that the upgrade of the island's Early Warning (EW) capabilities is a main goal.

**U.S. Strategy**

Since our official recognition of the PRC, U.S. foreign and defense policy has been designed to ensure continued stability and security of the Asia Pacific region. The overarching U.S. goal is to avoid any use or threat of force by China or provocative behavior by Taiwan to resolve differences in the strait. The "Three Communiqués" and the Taiwan Relations Act provide a political framework to manage the relations between Beijing, Taipei, and Washington. This framework has provided an environment within which China-Taiwan relations can develop without threatening the peace of the Taiwan Strait and the Asia-Pacific region.

U.S. objectives for the cross-strait relationship include:

- Deterring China attacking Taiwan;
- Supporting Taiwan's ability to defend itself without outside assistance; or
- Defending itself long enough to permit U.S. assistance so that the combination of Taiwan and U.S. forces can defeat a PLA attack, should the U.S. decide to intervene.\(^{11}\)

In 1979 the United States officially recognized the government in Beijing as the legitimate government of China and ceased recognition of Taiwan. In the same year the Congress passed The Taiwan Relations Act (TRA) to ensure that Taiwan's security would not be compromised as a result of the termination of diplomatic relations between Taiwan and the United States. In 1982 President Reagan promised Taiwan that the United States would not negotiate behind its back on Taiwan's status or arms sales.

Since its passage and reconfirmation by successive administrations, the TRA -- together with President Reagan's assurances -- has proved to be a solid foundation for Washington and Taipei relations. It has also been crucial in managing and shaping American policies toward Taiwan and Asia. Since its inception, however, Beijing has simply rejected the TRA as an attempt by the United States to interfere in China's internal affairs and has repeatedly declared the TRA invalid. It continues to insist that the "Three Communiqués" are the only basis for the Sino-American relationship.

While the TRA does not identify specific actions that the U.S. would take in the event that Taiwan's security of Taiwan was threatened, it does provide the option for the U.S. to come to Taiwan's defense. The U.S., however, is obliged by the TRA to help Taiwan defend itself through the provision of such items that it needs for its self-defense.

In assessing Taiwan's defense needs, DoD has dedicated significant resources to monitoring the security situation in the strait and continues to improve these efforts. It continually reevaluates Taiwan's defense posture to ensure that we make available to Taiwan such items as will provide a sufficient self-defense capability.\(^{12}\)

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\(^{12}\) Ibid.
In 2001, the U.S. approved the largest sale of defensive weapons and services to Taiwan in nearly a decade. Taiwan's legislature now needs to determine if it will fund the purchases. The major items in the proposed sale are:

- Four used Kidd-class destroyers
- 12 P-3C Orion aircraft, land-based, long-range surveillance aircraft, used primarily in anti-submarine or anti-surface warfare
- Eight diesel submarines designed to counter blockades and invasions
- Paladin M109A6 self-propelled artillery system
- MH-53E minesweeping helicopters
- AAV7A1 Amphibious Assault Vehicles
- Mk 48 torpedoes without advanced capabilities (designed to combat fast, deep-diving nuclear submarines and high-performance surface ships
- Avenger surface-to-air missile system (lightweight, highly mobile and air transportable)
- Submarine-launched and surface-launched torpedoes
- AN/ALE-50 self-defense pods for the F-16s (aircraft survivability equipment)
- 40 Maverick, AGM-65G air-to-ground missiles for the F-16s
- 40 Javelin anti-tank missile systems\(^{13}\)

Earlier, the Congress included a provision in the Defense Authorization Act of 1998 that required the Department of Defense to study ballistic missile defense for Taiwan. In April 2000 the U.S. approved the sale of sophisticated air-to-air and anti-ship missiles and a Pave Paws long-range radar system that could eventually be linked to a theater missile defense system.

In 2000, the U.S. sold Taiwan advanced AIM120C air-to-air missiles but with the caveat that the missiles be delivered only in the event of a threatened attack by China. U.S. policy is to avoid introducing capabilities that would go beyond what is required for Taiwan's self-defense. The AIM120C would have introduced beyond-visual-range capability into the region. Taiwan pilots, however, are permitted to train with the missiles on U.S. ranges. This decision should be reviewed if the transfer by Russia to China of AA-12/Aramks is verified.

The Commission notes that the role of Congress in developing U.S. policy towards Taiwan has been sporadic over the years because successive administrations have resisted active consultation as specified under the TRA. Important policy differences between Congress and the Executive Branch, many of which stem from a lack of consultation, have not been conducive to a coherent American policy. That has changed in the past two years in part because of new legal requirements for periodic consultations. This is a welcome evolution.

U.S. policies have been successful over the years because they have injected caution in the Chinese leadership about resort to force in dealing with Taiwan and, at the same time, induced caution in Taiwan about publicly declaring independence, fearful that without a firm U.S. commitment China might retaliate with force. The strategic ambiguity policy also sought to stabilize the status quo while the two resolve

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their differences. It is important for all sides to avoid miscalculation and for the United States to make it clear to leaders in both Beijing and Taipei that their behavior has consequences that may adversely affect the long-term gains in democracy on Taiwan and the impressive economic gains in both Taiwan and on the Mainland. The Commission believes it must remain U.S. foreign policy and national security objective to convince the parties that only a peaceful resolution of their differences is acceptable.

National Security Implications

Taiwan today has a strong economy and a vibrant, multiparty democracy. The people on Taiwan have demonstrated impressive courage and resilience in their embrace of freedom as they live under dangerous circumstances. Taiwan has achieved remarkable progress in democratic elections, civil liberties, market economic development, and stable, viable governmental institutions.

A strong defense capability is important to Taiwan’s security and economic well-being. The current posture of Beijing to pursue economic integration as a peaceful mechanism to asserting its sovereignty over Taiwan could be supplanted by more troublesome strategies and actions in the next three to five years. After that time, the PLA will have sufficient military capability, to pursue forceful unification.

A strong Executive-Congressional consensus on U.S. policy regarding Taiwan needs frequent updating based on regular consultations, given the severe national security implications of this situation and for U.S. credibility throughout the region.

Recommendations

- The Commission recommends that Congress work with the Department of Defense to continue its current policies of substantive military dialogue with Taiwan and conduct exchanges covering issues ranging from threat analysis, to doctrine to force planning.

- The Commission recommends that the U.S. along with its allies should continue to call upon China to renounce the threat of or the use of force against Taiwan and continue to caution Taiwan about declaring independence.

- The Commission strongly recommends those provisions in the FYs 2001 and 2002 Foreign Operations Appropriations Acts, providing for briefings to the Congress by the Executive Branch on the ongoing discussion between any Executive Branch agency and the government of Taiwan on U.S. arms sales and that the defense relationship be included as a permanent requirement.
Chapter 9 - The Defense Budget and the Military Economy

Key Findings

- China's defense spending is growing rapidly, funding a strategic buildup that is aimed at U.S. interests in the area. The budget and budget process are opaque, and our understanding of them is inadequate. We believe that the announced defense budget is only about a third to a fourth of real defense spending.

- Chinese leaders assert that advances in defense capabilities must parallel those of its economic development and modernization.

- China's aggregate defense spending is modest compared to the U.S. defense budget and similar in size to some major European powers; yet it is significant in areas that could challenge U.S. and allied security interests in the area.

- The People's Liberation Army's (PLA) role in the economy has been significantly reduced since 1998, but it retains a sizable number of commercial ventures from which it derives economic benefits and uses as fronts to acquire military and dual-use technology.

Introduction

China's military modernization has enormous significance to the United States and regional countries. Although China has emphasized economic expansion and development, its leaders recognize the benefits for military capabilities that can flow from a growing economy. Opinions differ whether the leadership has chosen to simply modernize the armed forces or undertake a threatening military buildup. There is general agreement that China is a growing military power and is expanding its involvement in regional and global affairs. China has the world's largest standing military, and its actual defense spending is second highest in the world according to the U.S. Department of Defense.1

While China currently lacks a conventional ability to attack the United States, it is implementing a ten to fifteen year program to build a modern military. The data show that China seeks to gain a tactical superiority over Taiwan, to narrow the gap with the U.S. and the West in certain sectors, including advanced military technology, and to at least reach parity with the United States in some systems.

How much money it will take to accomplish these objectives is unclear. No one outside top leadership circles in China fully understands the Chinese budget or has confidence in the numbers that are published. The published budgets have significance for the United States only insofar as they inform us of China's official priorities, goals, and needs. Much of China's defense spending is off-budget and concealed in secret accounts, sometimes in the national budget and sometimes through other means.

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This chapter explores the relationship between China's growing economy and its defense budget, including the relationship between the official and real defense budgets. The officially announced 2002 defense budget is $20 billion; the latest U.S. Department of Defense estimate of actual 2002 defense expenditures is $65 billion.²

**China's Budget**

The central government is severely limited by its low tax collections and must resort to deficit financing to meet the country's burgeoning demands. Testifying before the Commission, Richard N. Cooper stated that two-thirds of China's budgetary expenditures reside at the state and local levels, and only one-third at the central government level. The budgeted revenues collected at all levels of government amount to roughly 15 percent of GDP, which is low by international standards. The U.S., by comparison, collects 33 percent at all levels of government, and typical European total tax revenues are over 40 percent of GDP. The 15 percent PRC figure excludes so-called "extra-budgetary" revenues (various fees and charges) that are collected at the local levels and are roughly equivalent in amount to one third of the budget. When these extra-budgetary collections are added to the budgeted revenue, China's total collected revenue approaches 20 percent of GDP. That is the aggregate of central, provincial, and local revenue collections. However, the PRC central government collects only one third, roughly the equivalent of about 6 percent of GDP. Cooper refers to a World Bank list of 70 countries which notes that China is seventh from the bottom in central government revenue collection. His conclusion is that "the central government is strapped for funds". By comparison, the U.S. federal government collects 22 percent of GDP.³

Experts conclude that, over the past four years, China has been buying its way out of trouble with deficit financing – staving off signs of deflation, boosting demand, and countering the slowing economy. The result has been rapid, but diminishing, growth at the expense of fast rising deficits and government debt. Premier Zhu argued at the March 2002 National People's Congress (NPC) that the ratio of national debt to GDP (16.3 percent in 2001) was "still in safe limits" and that there was "still room" for issuing more long-term treasury bonds to finance construction projects. China's credit is good today, and it is still able to finance the record deficits domestically.

China's limited central government revenue collections, even though supplemented by its ability to raise additional funds with deficit financing and other means, set limits on government expenditures. If China's looming debt crisis becomes more severe because its expenditures are consistently exceeding its revenues and because of excessive borrowing, as observers have noted, defense spending will also be constrained.⁴ Substantial increases in official funding for the PLA would, under such circumstances, indicate a growing prioritization of the military goals and missions; conversely, a decline or stagnant growth rate would reveal a lower or lesser national and party priority. As Cooper noted:

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² Ibid.
It is in this context that PLA modernization has to be viewed, and in my judgment, the major battles that the PLA will be fighting during the next 10 years will be in Beijing over what it considers its rightful share of the budget. It will not be an easy battle to win.\(^5\)

The Official Defense Budget

China’s published defense budget is only a part of the real total. Furthermore the published budget contains only three major line items, so it is difficult to learn from the official data how actual expenditures relate to the announced targets and capabilities.

For 2001, the official figure for defense expenditures is $17 billion, about 1.5 percent of GDP, and about one-fourth of central government tax revenue.\(^6\) While the military budget has increased in nominal terms during the last two decades, in real terms (adjusted for inflation) such increases have occurred only since 1997. Official annual defense expenditure averaged 16.7 percent of the central budget over the last fifty years, but over the last fifteen years, it amounted to about 8.5 percent of the central budget. The share of official military expenditure as a percentage of GDP has decreased from 6.35 percent for the last fifty years, to 2.3 percent in the 1980’s, and to 1.4 percent in the 1990s.\(^7\)

The Defense Budget Process

The purpose of the introduction of Zero Base Budgeting (ZBB) reforms in 2001 was to decentralize the system to increase overall accountability, give total discretion to PLA headquarters, and prevent local units from accumulating off-budget revenues. The ZBB reforms left the internal budget bidding process unchanged. Central allocations are still made to all levels of the PLA. The central government’s General Logistics Department (GLD), the Central Military Commission (CMC), and the Ministry of Finance (MOF) together establish aggregate annual expenditure targets. Then a budget bidding process by the military regions and districts begins, and budget requests are submitted to the center. The center sets final district and regional budget amounts and the aggregate military budget.\(^8\) ZBB affects the process of PLA budgeting, requiring the unit level to draw up projected expenditures for the coming year from zero up, rather than from the prior year’s expenditure levels.

As with the rest of China’s economy, the military fiscal system is characterized by double accounting, hidden assets, and a variety of off-budget and extra-budgetary expenditures, as well as corruption.\(^9\)

2000 White Paper

According to “China’s National Defense in 2000”, published in October 2000 by the Information Office of the State Council, defense expenditures fall into the following three roughly equal categories: personnel expenses, costs for maintenance of activities, and costs for equipment. Beyond active force expenditures, analysts believe the official budget also includes militia, reserves, and various defense-

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\(^5\) Cooper, Oral Testimony, 31.


related social costs. The published defense budget reveals very little about China's intentions, strategic priorities, directions, or missions.

**Figure 9.1**
Composition of China's Defense Expenditures
(2000 White Paper, USD – Billions, $1 = 8.28 Yuan)

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personnel</td>
<td>$3.89</td>
<td>$4.21</td>
<td>$4.89</td>
</tr>
<tr>
<td>Maintenance</td>
<td>3.59</td>
<td>4.59</td>
<td>5.04</td>
</tr>
<tr>
<td>Equipment</td>
<td>3.79</td>
<td>4.20</td>
<td>4.70</td>
</tr>
<tr>
<td>Total</td>
<td>11.28</td>
<td>13.00</td>
<td>14.64</td>
</tr>
</tbody>
</table>

The 24 percent rise in announced equipment expenditures in the three years of published data is significant. It reveals that China's acquisition of technology and weapons is accelerating to support its military modernization program.

The White Paper compares the size of the official defense budget to those of other countries. At $14.6 billion, the official 2000 defense budget was five percent of U.S. defense spending, 30 percent of Japan's, 40 percent of UK's, 48 percent of France's, and 64 percent of Germany's. As a percent of the official national budget, the announced defense budget was 9.33 percent in 1995, 9.07 percent in 1996, 8.8 percent in 1997, 8.66 percent in 1998, 8.2 percent in 1999, and 8.29 percent in 2000. As a percentage of GDP, the United States spent three percent on defense, South Korea 2.8 percent, India 2.7 percent, United Kingdom 2.6 percent, France 2.15 percent, while China spent 1.31 percent.

**The 2002 Budget**

The official military budget presented in March 2002 is $3 billion or 17.6 percent larger than last year's military budget. At the same time, the announced national budget contains a projected deficit equivalent to three percent of GDP, "dangerously close to what the International Monetary Fund considers unsafe levels of debt."\(^{10}\) If, as announced in the White Papers, the priorities behind the military budget are for general defense requirements, it is notable that the defense budget contains such huge increases, especially in fiscally hard times. Added to the 2001 increase, the 17.6 percent 2002 increase will amount to a one-third increase in the acknowledged military expenditures over the last two years. Some of the budgeted increases will pay for increased personnel costs and for losses incurred by the PLA's divestment from its commercial enterprises, while the rest will be allotted to modernization. According to one account, these substantial increases are more understandable if China's "goal, according to Pentagon reports, is to become a 'regional hegemon', project Chinese power into every corner of Asia, protect sea lanes for Chinese oil, replace the United States as the preeminent power in the region, and use Chinese power to guarantee reunification with Taiwan."\(^{41}\)

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\(^{10}\) Winchester Yau, "China Faces Record Budget Deficit", *South China Morning Post*, 4 March 2002

The Real Defense Budget

"China’s published budget substantially understates its total expenditure on national defense, although there is no consensus as to where its ‘hidden resources’ of military financing lie and how large its actual defense spending really is." The missing money is either hidden in other budgets or simply not calculated. The official budget does not cover several areas, including: indigenously made weapons and equipment production; some Research Development Test and Evaluation (RDT&E) costs; funding the People's Armed Police (PAP) and reserves; funds for large foreign weapon systems procurement; funds directly allocated to military factories under control of the General Armaments Department (GAD); and foreign military aid.

Additional resources are provided to the PLA by state and local jurisdictions through cost-sharing arrangements, by profits generated through PLA-run enterprises not yet divested, from the production and sale of products and services, through funding allocations from other ministries, and from receipts generated by foreign military sales and transfers. As a result, the official budget is vastly understated; the range of annual estimated defense funding runs from $20 billion to $140 billion. The most recent Department of Defense estimate puts the real defense budget at about $65 billion, which is roughly three times the official claims or just under 5 percent of the GDP.

The PLA complains that the recent budget increases are still not rapid enough. Finance Minister Xiang Huaicheng announced that the 17.6 percent increase in 2002 is for "high technology, to raise our army's defense and combat capabilities"; but according to General Song Qingwei, one of 250 PLA delegates at the March 2002 National People's Congress, "many barracks in cold areas don't have heating, (and the) (t)roops and officers have to eat, live and repair equipment." PLA officers are increasingly urging a more accelerated pace of defense spending. Two Chinese military experts conclude that China's present 'gradual' budget increase model is no longer in line with the military's real needs, and state "the model for defense budget increase should be transformed from a 'gradual' to 'leaping' pattern." These experts believe China is in a military preparatory period and the budget must be significantly increased. Another PLA official says that "China's defense expenditure has come to a point where it has to expand, and the first ten years into the 21st Century should be grasped as the most opportune to increase its defense budget." On the assumption that GDP will grow at an average rate of 8 percent and defense spending increase at 20 percent per year, this official holds that China's official defense budget should reach seven times the 1999 level by 2010, or $100 billion.

A different way to assess the size and trends of the military budget is to look at expenditure per soldier. Based upon the $65 billion DOD estimate of China's military spending and the assumption that PLA

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14 Ibid., 7.
19 Ibid.
downsizing from 2,470,000 to 1,970,000 personnel has been completed, the expenditure per soldier in 2002 would be closer to $33,000. The comparable U.S. and Japan’s published expenditures are $213,208 for United States and $192,649 for Japan. Based upon the $65 billion defense spending estimate, the optimistic projections of sustained average GDP growth of 8 percent and average annual defense budget increases of 20 percent, spending per soldier in the downsized PLA in 2010 would be a respectable $170,220. It should be noted that these static expenditure comparisons ignore what the money is being spent on, for example, how much is for modernization and buildup and how much it buys in the local economy.

The PLA and the Economy

Between 1978 and 1998, the PLA became an important actor in the Chinese economy, controlling a multi-billion dollar international business empire that ran the gamut from large farms to world-class hotels, local airlines, and transnational corporations.

Initially to compensate for declining central government defense budgets, the defense industry and military-run units branched out into civilian commercial activity. The PLA-run enterprises in the 1990s began to operate under a different set of rules and policies than the rest of the economy. In the mid-1990s, “a loose network of some 20,000 companies operated as an integral part of China’s military establishment and routinely existed above the law. Military units engaged in business enjoyed privileges which often gave them commercial advantages, such as tax breaks and access to state-subsidized raw materials.”

PLA business activity included agribusiness, food processing, electronics, transportation, hotels, construction, real estate, tourist attractions, medical services, karaoke lounges, even smuggling. It first engaged in profit-making activities in 1985. Because of problems of discipline, loss of mission, and corruption, the central government decided to clamp down, and by 1995, 40 percent of these activities had been closed down. In 1998, President Jiang Zemin ordered the PLA and the People’s Armed Police (PAP) to divest themselves of their commercial enterprises and, beginning in 1999, to rely almost entirely on the central government’s budget for their funds.

Total profits from PLA’s domestic commercial activities amounted to about “10 percent of the published defense budget from 1989 to 1991, 15 percent for the two years 1992-93, and 12 percent in the years 1994-98.” It is unlikely that the contribution of PLA’s business earnings ever exceeded 20 percent of the official defense budget. PLA analyst Tai Ming Cheung estimated the annual revenues of PLA companies to be between $7 billion and $9 billion, with a profit of $480 million to $720 million. Profits in this range would have been equivalent to less than two percent of actual defense expenditures.

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21 Tai Ming Cheung; “Can PLA Inc. be Tamed?,” Institutional Investor (July 1996): 41.
23 Cheng, Written Testimony, 3.

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The PLA's income from arms export earnings is no longer a significant source of extra-budgetary revenue. China's arms exports have experienced a severe decline from the peak volume of $3.75 billion in 1988 to $0.58 billion in 1996; it is estimated the PLA accounts for only a half of these sales. Finally, when manufacturing and other real costs are subtracted, "it is unlikely that the PLA's net earnings exceeded 20 per cent of the income from arms exports." It is doubtful that PLA's arms trade earnings could have financed China's arms imports.  

Following the 1998 order removing the PLA and PAP from most commercial enterprises, many businesses were privatized or transferred back to the control of a civilian ministry. Some enterprises, however, remain only one step removed from the military. Many former active-duty military officers who ran them were offered the opportunity to return to the military or to stay with the enterprise, and many officers retired to run the companies. Some have been controlled by the so-called "princelings" - the children of influential high officials. 

Moreover, the Chinese government decided to allow the PLA to retain a number of production units and enterprises, proving the "notion that the PLA is out of business is not true." Observers estimate the PLA has held onto 8,000 to 10,000 such enterprises and units of which "a vast majority were subsistence" units like farms and food-processing units. Militarily useful enterprises were retained for national security reasons, most notably telecommunications, space and satellite-launch services, radar technologies and opto-electronics, lasers, civil aviation and railways. Some enterprises that provided cover for intelligence gathering, national security, foreign affairs, and front operations were only partially divested. 

PLA ownership and management of businesses, often referred to as commercialization, has had important indirect effects on the military budget. Commercialization allowed the PLA to use assets from its business enterprises for its own purposes. It has helped fund the construction of military ports, bases, warehouses and channel resources to the state sector. One Commission witness noted that infrastructure and the supply of logistics equipment, and natural resources have been adversely affected, because a good deal of such PLA infrastructure resources is being monopolized for PLA commercial use. The commercial elements of China's most profitable military conglomerates, such as Xinjing, Songlia, and Sanjju, were not handed over to local governments, but were placed directly under the control of the State Economic and Trade Commission in Beijing. Many PLA headquarters units, such as the General Armament Department (GAD), General Staff Department's Equipment Department (GSD/ED) and the General Logistics Department (GLD) still control private corporations, which use defense factories to produce weapons for the PLA and goods for export, including weapons. 

The military-run production units and the Chinese defense industrial complex remain heavily subsidized by the state. They are overstaffed, plagued with overcapacity, poor management, ineffective R&D, and a 

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28 Ibid., 112.
declining customer and product base. The Chinese have not been able to develop and manufacture military technologies in many key industries. Twenty years of reform efforts aimed at creating state-owned enterprises capable of providing technological support to Chinese military modernization have only met with limited success, notably in the very important sector of missile technology.\textsuperscript{31} This has forced the military to buy from foreign suppliers and forced defense and PLA-run enterprises to actively pursue foreign technologies and capabilities.\textsuperscript{32}

The PLA command is working to make up for these shortfalls. Military scientific research currently emphasizes smaller-scale products incorporating increasingly advanced levels of technology. By emphasizing the strengthening of key science and technology foundations, China is making progress on revitalizing its military production capability.\textsuperscript{33} Currently, Chinese companies with deep military ties are producing state-of-the-art or near-state-of-the-art equipment and systems. In some sectors there is no longer a need for China to "steal" advanced technologies from the United States and other Western countries as was allegedly done in the 1980s, because they have achieved cutting edge technology.\textsuperscript{34}

**PLA-Run Enterprises in the United States**

As part of the larger push by the PLA into civilian goods production, PLA-run companies have sought international markets for their products. Many PLA firms have long had representative offices in the United States, and goods made under subcontract or in joint-ventures are commonly sold in United States.

The Chinese trading offices or representative offices identified in the 1990s may no longer be active or may be operating under different names or in different locations. The Commission heard testimony from one researcher that he had not been able to locate any Chinese military enterprise's international subsidiary operating in the United States since 1997.\textsuperscript{35} Efforts by the Commission to obtain data from the Executive Branch on Chinese companies in the United States have not been successful. To date, the Executive Branch has not complied with legislation that requires an official report on Chinese companies operating in the United States. Specifically the legislation requires that the Secretary of Defense "shall make a determination of those persons operating ... in the United States ... that are Communist Chinese military companies and shall publish a list of those persons in the Federal Register."\textsuperscript{36}

**Trade Surplus and the Military Budget**

The Commission is required under its Charter to examine "the extent to which the trade surplus of the People's Republic of China with the United States enhances the military budget of the People's Republic of China." The role of international trade in China's economy and the relationship of U.S.–China bilateral trade to U.S. national security interests are discussed fully in other sections of this Report, particularly

\textsuperscript{33} Marbie, Oral Testimony, 168.
\textsuperscript{34} Mulvenon, Oral Testimony, 117.
\textsuperscript{35} *Ibid.*, 115.
Chapter 2. It is difficult to document any direct connection between China’s bilateral trade surplus (over $80 billion in 2000 and in 2001) and the PRC military budget. A few preliminary observations may be useful in clarifying some of the considerations that need to be addressed.

China’s economic reforms and integration into the world trading system have contributed significantly to its economic growth over the last two decades. The expansion of its export industries has boosted employment in some sectors, attracted vast sums of foreign investment, and made millions of people better off than before. This prosperity has also made more resources available for the government to spend for various purposes, including the military. In this broad sense, trade has not only helped make China richer, it has also helped make China stronger.

The accumulation of dollar reserves, which are needed for PLA modernization (specifically but not exclusively for foreign military purchases), is one important aspect of China’s trade surplus with the United States.37 These cumulative foreign exchange reserves have skyrocketed to about $212 billion at the end of 2001. While the hard currency reserves accumulated by China from its trade surplus with the United States may not directly track to the revenue side of the military budget, not least because the published budget is so unreliable, they have made it possible for China to buy foreign weapons, technology and other components for its modernization program, as detailed in Chapter 10 of this Report. Since the early 1990s, China has spent some $10 billion on purchases from Russia, with Israel’s sales to the PLA trailing close behind.38

In a growing, export-driven economy with a positive trade balance, the accumulating foreign currency reserves can be utilized for different national objectives, including defense. China’s huge foreign exchange reserves, now second only to Japan’s, are the result not only of its bilateral trade surplus with the United States, but also of substantial inflows of world foreign direct and portfolio investment. World FDI into China was about $47 billion in 2001, of which nearly $5 billion was from the United States according to Chinese data. World equity investment into state-owned firms has been running at around $7.5 billion (except for the $20 billion spike in 2000) of which the U.S. share has been around a third. Clearly, the major source of China’s foreign exchange reserve accumulation remains its annual trade surplus with the United States. The Commission heard testimony from one expert, who noted that 40 percent of China’s foreign reserves were invested in U.S. Treasury securities, rather than in the Chinese economy. “It is silly for China to be a net capital exporter at this stage in its development,” this observer concluded.39 The benefits to China of the growing foreign exchange reserves may be other than economic.

National Security Implications

China’s strong and steady economic growth has enabled it to implement an ambitious military modernization program that, if successful, will catapult China forward as the leading military power in East Asia and a rival to U.S. interests in the region. It has been able to allocate increased resources to its

defense budget to achieve this status because of increased revenues generated from its unprecedented economic expansion, access to international capital markets, substantial financial inflows, including foreign direct investment, and accumulated foreign exchange holdings, most of which have been derived from its very favorable trade balance with the United States.

The implications of China’s military modernization for the United States and regional states are enormous. We need to know more about China’s national budget and its defense budget because miscomprehension, whether due to underestimation or overestimation of the size and purpose of China’s defense budget, could be dangerous and lead to miscalculation. Although China’s defense budget is small in the aggregate when compared to that of the United States, China allocates significant funds to its missile buildup opposite Taiwan, to preparing for possible conflict in the Taiwan Strait, to modernizing its nuclear-capable ballistic missiles, and to developing capabilities for conducting electronic information and other forms of asymmetrical warfare against the United States and other technologically superior forces.

Given the disparities in the PRC and U.S. military budgets, the question remains: does China’s growing military budget reflect a hostile buildup inimical to U.S. and allied interests or is it merely a normal upgrading? The decade of the 1990s was generally peaceful for China, yet its defense spending rose sharply. Some observers conclude that the “PLA is undertaking a complex and long-needed process of modernization”, not a hostile buildup. The Commission heard testimony that the pace of this military modernization may be “moderate” and “deliberate”. According to that view for China to undertake a hostile buildup, the pace of military modernization would have to be “rapid” and “massive”, and the military expenditure would have to increase to hundreds of billions per year.

Others disagree and cite China’s military spending as one of the fastest expanding defense budgets in the world. According to the DoD, it is the “second largest defense spender in the world...and the largest defense spender in Asia.” They further point to the increasing allocation of resources devoted to military programs and missions which affect U.S. interests in Asia, prominent among which are to threaten and intimidate Taiwan and project China’s growing power.

The latest DoD estimate of China’s 2002 actual defense spending at about $65 billion is clearly above a “moderate” level while not yet explosive in size. The allocation of just a moderate part of the $65 billion to a narrow objective could result in the deployment of large forces and other assets on specific targets. That could challenge U.S. interests in the region. It is not simply the issue of how much China is spending, but what China is buying, what it plans to achieve, and how doing so affects its economic growth rate.

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41 Colton, Written Testimony, 4.
42 During the Commission’s 7 December 2001 hearing on the Chinese budget an exchange between the Commission and Dr. Shambaugh (194-205) about what constitutes a military build-up prompted this response from Dr. Shambaugh: “Well, it would be, in terms of external purchases of arms, in the range of probably five to seven times what they are buying now per year from Russia. It would be probably a quadrupling of the internal allocation for procurement of equipment and indeed, investment into R & D. It would be procurement particularly of ships to acquire “blue water” capability, a submarine force as well, and in other categories of conventional equipment.”
Recommendations

- The Commission recommends that the Congress direct the Congressional Budget Office and the Congressional Research Service to enhance monitoring of PRC central government's fiscal and financial activities. Particular emphasis should be placed on China’s military budget.

- The Commission recommends that the Congress request the Intelligence Community to conduct an annual "output analysis" of China’s defense budget to assess its impact on and relation to China's military capabilities.
Chapter 10 - Technology Transfers and Military Acquisition Policy

Key Findings

- China has well-established policies and a broad-based program (including both legal to illegal methods) to acquire advanced Western technologies for its industrial development, military programs, espionage capability and intelligence gathering and surveillance.

- China is acquiring dual-use and military technology legally through joint ventures, the establishment of U.S.-based companies, Western investments, and approved exports.

- China is covertly acquiring the more sensitive technologies it cannot buy on the open market through a targeted collection program and espionage initiatives.

- Over the next 10 years China will acquire a modernized industrial capability to build advanced conventional and strategic weapons.

- Russia is the largest arms exporter of military goods and services to China but Western countries are contributing to the industrial base for military production.

- The Western countries have no coordinated policy dealing with transfers to China of dual-use items.

- The Western countries have an inconsistently applied policy to handle the transfer of arms, armaments technologies, goods, and services to China, thereby increasing Chinese military capabilities.

Introduction

A substantial part of China's military modernization program involves merging modern civilian industrial skills and assets with its older military/defense assets. China's defense industry is undergoing strategic reform aimed at building an integrated production system viable for both military and civilian purposes. In 1997, the Chinese Communist Party (CCP) defined the country's economic strategy. It called for close coordination between the military and civilian sectors, and put the civilian sector at the service of the military.

Foreign investment, particularly in R&D areas, interaction with U.S. industry, reverse migration of Chinese scientists and engineers back to China, and government-sponsored S&T initiatives continue to accelerate China's across-the-board development and use of new technology. China has made extensive efforts through both legal and illegal means to acquire advanced U.S. and western military and dual-use technologies. China uses both indigenous R&D activities and foreign joint ventures to meet its

Translation of the 16 Character Policy: Jun-min jiehe—Combine the military and the civilian; Ping-zhan jiehei—Combine peace and war; Jun-pin youxian—Give priority to military products; Yi min yang jun—Let the civil production support military production.
technology needs. Because of concerns with U.S. export controls, China has made significant efforts to locate and source sensitive technology from suppliers in Europe, Israel, and Japan, particularly when they meet U.S. standards. China has implemented programs to acquire dual-use and military technologies through espionage.

**PLA Modernization Efforts**

**Priorities**

China's leaders view the United States as the primary obstacle to its interests in East Asia, especially Taiwan. The Chinese realize that they cannot win a traditional war against the U.S. in this area and are seeking unorthodox ways to defeat the U.S. in any such conflict, all the while building up their military power to eventually match or exceed U.S. military capabilities in East Asia. The PLA's development program emphasizes technological advances in its air and naval power and a reorganization of its force structure to be able to operate ships and aircraft several hundred miles from its coastlines. China's major force modernization efforts are focused in the following areas:

- Assuring the viability of its nuclear forces
- Improving the range, mobility, and capabilities of its strategic missile force
- Acquiring a next-generation fighter aircraft with aerial refueling capability
- Acquiring the capability to sink an American aircraft carrier
- Acquiring the power projection capabilities necessary to absorb Taiwan
- Developing the asymmetrical warfare weapons to counterbalance U.S. technological superiority

**Chinese Military Strategy and Policies**

China has the financial and political resources to build a large, focused force. Beginning in 1985, the PLA began to transform itself from a large army designed to fight a major land-based "people's war" to one based on a technologically advanced force capable of fighting in various environments. The PLA has shifted from threat-based planning to contingency-based planning (e.g., military action against Taiwan). China's new doctrine commonly referred to as "local war under high-tech conditions," focuses on preparing to fight small-scale, regional conflicts along the nation's periphery.

China's aim is to project power and operate ships and aircraft several hundred miles from its coastlines in order to protect its maritime, economic, and geopolitical interests. To meet these goals it is introducing a combined arms capability integrating smaller, highly trained, technologically advanced, military forces into the PLA's overall force structure. Chinese strategists argue that regional conflicts into which China can be drawn require the deployment of smaller, more flexible, so-called rapid reaction, joint-force combat units supported with airborne and amphibious landing capabilities.\(^2\) Over the long run, this program will

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Chapter 10 - Technology Transfers and Military Acquisitions
significantly increase China's military capabilities and make it a formidable regional actor. At least for the next ten years, the PLA will have to rely on its very large inventory of old Soviet-era equipment and a much smaller inventory of advanced systems. China's military production capabilities cannot now support the demands of the new doctrine, which are dependent on information-based systems. Even though much of the appropriate technological infrastructure is already in place, it will take many years to create self-sustaining institutions and infrastructures.

**Nuclear Weapons/Ballistic Missiles**

China's nuclear forces today consist of a triad of land-based missiles, bombers and submarine-launched ballistic missiles, and some 350-450 warheads. Its second-generation nuclear force, to be deployed over the next five to fifteen years, will be far more mobile, accurate and reliable. The Second Artillery, China's strategic missile force, continues to modernize. Over the last several years it has begun to develop four new types of missiles and to modernize its current intercontinental ballistic missile (ICBM) force in order to serve as a strategic deterrent against the United States. China can be expected to field new mobile ICBMs, more accurate medium- and short-range ballistic missiles, a new land-attack cruise missile, and a submarine-launched anti-ship cruise missile.

Land-based missiles remain the strongest element of the present nuclear arsenal. China has about twenty DF-5 ICBMs with a striking range of 13,000 km (8,100 miles), which gives China the ability to attack the United States mainland. This number could increase to sixty by 2010. China operates a single nuclear submarine, the *Xia* armed with twelve JL-1 submarine launched ballistic missiles with a range of 1,700km (1000 miles). As for intermediate range and long-range missiles, in addition to the DF-5s, China has at least ten DF-4s land-based missiles with a striking range of 4700km (2920 miles); thirty-eight DF-3s and DF3A missiles with striking ranges of 2,650km (1646 miles) and 2,800km (1740 miles); and thirty DF21 and DF21A missiles with striking ranges of 1700-1800 km (1050-1120 miles) respectively.

The new mobile, solid propellant strategic missiles in development are the JL-2 submarine-launched ballistic missiles (SLBM) and the road-mobile CSS-X-10 ICBM/DF-31. The DF-31 was tested for the first time in August 1999 and full deployment is expected soon. China's strategic nuclear force includes 20 ICBMs, 80 Intermediate-range ballistic missiles (IRBM), 120 nuclear-capable bombers, and 12 SLBMs. The Intelligence Community projects that by 2015, China's nuclear long-range force will quadruple in size and that most of its strategic missile force will be mobile.

**Conventional Force Modernization**

The PLA has begun to integrate modern, state-of-the-art equipment, doctrine, and training into its armed forces. China wants a next-generation fighter aircraft, strategic airlift, force projection, aerial refueling, and sophisticated ground-attack capabilities, along with a credible Taiwan invasion force and the ability to

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3 It is interesting to note that in the six years between the Gulf War and the spring of 1996, the PLA was able to acquire, train, and plan a joint-land-sea-air military maneuver. According to the Xinhua Domestic Service, "the maneuver was a complete success, which demonstrated that the PLA has enhanced its combat capability and that the PLA has the resolution and ability to safeguard the motherland, the sovereignty and territorial integrity of the state."

sink an American aircraft carrier.\(^5\) The PLA places a high priority on the procurement and co-production of air and naval electronic warfare systems, improved missile and aircraft guidance systems, improved surface ships (especially in air defense and fire control), a more advanced communications and early warning/battle management system (AWACS), and precision-guided munitions. China has already used navigation data from the U.S. Global Positioning System (GPS) constellation to increase the accuracy of its 360-mile-range DF-15 missiles, which were used near Taiwan during exercises in 1995 and 1996. For now, China has little choice but to continue to rely on imported foreign systems as a shortcut to close the gap between its strategic requirements and operational capabilities.

The Chinese know they must integrate new high-technology weapon systems on the training field, including the use of modern communications, intelligence, and logistics systems. For limited numbers of divisions, and using limited assets, the PLA has demonstrated it can incorporate new technologies and employ them on the battlefield.\(^6\)

**Ground Forces**

Only a small portion of the army is currently capable of fighting effectively outside of Chinese territory. While the PLA will retain many existing weapons in an attempt to develop new tactics and techniques to defeat a high-technology enemy, only limited amounts of foreign weapons and equipment will be introduced. The new force will require more time and money to train in order to perfect the PLA's new war-fighting doctrine.\(^7\)

China has approximately 1.7 million personnel in the ground forces, by far the largest fighting organization on the world. There are 21 integrated Group Armies, roughly analogous to a U.S. corps, each with two to three infantry divisions, sometimes an armored division, as well as artillery, combat support, and combat service support units. In total, China has over 100 combat divisions in its active forces. Of these, at least three have a national-level rapid reaction role and nine others have regional rapid reaction roles. These divisions can mobilize and deploy within 24-48 hours. The PLA's ground forces can be augmented by the paramilitary People's Armed Police (PAP), containing another 1 million personnel organized into divisions and regiments. PAP divisions and regiments often have their own integral armor and artillery. China has also improved its reserve forces so that the active PLA can draw on another 500,000-600,000 reserve personnel distributed around the country. They are organized into about 50 infantry, artillery or air defense divisions and numerous independent regiments.


These ground forces have over 7,000 main combat tanks, about 5,500 of which are of 1950’s vintage. These tanks have been improved by adding laser rangefinders and new guns. The PLA has some 12,000 pieces of towed artillery, 1,200 self-propelled artillery pieces, and 2,500 multiple rocket launchers.

China’s formidable ground forces can mobilize quickly with good operations security. However, they are limited by a predominance of equipment that is of 1950s and 1960s vintage. China can project force decisively and quickly inside its borders and about 500 miles beyond, but the PLA lacks the capability to project decisive ground force power across the ocean or at great distances. China’s amphibious lift capability is limited to perhaps two divisions at best, and its capability to insert airborne forces is limited to one, of its three airborne divisions at a time.

Air Defense Systems

China is building the framework for a Chinese theater missile defense system. China has bought or is building, with Russian help, advanced surface-to-air missile systems, deployed around key government and industrial complexes. There are reports indicating China has recently contracted for the purchase of additional advanced S300 PMU2 air defense systems. It is developing a domestic variant of the SA-7, the Russian version of the Stinger anti-aircraft missile. Additionally, it was reported last year that the Ukrainian design bureau Kvant had supplied equipment to China to upgrade its air defense systems. According to the bureau’s director, Kvant supplied China with equipment, manuals and technology. Kvant has developed a unique system called Kashtan-3, capable of leading laser-guided bombs and missiles away from their targets. Also in accordance with the agreement between Ukraine and China, the Kharhiv Military University has started training Chinese specialists in air defense. Using both domestically produced systems and components and imported Russian technology China is making many kinds of surface-to-air missiles (SAM) systems and will soon have a complete air defense capability.

Air Forces

The People’s Liberation Army Air Force (PLAAF) has 150 medium bombers, many of which are capable of carrying nuclear weapons and cruise missiles. It has about 1,000 fighter aircraft, and 1,900 ground-attack aircraft. The majority of these aircraft of all types are of 1950s or 1960s vintage, although in many cases they have been upgraded with modern fire control systems and radar, often obtained from Western countries. Russia has assisted the PLAAF by selling or licensing for co-production the SU-27 and SU-3MKK. In addition, in order to solve China’s limitations on force projection, the PLAAF has recently developed, with the assistance of British companies, six air-to-air refueling tankers. This capability permits China’s naval air forces to project power into the South China and East China Seas to reinforce maritime claims in the Spratly Archipelago. Naval air forces include an additional 500 shore-based combat aircraft.

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10 “Ukrainian design bureau offers new air defense technology to Russia”, Kiev 2000, GMT 0000, 7 December 2001; translated in FBIS. Note: The SU-27 is also in Ukraine’s inventory.
The PLA AF has been able to arm its aircraft with modern air-to-air missiles, many of which are as capable as some of the best American or Western armaments. Within the next ten years, the PLA AF should have an effective offensive strike force. During this decade the PLA AF will acquire and deploy increased numbers of third- and fourth-generation aircraft and will be able to integrate more sophisticated Command, Control, Communications, and Intelligence systems (C3I) and early warning support, allowing it to project air power much more effectively.\(^\text{11}\)

Acquisition of the multi-role SU-27 constitutes a quantum leap for the PLA AF. The SU-27 is comparable to the U.S. F-15. If the PLA AF does receive its total of about 300 SU-27s (72 purchased plus 200 domestically produced) that would represent a significant power projection capability. The PLA AF may also have received a shipment of Russian AA-12 air-to-air missiles (nicknamed: Amramsks). An SU-27 armed with AA-12s will obtain an advantage over Taiwan’s Mirage 2000-5 armed with MICA missiles.

The integration of the SU-27s into the PLA AF operational forces has proven difficult, however, particularly with respect to training and maintenance costs. The PLA AF apparently has not achieved a consistent capability with the SU-27s to employ air-to-air missiles in all weather conditions and beyond visual range. The General Manager of Russia’s Aeronautical Equipment Corporation for instance is reported to have said, “. . . half of the Mainland’s fighter planes, the SU-27s, are unable to conduct normal take-off and flight due to damage to electronic equipment on board. Russia has decided to help China replace and repair the equipment”.\(^\text{12}\)

China has also acquired the SU-30MKK ground-attack plane. The SU-30MKK is the first fourth-generation Russian aircraft to be produced in a large series. It is being built according to a PRC order, and is a technologically sophisticated, long-range and well-armed aircraft. The extended range of the SU-30MKK would allow the PLA AF to circumnavigate Taiwan and strike lesser-defended facilities on the eastern side of the island. The SU-30MKKs can carry the Kh-31 supersonic anti-ship missile or other supersonic cruise missiles and pose a greater threat to U.S. and ROC vessels.\(^\text{13}\) All 38 SU-30MKKs ordered in 1999 were reportedly delivered between December 2000 and late 2001.\(^\text{14}\) There are recent reports to indicate that China signed a second contract last year for an additional supply of 40 SU-30MKKs for delivery within the next 4 years.\(^\text{15}\) Additionally, the radar on the SU-30MKK is capable of “data-linking” with the SU-27s giving the “complex of aircraft” a cooperative target engagement capability.


\(^\text{12}\) Lin Wei-chu, “Half of Mainland Principal Fighter Planes, SU-27s, Unable to Fly Due to Damaged Electronic Equipment on Board, Says Russian Expert in Zhuhai On 7 November”, Hong Kong Ming Pao, 8 November 2000: translated in FBIS.


\(^\text{14}\) http://www.concentric.net/~Jetfieght/gallery1; see also Konstantin Makienko, “Preliminary Estimates of Russia’s Arms Export in 2001”, Eksport Vooruzheniy, November-December 2001; Interfax, December 25, 2000; translated in FBIS.

\(^\text{15}\) Pom “Russian Submarines,” ITAR-TASS “Russian Arms,” Mikhail Kozyrev and Alexsey Nikolsky, “Kasyanov Has Taken Up Military-Technical Cooperation”, Vedomosti, 19 March 2002; translated in FBIS.
Maritime Issues

In the last 15 years, the Chinese Navy has put great emphasis on operational and combined-arms tactical training. The integration of the Sovremenny-class destroyers into its operational force will provide the PLA Navy (PLAN) one of the world's most advanced military systems with a balanced armament of anti-ship and anti-aircraft missiles, long-range weapons, and anti-submarine capabilities. There are additional reports that indicate China has recently purchased two additional Sovremenny-class destroyers.\textsuperscript{16} China's sea-based mobile forces have enhanced their air-defense, anti-submarine, and anti-ship fighting capabilities. The PLAN has also begun to work on advanced anti-submarine and over-the-horizon anti-ship fighting capabilities.

China views the United States as the primary maritime obstacle to its interests in East Asia, especially Taiwan. Enforcing its South China Sea territorial claims—including the Spratly Islands—requires the PRC to possess a navy that can sustain itself away from shore, with air defenses, and air cover.

The four Russian-built Kilo submarines are among the quietest diesel submarines in the world, and come equipped with both wake-homing and wire-guided acoustic homing torpedoes. Because of its diesel-electric propulsion system its quiet operations are well suited for narrow water lanes and shallow sea areas. The Kilo is equipped with radars and sonar to search for targets. The wake-homing torpedo is designed to ignore acoustic ship defense and evasive maneuvers and has been described by the U.S. Office of Naval Intelligence as particularly effective. It has been reported that China also negotiated with Russia to transfer the technology to permit Chinese construction of Kilos.\textsuperscript{17} It has recently been reported that China has purchased an additional eight Kilos from Russia. These newer submarines will be ready for delivery by 2007. Of concern with this latest contract is the reported sale of the KLUB S anti-ship missile. The KLUB-S (SS-N-27) has a range of 300kms (186 miles), which is close to the defense radius of an aircraft carrier battle group. It is interesting to note that Russia only operates the Kilo production facilities for the Chinese order.\textsuperscript{18}

In addition, the first of a new class of nuclear-powered attack submarines, known as Project 093, is under construction. A new class of ballistic-missile-armed nuclear-powered submarine Project 094 is also in the design stage and production is expected to begin between 2003-2005. Russia is aiding China in covering the hulls of the new submarines with a layer of anechoic tiles to reduce noise.

Asymmetric Warfare

In the short to mid-term, PLA strategic writings focus on so-called "assassin's mace weapons" and asymmetric capabilities and strategies to compensate for its overall weaknesses and deficiencies.\textsuperscript{19} The PLA fully recognizes the paradigm shift from conventionally planned warfare to warfare under 21\textsuperscript{st} century conditions. Instead of improvement of its entire armed forces across-the-board, the PLA is targeting those

\textsuperscript{16} Ibid.
\textsuperscript{17} Michael J. Barron, "China's Strategic Modernization: The Russian Connection," Parameters, Winter 2001, 72-86.
\textsuperscript{18} Fisher, Oral Testimony, 182.
programs and assets that will give it the most effective weapon to attack critical U.S. military vulnerabilities.

**Crippling Weapons**

Because the Chinese recognize they lag the United States in technology warfare, they are developing weapons and means to quickly narrow the difference. These stratagems known as "assassin's mace weapons," are either a concept or device designed to attack an American vulnerability in an attempt to destroy its strengths. An authoritative article in the Liberation Army Daily on February 13, 2001, reported that President Jiang Zemin had called for accelerated development of such weapons in August 1999. They focus on such weaknesses as the U.S. reliance on computer networks and dependency on satellites for our strategic military and economic communication network. Chinese military strategists envisage attacks on all American vulnerabilities, including civilian communications systems or on the vital nervous systems of our economic institutions such as the New York Stock Exchange's computer system. Since mid-1999, the PLA has openly recruited, in civilian newspapers, an "army of hackers." The PLA is also attempting to develop an ability to target forward-based command, control, communications, computers, and intelligence (C4I) nodes, airbases, aircraft carriers and sea- and space-based command and control platforms.

Chinese analysts have written extensively on the concept that in a future war those combatants with information superiority will gain the initiative by integrating human and mechanical functions in three-dimensional space.

**Information Warfare (IW)/ Electronic Warfare (EW)**

Chinese strategists believe the Gulf War and the war in Serbia and Kosovo showed that reliance on heavy armor and mechanization is diminishing, while information and digitization are becoming the principal method of war and combat. Several senior Chinese military analysts such as Major General Wang Pufeng, former director of the strategy department of China's Academy of Military Science, believe that "in the near future, information warfare will control the form and future of war. Even as governments mobilize troops, the numbers and roles of traditional warriors will be sharply less than those of technical experts. An IW victory will likely be determined by which side can mobilize the most computer experts."  

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Xie Guang, Vice Minister of Commission of Science, Technology, and Industry for National Defense (COSTIND) has written that as information technology develops and as dependency on rapid and secure electronic transmission of information grows, information activities will infiltrate every dimension of both peacetime and wartime space.²⁴ The PLA’s offensive IW program is in the early stages of research and the Defense Department believes China is studying offensive employment of IW against foreign economic, logistics, and C4I systems,²⁵ specifically to establish a competence to attack computer systems. China is developing cyber warfare capabilities that could put at risk the computer networks that the U.S. military increasingly relies on for its operations. “We see this in terms of capabilities we know they have, we see this written in their doctrine, we see this espoused by their leadership.”²⁶

Space

Satellite space telecommunications, reconnaissance, and navigation systems all make it possible to provide the warfighter with real-time, continuous, accurate information and to guide modern cruise and ballistic missiles to distant targets. China has an active domestic program and is seeking Russian and perhaps European help in this area. And it continues to acquire the space and airborne reconnaissance systems necessary to provide the PLA with the precise targeting information required for the next-generation of intermediate range ballistic missiles and both land-attack cruise missiles and contemporary anti-ship cruise missiles.

China is constructing a new satellite positioning system to provide it a capability independent of the U.S. GPS system and the Russian version GLONASS. GPS is absolutely critical to U.S. military operations because it allows for significant capabilities over previous systems such as those used in Desert Storm to target missiles and bombs remotely. Chinese military analysts have written extensively on the ever-increasing role GPS has in long-range precision attacks, precision bombing, and accurate deployment of troops. Two years ago China launched two indigenous navigational satellites, the geostationary Beidou national satellites, which will provide it all-weather, round-the-clock navigational information. However, more satellites would be needed to form a system and provide better and higher precision service globally.²⁷

In the next several years China is expected to field several high-technology space platforms, including higher resolution imagery satellites, electronic signals intelligence satellites, and military communications satellites.²⁸ The World Journal reported a story that appeared in the Hong Kong paper Taiyang Bao

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Pufeng Dusucsee, Definition, Significance of Information Warfare*, Hong Kong Hsien-Tai Chun-Shih, 11 April 2000, 19-21: translated in FBIS.

²⁴ Xie Guang, Vice Minister of COSTIND, and Senior Advisor to the China Association of International Strategy, “Wars Under High-Tech”, Renmin Ribao, 27 December 1999; translated in FBIS.


concerning Chinese military satellites. "A source in Beijing revealed [to Taiyang Bao] that before U.S. Secretary of State Powell's 28 July 2001, visit, China successfully launched two military satellites on the same day, from the same site. According to a reliable source, the two satellites have different functions. One of the satellites, code name “Xianfeng-7” (Vanguard-7), is China's seventh military satellite. Its missions are to target U.S and Japan military activities and deployments near the Chinese Mainland and deployments in the Taiwan Strait. The satellite can coordinate with early warning aircraft, navy radar, and the land-based defense network; it can also conduct reconnaissance and take pictures of enemy military activities. The other satellite’s code name is “Shiji-1 (Century-1). It represents China’s current hi-tech, state-of-the-art military space technology, and it can evade an enemy's military satellite’s detection and interference.\(^{29}\)

**Foreign Military Sales to China**

A more detailed discussion of the transfers identified below is contained in the Commission’s classified Report.

**Russian Assistance**

China is modernizing its military forces with specific military assets in mind and in the past ten years it has had a major acquisition program with Russia worth roughly $1 billion (or more) per year. Russia is China's primary weapons supplier. Chinese purchases have increased in recent years and China is systematically acquiring the aviation and blue-water systems necessary to control critical sea-lanes of communication, and the command and control infrastructure to project a regional force. Russian weapons have filled the void resulting from the termination of Western arms transfer programs to Beijing after the Tiananmen Square massacres of 1989.

Moreover, Chinese leaders want to obtain Russian know-how, so that they can reverse engineer the weapons or obtain licenses, as in the SU-27, and remarket its own version of the system at a cheaper price. Military industrial cooperation between China and Russia is extensive. Technicians and scientists from several states of the former Soviet Union have spent time in China over the past decade and there are periodic visits and information exchanges among specialists. Nearly 90 percent of all China's arms imports since 1990 have come from Russia.\(^{30}\)

**Israeli Assistance**

Israel ranks secondly only to Russia as a weapons systems provider to China and as a conduit for sophisticated military technology followed by France and Germany. Recent upgrades in target acquisition and fire control, probably provided by Israeli weapons specialists, have enhanced the capabilities of the older guided missile destroyers and frigates in the PLA Navy's inventory. Hong Kong's AFP reported in November of 1999 that "as the world's fifth biggest weapons exporter, Israel has supplied China with radar systems, optical and telecommunications equipment, drones and flight simulators."\(^{31}\)

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\(^{31}\) *Hong Kong AFP*, November 30, 1999; translated in FBIS.
established itself as an important exporter of high-technology niche weapons containing more sophisticated technology than what is provided by Russia.

**Western European Assistance**

Although foreign investment in China’s military-industrial complex is not allowed, China has benefited from numerous sensitive transfers. Western and Chinese firms have accomplished this through cooperative production, licensing and joint ventures.\(^{32}\)

- Harbin Helicopters has licensed the French "Dauphine" helicopter production from Aerospatiale.
- The UK has sold and has possibly delivered 80 to 90 Rolls-Royce Spey engines for China’s indigenous JH-7 fighter. The JH-7, will be armed with advanced radar, advanced low-light sensors, and will carry advanced supersonic missiles. Its obsolescence is becoming less important as it will contain advanced electronics, sensors and missiles that are difficult to defend against.
- Air-to-air refueling provided by the UK.
- The newest class of Chinese guided missile frigate has a German diesel engine.
- The new Song-class submarine has a French-design sonar array on the bow; China has received considerable assistance particularly from France’s Eurocopter to help develop specific capabilities within the helicopter industry as well as the aircraft industry.
- At the Paris Air show, the Chinese and Russians announced the sale of over 100 very modern ground-attack radars to be put on the Chinese built J-8.

Reportedly, in 1999 two of Europe’s biggest military electronics firms – Marconi Electronics Systems of Britain and Thomson CSF of France – jointly approached China to offer to re-equip the Varyag aircraft carrier. Thomson-CSF provided the major systems for the upgrading of China’s Luda-class guided-missile destroyer. Marconi is trying to sell Beijing airborne early-warning systems, and is competing with Thomson CSF to supply radar and avionics for Beijing’s’ first fly-by-wire fighter aircraft.\(^{33}\)

**Defense Science and Technology Initiatives**

China’s objective in developing its national defense S&T industry is to satisfy basic operational needs and guarantee the production and supply of military equipment during times of crisis or military hostilities.\(^{34}\) Its S&T focus includes acquiring the ability to manufacture technologies such as super-scale integrated circuits, computer software, information security systems, and biochips as well as the establishment of key technical standards. Improvements in such commercial sectors as computers, microelectronics, telecommunications, flexible manufacturing, and satellites are all directly applicable to improvements sought by the PLA for Command, Control, Communications, Computers, Intelligence, Surveillance, and Reconnaissance (C4ISR), advanced guidance systems for modern land-attack cruise missiles (LACMs),

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\(^{33}\) Al Santoli, Editor, "CIA: China Has "Total " Penetration of U.S. Nuclear Labs; Chinese Publications Describe Industrial Espionage Against West", *China Reform Monitor, American Foreign Policy Council*, no. 186, 7 April 1999.

\(^{34}\) President Jiang Zemin, "Act Fully on the Requirements of the 'Three Represents' and Work Hard to Promote Scientific-Technological Innovations", *Xinhua Domestic Service*, speech, 28 May 2002; translated in FBIS.
advanced avionics and aviation as well as evolutionary improvements in nuclear weapons and modern intercontinental ballistic missile production.\textsuperscript{35}

Minister of Science and Technology Xu Guanhua indicated that during 2002 China plans to launch research into 12 key technologies with information technology at the top of that list. China plans to be a world leader over the next five to ten years in the design and manufacture of super scale integrated circuits.\textsuperscript{35} Another initiative, "Project 1-26", was initiated in January 2000 and involves the development, primarily by the military, of six major technology projects including dual-use space and information technology, and exotic weapons such as miniaturized nano-technology weapons.\textsuperscript{37} The underlying informational technologies, artificial intelligence, and electrical engineering make the Revolution in Military Affairs (RMA) an effective war-fighting strategy in which China plans to invest heavily. Computer sciences and telecommunications are RMA-related technologies in which China is demonstrating significant technical progress.

\textit{China's military and defense managers study closely how Western defense corporations have worked cooperatively on joint production and development projects. This is recognized as another characteristic of the globalization trend in the world defense industry. The Chinese military industrial conglomerates view this as an opportunity for the integration of the defense industry into a world supply and development chain. One China Academy of Social Sciences researcher said in 1998, 'If China's defense industries are not prepared to grasp the opportunity offered through China's entry into the WTO to export massive quantities of new military products to the world market, it will be difficult to sustain any further research and development. Otherwise, ultimately they will have to continue turning to civil-use goods.'}\textsuperscript{38}

\section*{U.S. Export Control System}

The United States has two separate export control systems. One controls the export of munitions list items and is run by the Department of State. The statutory authority for it is the Arms Export Control Act (PL 90-629). As a result of the Tiananmen Square massacre Congress has prohibited the export of munitions list items to China (section 902 of Public Law 101-246).

The second system controls the export of so called dual-use items and is run by the Department of Commerce. Its statutory authority is the Export Administration Act of 1979 (FL 96-72). This act restricted

\textsuperscript{35} Note: China has technological representatives in more than 60 countries to facilitate and channel support for international cooperation for the development of science and technology in different Chinese regions and industrial sectors.


the export of dual-use items that would be detrimental to the national security interests of the United States.

There is some cooperation among advanced industrial nations in an organization called the "Wassenaar Arrangement on Export Controls for Conventional Arms and Dual-Use Goods and Technologies." The Wassenaar Arrangement is an informal agreement and is based on coordination of national controls. It was established to contribute to regional and international security by promoting transparency and greater responsibility in transfers of conventional arms and dual-use goods and technologies. The Wassenaar Arrangement, however, does not apply to exports to China.

The Arrangement is essentially an information exchange and discussion system and does not control international arms sales. Under it member countries provide semi-annual reports to the Secretariat of export licenses they have approved or denied. Reporting for arms transfers is more limited than for dual-use technology. Members report twice a year the aggregate information on transfers now reported annually to the UN Register of Conventional Arms, plus the model and type of each item (except for missiles and missile launchers, which are reported generically).

In the United States these decisions have resulted in decontrol of numerous technologies mainly in the electronics, computer, and telecommunications sectors, primarily for use in the civilian sector. Nevertheless, U.S. export controls to China remain in place for potential dual-use items, and licenses are reviewed on a case-by-case basis. Recently, the number of dual-use export license applications has declined, and the percentage of denials has increased.

China's military leaders target the acquisition of advanced dual-use and production technologies for indigenous development and manufacture, but they have not been successful in assimilating and exploiting advanced technologies they have acquired. China has begun to emerge from its sole focus on reverse engineering of the military equipment it acquires from Russia or the West and has begun a technology program to produce domestically designed and enhanced weapons systems and technologies. It remains to be seen if they are successful.

China has gone to extensive legal and illegal lengths to target and acquire advanced U.S. and Western defense and dual-use technologies. To counter problems with the U.S. export control system, Chinese manufacturers and designers have made significant efforts to find sensitive technology suppliers in Europe and Japan, particularly in those technologies equivalent to U.S. standards. China's military-industrial sector still lags significantly behind that of the West, giving the PLA little choice but to continue to rely on the imports to close the gap between strategic requirements and operational capabilities. Consequently, pressure for more contacts between the military and civilian sectors is expected.

China has implemented programs directed at leveraging useful dual-use and military technologies through indigenous R&D as well as foreign joint ventures in specified industrial sectors. The PLA has begun to narrow the technology gap between PLA forces and Taiwan, and between itself and other U.S.-allied operational forces. China is using its access to U.S. advanced commercial technology to develop advanced systems with a goal of reaching a military capability equaling or exceeding those of the United States. But they are far from achieving that goal.

*China's electronics sector has emerged rapidly and achieved some technological successes. China's capacity and increasing sophistication in the electronics sector could, if current trends*
continue, easily make China a leading producer (by volume) of electronics in the next decade or two. However, China’s electronics industry remains highly dependent on foreign inputs for design, marketing and R&D.  

The sectors discussed here were chosen to show Chinese dependency on Western technology in those technologies critical to power projection. Telecommunications is critical for advanced battlefield management, command and control; space navigation is becoming more critical every day for ballistic and cruise missile targeting data. Semiconductors and integrated circuits are the foundation technologies for all modern weapons and associated military systems. And computers are critical components in the design, development, manufacturing and integration phases of weapons development programs.

There were 893 licenses issued for American exports to China in 2001 with a majority of those licenses issued for exports related to telecommunications, high performance computers, and semiconductors and integrated circuits discussed below.

Telecommunications

China opened its domestic market to foreign providers in the early 1990s, a decision that has been fundamental to China’s successful telecommunications development.

China’s leaders have emphasized the development of a survivable high-capacity fiber optic system with common channel signaling software. It has focused on the development of domestic satellite communication systems with critical systems integration and data fusion capabilities. With these technologies China is establishing a high-speed, large-capacity, safe and reliable countrywide, globally connected telecommunications network.

Even though telecommunications technology is intrinsically dual-use with both military and commercial applications, China cannot simply acquire systems and supporting equipment and redirect those systems to military use. Systems integration is critical to flawless functioning.

Both civil and military communications networks support China’s national command and control infrastructure. The PLA is building a battle-management system for strategic and tactical planning and operations oversight. China has developed an automated tactical air defense C4I system providing field systems with prompt and accurate information to better exploit combat efficiency. However, its current command and control system is not capable of directing operational forces in a complex war-fighting environment. Recognizing the threat from modern sensor-to-shooter warfare capabilities, the PLA is working closely with the Ministry of Post and Telecommunications, the electronics sector, and the space industry to establish a domestically controlled, integrated high-capacity national information infrastructure.  

High Performance Computers

The sale of high performance computers has long been a sensitive national security issue. The United States uses high performance computers to design next-generation defense systems, reduce costs, and improve performance. The National Security Agency uses high performance computers to keep track of our adversaries and leading defense contractors use them to develop stealth technology and simulate testing of precision-guided munitions and advanced weapons platforms. These computers make it easier to crack encrypted commercial and military codes.

High performance computers can save China billions of dollars in R&D time and expenditure and significantly advance their efforts to rapidly design modern nuclear weapons and other sophisticated military systems. Furthermore, with supercomputers China can model and simulate tests of nuclear weapons and advanced delivery systems and do so covertly without the U.S. recognizing what China is undertaking. China is seeking to enhance its nuclear weapons and their delivery systems. High performance computers enable their engineers to more rapidly design state-of-the-art weapons, add stealth capability to missiles and aircraft, and improve anti-submarine warfare technology. More important still is the ability to simulate tests of nuclear weapons, conventional explosives, and chemical and biological weapons, and the ability to design and build smaller nuclear weapons without actually exploding them, and produce and test missile systems without actually launching them.

Direct sales to the Chinese military are strictly prohibited, but U.S. firms can and do sell to Chinese government agencies. Thus, if the computers are sent to a Chinese University or a government-owned toy factory, the machines can easily be diverted to military R&D. Two recent examples include the Chinese Academy of Engineering Physics using U.S. high performance computers illegally to simulate warhead detonations. And "mainland China had successfully completed laboratory simulations of a launch of its latest ICBM which can reach targets in most parts of the United States."

Department of Commerce statistics for the year 2000 show that 23 license applications for controlled computers were approved to China for a total of $10,939,033. For the year 2001, two applications were approved for a total of $3,942,456. These statistics suggest that most of the trade in high performance computing is no longer licensed and monitored.

Semiconductors/Integrated Circuits

According to Wu Jichuan, China's Minister of Information Industry, electronics was declared a "pillar industry" in China's Ninth Five-Year Plan (1996-2000) and several billions of dollars were appropriated for the development of its domestic microelectronics industry. According to its new Five-Year Plan, China will accelerate development in the fields of super large-scale integrated circuits (SLIC), high-powered computers, large-scale system software, and high-speed networking systems.

The China market for semiconductor equipment was about $1.2 billion in 1999 and the Semiconductor Industry Association estimates that it will grow to $7 billion by 2003. China is now the most dynamic and

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fastest-growing market for such materials since, at present it produces only about 10 percent of what it needs. Thus, while much of the technology industry has faced steep downturns in the last year, China launched many new projects.\(^4^3\) Chinese manufacturers are beginning to narrow the gap between U.S. and Chinese semiconductor manufacturing technology, the direct result of transfers of European, Japanese, and U.S. integrated circuit production technology to manufacturers in China. China is expected to become the world’s third largest user of microelectronics by 2005. Though the Mainland’s chip market, at $11.4 billion, is the largest in Asia, current chip production meets only about 20 percent of demand. Consequently there is a boom in the development of semiconductor manufacturing projects:

Among China’s highest priorities is the development of an indigenous microelectronics industry. According to DOD, “A cutting-edge domestic microelectronics sector will support both military and commercial modernization in China. China’s increasing emphasis on development of very large-scale integrated circuits will have direct application in future military systems, for example, advanced phased-array radars.”\(^4^4\)

As in other high-tech sectors, China has experienced problems converting its domestic designs into components for reliable weapons systems. As a result it continues to target sensitive and controlled technology abroad. On May 3, 2001, U.S. Customs and the Department of Commerce Export Control Enforcement officers raided the Orlando, Florida, office of the firm Means Come. The firm was investigated for the illegal export of radiation-hardened integrated circuits to China without appropriate export licenses. These chips are particularly critical for missile and satellite development programs.

**National Security Implications**

China is engaged in a comprehensive military modernization effort. It has determined which technologies it requires to accomplish its strategies and missions, and has implemented a program to acquire the capabilities and technologies needed to achieve its goals. China’s objective is to be self-sufficient in the production of weapons it deems vital to its national interests. A China self-sufficient in the production of state-of-the art power projection systems such as the SU-27 and SU-30MKK, and the continued acquisition of Kilo-class submarines will seriously affect operational decisions of the U.S. and its allies in the region. In time, China hopes to be able to effectively exploit several elements of asymmetric warfare and assassin’s mace weapons systems, to counter U.S. technological superiority. The impact on U.S. operations will be dependent on the ability of the United States to understand China’s programs and the current success of U.S. research and development programs for countering such programs.

Moreover, China is actively acquiring sensitive technologies to improve its commercial industrial base and to significantly enhance its military capabilities to better challenge U.S. influence in Asia. While not a current or imminent threat, China will at some point soon have the capability of seriously degrading U.S. capabilities and its operations in the South China Sea. If China can more successfully integrate a modern industrial base with interoperable forces and advanced weapons systems and capabilities, U.S. operational force strategies will have to be scrupulously reexamined.

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Recommendations:

- The Commission recommends that the Congress require an annual joint DoD/FBI classified assessment of Chinese targeting of sensitive U.S. weapons-related technologies and what actions were taken, or need to be taken, to prevent or deny that acquisition. The report should also provide the Congress with information detailing trends of China's acquisition targeting attempts.

- The Commission recommends that the Congress require that both pre-license and end-user checks be conducted on sensitive exports to China.

- The Commission finds the S&T report submitted to the Congress and this Commission this year a useful tool for monitoring U.S.-PRC government-to-government S&T programs. The Commission recommends the Congress request that such a report be conducted biannually beginning in 2004. The Commission also recommends that the Executive Branch establish an effective coordinating group that should set standards for S&T transfers, monitor the programs and coordinate with the intelligence community.
Conclusion

This first annual report of the U.S.-China Security Review Commission has provided a comprehensive analysis of U.S.-China relations and a set of findings and recommendations on the effects of the expending economic ties with China on U.S. national security, including our technological and industrial base. The ten chapter narratives represent the judgment of the Commission that the U.S.-China relationship contains both hopeful and troublesome elements. We have tried to address both, but have given greater emphasis to the problems and potential problem areas of the relationship in keeping with the matters we were charged by Congress to address.

The trend lines in China's race to modernity bear close scrutiny. The Commission notes that many of the issues discussed in this Report -- the growing trade deficit, unprecedented investment flows, recurring political tensions, technology transfers, restrictions on human rights, WTO compliance, proliferation of technologies associated with weapons of mass destruction, military modernization, and others -- have been thorny issues in our relations with other countries from time to time.

China is unique for the U.S., in part, because the trade relationship and the trade deficit have grown so large so quickly and because foreign investment flows into China have been so massive, while, at the same time, political tensions over proliferation, trade and other issues continue. China's military buildup continues and appears aimed at projecting its influence and interests in Asia, human rights abuses continue, and the Communist Party's authoritarian regime remains in place. Because China is not a status-quo country, its size and rapid emergence as a magnet for foreign investment and advanced technologies and the growth of its military capabilities have sounded alarm bells in the U.S., and in other industrialized democracies. These concerns would not be as strong as they have been if these same trends had developed in a country with whom we have established a trusting relationship. Despite a decade of extensive economic interactions and cooperation with China, that sort of relationship has not developed and our efforts at confidence building measures (CBMs) have not materialized.

Our relations with China are complex, and in need of more careful study and understanding. There is both promise and danger in the relationship and neither should be ignored or minimized. In this fast-changing relationship, our policy, if unattended, will lag behind events on the ground, thereby increasing chances of miscalculation and damage to important U.S. interests.

Looking Forward

Congress created the U.S.-China Security Review Commission as a permanent bipartisan independent Commission because the issues involving Sino-U.S. relations are neither short-term, nor static, nor simple. Looking forward, the Commission believes that special emphasis should be paid to the following issues:

- **China's Compliance with its World Trade Organization Obligations** - The Commission should continue to monitor China's record of compliance with its WTO obligations and assess if shortcoming in compliance show a lack of political will or institutional capacity. Because China's adherence to its WTO commitments is in our national interest, the Commission will conduct its own independent analysis and compare it with analyses by others who will be addressing the same compliance issue. This could also include an assessment of official and public opinion in China on China's first year in the WTO.
• **China's Regional Influence** - The Commission intends to evaluate shifts in manufacturing from other Asian countries to China and shifts in U.S. trade and investment patterns from other Asian nations to China, and the impact such relocations have on U.S. economic and security interests in the region. Of particular interest is the growing economic, demographic and communication linkages between Taiwan and the Mainland and the effects these expanding interactions may have in ameliorating political tensions in cross-strait relations.

• **China's Economic Reforms** - China is burdened with domestic problems inherent in a legacy of a centrally planned economy, its transition to a market-based economy and its integration into the global economy. The Commission should monitor China's management of its difficult domestic problems, including social dislocations likely to emerge from WTO membership, a weak banking system burdened by huge debts, widespread official and party corruption, growing social and economic inequalities, an under-funded pension system and huge unemployment, local protectionism, growing environmental and natural resource problems, and much more. Students of China disagree on whether China can successfully manage its economy and survive these enormous challenges.

• **U.S. Economic Transfers** - The Commission should assess trends in out-sourcing manufacturing to China by U.S. companies, including the shift of R&D facilities and capabilities and the adequacy of U.S. export control statutes and regulations in helping to manage this trend. We should continue to assess the degree to which the U.S. industrial base, including the defense industrial base, is reliant on Chinese imports, especially imports of advanced technologies. We should continue to assess the effects these transfers have on U.S. employment trends, wages, and standard of living. Finally, we should assess the validity of the so-called "hollowing out" phenomenon associated with the relocation of manufacturing capacity to China, and measures to deal with it.

• **Military Modernization** - The Commission should continue to track the relationship between China's trade surplus with the U.S., its access to U.S. capital markets and the inflow of U.S. foreign direct investment on China's military modernization program, its defense budget and spending, and its strategy for challenging U.S. influence in Asia.

• **Access to U.S. Capital Markets** - The Commission developed recommendations in this Report on Chinese and other foreign companies seeking access to or trading their securities in U.S. capital markets. We believe that more review and analysis should be conducted on the adequacy of existing disclosure and transparency requirements with respect to the identities, global activities and senior management of Chinese entities coming to or already in our markets. Specifically, the Commission should focus on the use of capital markets to advance Chinese military modernization programs, its proliferation activities, and its relations with terrorist-sponsoring governments.

• **Proliferation of Weapons and Technologies of Mass Destruction** - The Commission believes that additional analysis is needed to assess China's role in the proliferation of weapons of mass destruction and related technologies and know-how to terrorist-sponsoring states and the effectiveness of unilateral and multilateral sanctions or controls aimed at the Chinese government in limiting or eliminating this practice.

• **Bilateral Cooperation Programs** - The Commission should assess China's compliance with its existing U.S. bilateral cooperation agreements, including the 1979 Agreement on Science and Technology, the agreement on exports of prison-made products, the Agreement on Intellectual Property Rights, and to consider measures that should be taken to increase compliance with them.

• **Chinese Perceptions in the Media and Education System** - The Commission should evaluate Chinese government efforts to shape and influence Chinese perceptions of the United States through
the control of the Internet and the print and electronic media in China. We believe this should be coupled with a review of how China's educational system depicts the United States, our history, values and behavior.

- **Patterns of U.S. Investment and Trade in China** - The Commission will continue to monitor and assess year-to-year U.S. trade and investment patterns with China and the incentives and others inducements China may be offering U.S. corporations to locate or relocate production facilities and R&D to China.

- **Energy** - The Commission will assess China's growing energy needs, how these needs shape its relations with other countries, particularly oil-producing, terrorist-sponsoring states. In addition, it will examine China's plans to diversify its energy sources, the security-related inducements it employs to insure reliable sources and the plans it may have to secure maritime and other lines of commerce and communications to bring reliable supplies of energy to China's expanding economy.

- **Trade Deficit and Chinese Military Spending** - The Commission should assess the relationship between the U.S. trade deficit and China's expanding economy and its military spending. Because China's financial data are unreliable, we will devote special attention to this difficult but crucial issue in understanding China and Chinese military growth and modernization.

- **China's Activities in the United States** - The Commission should also devote attention to China's activities in the U.S., including its drive to acquire U.S. technologies, the activities of PLA-affiliated companies operating in the United States, and the role that Chinese students, researchers and scholars studying and conducting research in the U.S. play in the transfer of U.S. technology and know-how to China.
Additional Views of Commissioner Kenneth Lewis (Commissioners Arthur Waldron and June Teufel Dreyer Concur)

There are two subjects discussed in the Report that should be emphasized:

Sale and Export of Dual-Use Items

There is an inherent conflict between the desire of business to sell and export and the need to restrict or ban such sales and exports when national security could be jeopardized. Accordingly, we believe the U.S. should prohibit the sale and export of dual-use items (items covered under the Export Administration Act) that have clear military applications, when the U.S. has a unique technological and manufacturing capability, and where there is no foreign availability, except in very rare cases and only to our most trusted allies under restricted conditions. Therefore, such dual-use items should not be sold to China.

U.S. Trade and Investment Relationships with China

U.S. trade and investment relationships with China confound normal trade and investment theories. The most developed country in the world (U.S.) is increasingly purchasing manufactured goods from a country (China) less developed than we are, and the developed country (U.S.) is selling large quantities of raw materials and agricultural goods, as well as manufactured goods, to the less developed country (China).

Trade between nations can be reciprocal and mutually advantageous, but our trade with China is not. When we buy $103 billion but only sell $16 billion (as in the year 2000) this is not reciprocal and it is not mutually advantageous. Yes, our exports to China create jobs but our imports from China lose jobs, and it is clear, with movement of U.S. manufacturers to China and the purchases made in China for the U.S. consumer market, many more jobs have been lost to imports from China than have been gained from exports to China.

The U.S.-China trade and investment relationship was succinctly and well covered in a statement presented to us by Senator Paul Sarbanes, Chairman of the Banking Committees. His statement reads in part:

"Some observers have argued that the prospects for opening the Chinese market may actually be better than those of opening the Japanese or Korean markets at a comparable stage of development. These observers point out that China is much more open to foreign investment than Japan or Korea were. In fact, China has actively sought foreign direct investment as sources of western capital and technology. Foreign direct investment has been a key element of China's development strategy.

"China’s receptiveness to foreign investment does not necessarily mean, however, openness to imports. In fact, trade barriers in sectors such as automobiles have been part of China’s strategy to encourage foreign investment. Since the Chinese market could not be accessed easily through exports, western automakers that wanted a portion of the Chinese market were effectively forced
to invest. Once inside the market, many western companies took a different view of Chinese trade barriers because they now also protected them from competition from outside China.

"The unstated assumption is that openness to foreign investment will eventually lead to openness to foreign trade. It is not clear, however, that reforms undertaken to encourage foreign investment will inevitably lead to lower trade barriers and more imports. In fact, China's increasing demands for domestic production and transfer of technology suggest that the opposite may be true.

"An article in the Wall Street Journal on May 25, 2000 the day after the House voted on PNTR, focused on the investment aspect of the China WTO agreement. The article stated:

'Even before the first vote was cast yesterday in Congress's decision to permanently normalize U.S. trade with China, Corporate America was making plans to revolutionize the way it does business on the mainland. And while the debate in Washington focused mainly on the probable lift for U.S. exports to China, many U.S. multinationals have something different in mind. "This deal is about investment, not exports," says Joseph Quinlan, an economist with Morgan Stanley Dean Witter & Co. "U.S. foreign investment is about to overtake U.S. exports as the primary means by which U.S. companies deliver goods to China."

"A comparison of U.S. trade with China and U.S. investment in China over the past decade is instructive. From 1991 to 1999, U.S. exports to China increased on an annual basis from $6.2 billion to $13.1 billion, slightly more than doubling. Imports from China during that same period rose from $20.3 billion to $81.7 billion, more than a four-fold increase. During that same period U.S. foreign direct investment in China rose from $323 million in 1991 to $4.3 billion in 1999, a thirteen-fold increase. Whereas the U.S. ranked behind Japan, the European Union, and Taiwan as a source of exports to China, it ranked ahead of all of them as a source of foreign direct investment in China.

"Rather than expanding exports and reducing the U.S. trade deficit with China, China's purpose in encouraging U.S. investment in China may be the opposite."

We totally agree with these views.

It has been a pleasure to study, analyze and discuss these issues with such a divergent group as this Commission, and for eleven of the twelve of us to reach near unanimity would seem to indicate the need for policymakers to deal with the subject of China in a comprehensive way.
Additional Views of Commissioner Patrick A. Mulloy

This Report discusses a full range of issues that affect America's relations with China including aspects of policies presently being pursued by both countries that do not serve our Nation's long term national security interests. It states that it is not clear, at this time, how our relations with China will evolve, as that will depend on future policies pursued by both nations. I agree.

One key issue discussed in the Report is how to keep America's industrial, scientific, and technological base from eroding as a result of our economic relations with a China whose government has adopted policies to expand its own base, even at our expense. Decisions about such matters cannot be left solely to our business community, as they are too important to the future standard of living of our people and to our long-term national security and well-being. Our elected leaders must play a greater role in guiding such decisions.

It is my hope that China will continue to find ways, consistent with our own economic well-being, to raise the standard of living of its people while at the same time establishing greater political and human rights for its own populace. Whether China achieves either of these stated objectives, it is still clear that the two countries will have to build new structures to resolve the inevitable problems and differences that will arise as China's world political and economic profile increases. It would be a tragedy for both countries if we evolved toward a new cold war marked by a spiraling arms race involving weapons of mass destruction. That is why, in my view, we should develop policies toward China that protect our interests but do not demonize a country with whom we will have to work in building structures of peace that will make mankind's future brighter.

President Kennedy, in addressing the United Nation's General Assembly in September 1963, pointed out that resolving international problems and building peaceful relations in the world is not a dramatic process but rather "a daily, a weekly, a monthly process, gradually changing opinions, slowly eroding old barriers, quietly building new structures." That advice is as true today as it was at the height of the Cold War.

We have attempted in this Report to be balanced in recognizing that we need to put new programs in place to build a much wider expertise about China both in our society and among our policymakers. At the same time, we recommend that we take new measures to protect our own economic interests and also work to build new structures and confidence-building measures to guide U.S.-China relations.

Reaching consensus on a Report such as this requires that each Commissioner not insist on his or her preferred wording for every paragraph and phrase. By working together, and with the help of able staff, we have achieved a near unanimous bipartisan consensus on the complex matters we were charged by Congress to address. It is an honor to have been part of the effort.
Additional Views of Commissioner Arthur Waldron (Commissioners Kenneth Lewis and June Teufel Dreyer Concur)

We sign the Commission's report with the following additional comments:

- The wide-ranging purpose of China's current military buildup must be recognized. It is not a response, as is sometimes suggested, to U.S. support for Taiwan and other Asian friends. Rather, the buildup should be understood as aimed at excluding the U.S. from Asia, and establishing the ability to threaten and coerce neighboring states ranging from Mongolia to Japan to India. This conclusion is supported not only by evidence of China's capabilities, but also by widely available statements of Chinese intent. If Taiwan did not exist, today's China would still pose serious security issues to all Asian states.

- Money gained through trade with the U.S. must not be permitted to strengthen China's military and security apparatus. Current measures are entirely inadequate. A massive strengthening of counterintelligence is required; scrutiny must be imposed on Chinese access to U.S. capital markets, with real sanctions. U.S. companies should be forbidden to do business with army and security related Chinese entities. Chinese attempts to circumvent such regulations must be punished severely, with measures including denial of access to U.S. markets. Foreign companies helping China's military and security apparatus (e.g., with military technology, computers, internet monitoring, etc.) should be denied any participation in U.S. Government procurement or development programs. This provision would affect England, France, Italy and other NATO countries, it would affect Israel, it would affect Russia, Ukraine and other members of the former Soviet Union, as well as other states.

- With respect to China's proliferation behavior, we have all the evidence we need: China is a major source of advanced weapons to terrorist-sponsoring and other dangerous states. What is required is firm action.

- Far more work is required, both from the Commission and from government, on China's role (or lack of role) in international terrorism. Beijing's close connections to terrorist-sponsoring states provide ample reason for concern.

- We must not assume that China is engaged, as is sometimes stated, in a "transition to a market based economy." In fact China's government has repeatedly stated that it is rather creating "Socialism with Chinese characteristics." Current evidence does not support the idea that the Chinese government (the Party) has any intention whatsoever of turning over its economic powers to a free market. We must not blandly assume that it will.

- U.S. intelligence operations with respect to China are inadequate and often misguided. Thorough reform is required, along the lines suggested by the Congressionally-mandated Tilelli Report which the CIA did not implement.

- Only democratic change can transform China into a genuine friend of the United States and her allies. U.S. policy should further that goal, and avoid propping up the current regime. In particular, we must distinguish the broad long-term interests of the United States and its friends and allies from the short-term interests of American business. The business relationship must not be permitted to drive or affect the political and security relationship.
Additional Views of Commissioner Larry M. Wortzel

Free trade creates jobs. That said, there are prudent reasons for a nation to withhold certain goods from the marketplace or to restrict trade. If a nation poses a direct military threat to the United States, or because its international behavior and security policies pose a latent or potential threat to the United States, as is the case with China, it is prudent to restrict the sale of military goods. By this I mean items controlled by the Arms Export Control Act. Given the use of the People’s Liberation Army (PLA) against innocent demonstrators in the Tiananmen Massacre in June 1989, there is no reason to make the PLA a more effective force by selling it weapons. Given the explicit threats by China against Taiwan, and its actions towards U.S. forces, the United States should not make the PLA a more effective fighting force through the sale of military goods or military technologies. In my view, the Tiananmen Sanctions of 1989 should be maintained, at the very least, until such time as the Chinese Communist Party reverses its own decision on the Tiananmen Massacre and Chinese leaders renounce the threat of force against Taiwan. The United States should use diplomacy to convince its allies to adopt this position.

Dual-use items, that is, those goods and technologies regulated under the Export Administration Act, are a more difficult problem. In general, the existing licensing process is sound and permits departments of government and industry to make the case for or against a sale in a fair, albeit sometimes adversarial, process. I strongly endorse the Report’s recommendations in favor of pre-license checks and post-license, end-user verification. The U.S. Embassy in Beijing and U.S. Consulates in China should be staffed to permit adequate pre- and post-license checks. In those cases where the United States has a unique technological or manufacturing capability with clear military application there are prudent reasons to control the licensing of such capabilities or processes. This is particularly important where there is no foreign availability for such technologies or manufacturing capabilities.

It is also prudent for a major power to maintain a defense industrial base on which it can depend in case of war. The United States should do so and, in limited cases, this may require that special industries be protected.

I find some of the recommendations in this Report to be protectionist for the wrong reasons. Trade and competition create jobs and create an environment in which industries must innovate. Corporations and whole sectors of industry revitalize themselves in the face of fair competition. Changes in manufacturing techniques and the availability of new materials may create conditions where there is some labor dislocation; i.e., workers may have to learn new skills or shift to other industrial sectors. But that is not the reason to restrict trade; instead it means that opportunities must be provided to American workers to learn new skills that permit them to compete in the job market.

Trade promotes American values and goals in China. It creates conditions where people are free from the direct dependence on the Communist Party and the government by promoting economic freedom.
DISSENTING VIEWS OF COMMISSIONER WILLIAM A. REINSCH

With regret, I dissent from this Report. On the whole it fails to present a fair and objective analysis of the U.S.-China security relationship. Instead, by consistently seeing the glass as half empty rather than half full, the Report ignores progress made over the past twenty years, adds to the level of paranoia about China in this country, and contains recommendations that could make that paranoia a self-fulfilling prophecy.

In fairness, the Chinese provide ample incentive for a negative Report. They are far from democracy and a market economy and are making little progress toward the former and irregular progress toward the latter. Market access problems and failures of intellectual property protection abound. An accurate description of China is that it is a work in progress. Unfortunately, this Report ignores the progress, holds the Chinese to a higher standard than we hold others, fails to understand that U.S. and Chinese geopolitical interests in the region will inevitably diverge regardless of what kind of government China has or what kind of economic policies it pursues, and assumes a static U.S. policy incapable of taking the initiative in the relationship. The Report spends virtually all its space describing Chinese past actions that have damaged our relationship and future actions that would make it worse and only rarely focuses on the more important question of how we can make it better.

The Report’s tilt is embodied in its perspective and tone. It consistently implies the Chinese deserve blame for acting in their own interest rather than ours. It is ironic that the Report implicitly criticizes the Chinese for viewing the U.S. as a hegemon at the same time it presents a view of U.S. interests in Asia that can only be described as hegemonic. The Commission majority has bent over backwards to avoid describing the Chinese as a “threat,” yet the belief that they are permeates every chapter. At the same time, the Commission majority implicitly but clearly would abandon the policy of engagement that has characterized the last five administrations in favor of a policy of suspicion driven by preparation for a variety of worst-case scenarios. In doing so, the Report ignores or denigrates the positive role of American business in bringing free market principles and American democratic values to China. Ironically, the Report criticizes China’s efforts to prevent these influences from spreading, thus acknowledging their significance, while it discourages American companies from expanding their activities.

The truth is our bilateral relationship is doomed to be difficult. We vie for influence in the region. This is neither unnatural nor unusual and should not be justification for demonizing China and turning our relationship into a struggle between good and evil.

One of the main reasons for our concern – barely noted in the Report – is the sheer size of the Chinese economy. The Western market system has no experience absorbing a new entrant of such enormous productive capacity. Instead of looking at that seriously, the Report attempts to blame China for virtually every economic problem the U.S. has, ignoring the fact our manufacturing base has been eroding; the trade deficit has been growing; and the dollar has been too strong for a long time for reasons that have little to do with China. In fact, China is pursuing policies that Japan, Korea, Taiwan, Malaysia, and others have pursued for years. The difference, again, is not policy but the size of the economy. The U.S. has
spent very little time analyzing the problem from that perspective and is largely unprepared to deal with rapid Chinese growth. Unfortunately, this Report adds heat rather than light to the debate by focusing on short term protectionist solutions rather than recommending a coherent program for staying ahead technologically — "running faster" — in the long term.

There are many recommendations in the Report that are objectionable, but space does not permit either a full list or detailed comments on them. Some highlights:

- Chapter Six's added disclosure requirements will politicize and thereby destabilize the capital markets, and by extension, the dollar, and encourage capital flight at a particularly critical time for our economy.

- Other proposals, such as those for a legislated corporate code of conduct and a corporate investment reporting requirement are administratively burdensome and confusing and will make the American business community assume the costs of our foreign policy. As with unilateral sanctions, which the Report also favors, these provisions disadvantage the American business community, cede the playing field to our European and Asian competitors who cheerfully pick up what our companies leave behind, and do not help us achieve our policy goals. Another good example is the recommendation that satellite sanctions continue, which only serves to put another nail in the coffin of our commercial communications satellite industry, the inevitable consequence of which will be that the U.S. industry will fall behind Europe's, and our military satellite capabilities will be compromised as well.

- These unilateral policies almost always fail because they ignore the realities of commerce in a globalized world. Worse, their effect is to deter American companies from doing business in the target country, in this case China, thus preventing the kind of economic engagement that I believe will ultimately lead to a more democratic China.

- Finally, the portion of Chapter Ten that discusses technology transfers, particularly computers, reflects a Cold War mentality that ignores both the spread of these technologies over the past decade and their importance in bringing freer communication and information to the Chinese people. Similarly, the recommendation that the Administration consider controlling exports of some internet-related items reflects both ignorance of the technology and a lack of appreciation of the importance of Internet access in promoting freedom in China.

In conclusion, although the final version of the Report is an improvement over earlier drafts, I must nevertheless dissent because it chooses simplistically to blame China for too many of our problems and misses the opportunity to focus constructively on how this relationship can be improved.
Commissioners Approving the Report

Michael Ledeon, Vice Chairman  Date

C. Richard D'Amato, Chairman  Date

George Becker, Commissioner  Date

Stephen D. Bryen, Commissioner  Date

June Teufel Dreyer, Commissioner  Date

Kenneth Lewis, Commissioner  Date

Patrick A. Mullany, Commissioner  Date

Arthur Waldron, Commissioner  Date

Roger W. Robinson, Jr., Commissioner  Date

Larry M. Wortzel, Commissioner  Date

Michael R. Wessel, Commissioner  Date

Commissioner Dissenting from the Report

William A. Reinsch, Commissioner  Date
United States-China Security Review Commission Charter

22 USCS § 7002 (2001)


§ 7002. United States-China Security Review Commission

(a) Purposes. The purposes of this section are as follows:

(1) To establish the United States-China Security Review Commission to review the national security implications of trade and economic ties between the United States and the People's Republic of China.

(2) To facilitate the assumption by the United States-China Security Review Commission of its duties regarding the review referred to in paragraph (1) by providing for the transfer to that Commission of staff, materials, and infrastructure (including leased premises) of the Trade Deficit Review Commission that are appropriate for the review upon the submittal of the final report of the Trade Deficit Review Commission.


(1) In general. There is hereby established a commission to be known as the United States-China Security Review Commission (in this section referred to as the "Commission").

(2) Purpose. The purpose of the Commission is to monitor, investigate, and report to Congress on the national security implications of the bilateral trade and economic relationship between the United States and the People's Republic of China.

(3) Membership. The United States-China Security Review Commission shall be composed of 12 members, who shall be appointed in the same manner provided for the appointment of members of the Trade Deficit Review Commission under section 127(c)(3) of the Trade Deficit Review Commission Act (19 U.S.C. 2213 note), except that—

(A) Appointment of members by the Speaker of the House of Representatives shall be made after consultation with the chairman of the Committee on Armed Services of the House of Representatives, in addition to consultation with the chairman of the Committee on Ways and Means of the House of Representatives provided for under clause (iii) of subparagraph (A) of that section;

(B) Appointment of members by the President pro tempore of the Senate upon the recommendation of the majority leader of the Senate shall be made after consultation with the...
chairman of the Committee on Armed Services of the Senate, in addition to consultation with the chairman of the Committee on Finance of the Senate provided for under clause (i) of that subparagraph;

(C) Appointment of members by the President pro tempore of the Senate upon the recommendation of the minority leader of the Senate shall be made after consultation with the ranking minority member of the Committee on Armed Services of the Senate, in addition to consultation with the ranking minority member of the Committee on Finance of the Senate provided for under clause (ii) of that subparagraph;

(D) Appointment of members by the minority leader of the House of Representatives shall be made after consultation with the ranking minority member of the Committee on Armed Services of the House of Representatives, in addition to consultation with the ranking minority member of the Committee on Ways and Means of the House of Representatives provided for under clause (iv) of that subparagraph;

(E) Persons appointed to the Commission shall have expertise in national security matters and United States-China relations, in addition to the expertise provided for under subparagraph (B)(i)(I) of that section;

(F) Members shall be appointed to the Commission not later than 30 days after the date on which each new Congress convenes;

(G) Members of the Commission may be reappointed for additional terms of service as members of the Commission: and

(H) Members of the Trade Deficit Review Commission as of the date of the enactment of this Act [enacted Oct. 30, 2000] shall serve as members of the United States-China Security Review Commission until such time as members are first appointed to the United States-China Security Review Commission under this paragraph.

(4) Retention of support. The United States-China Security Review Commission shall retain and make use of such staff, materials, and infrastructure (including leased premises) of the Trade Deficit Review Commission as the United States-China Security Review Commission determines, in the judgment of the members of the United States-China Security Review Commission, are required to facilitate the ready commencement of activities of the United States-China Security Review Commission under subsection (c) or to carry out such activities after the commencement of such activities.

(5) Chairman and vice chairman. The members of the Commission shall select a Chairman and Vice Chairman of the Commission from among the members of the Commission.

(6) Meetings.
   (A) Meetings. The Commission shall meet at the call of the Chairman of the Commission.
   (B) Quorum. A majority of the members of the Commission shall constitute a quorum for the transaction of business of the Commission.

(7) Voting. Each member of the Commission shall be entitled to one vote, which shall be equal to the vote of every other member of the Commission.
(c) Duties.

(1) Annual report. Not later than March 1 each year (beginning in 2002), the Commission shall submit to Congress a report, in both unclassified and classified form, regarding the national security implications and impact of the bilateral trade and economic relationship between the United States and the People's Republic of China. The report shall include a full analysis, along with conclusions and recommendations for legislative and administrative actions, if any, of the national security implications for the United States of the trade and current balances with the People's Republic of China in goods and services, financial transactions, and technology transfers. The Commission shall also take into account patterns of trade and transfers through third countries to the extent practicable.

(2) Contents of report. Each report under paragraph (1) shall include, at a minimum, a full discussion of the following:

(A) The portion of trade in goods and services with the United States that the People's Republic of China dedicates to military systems or systems of a dual nature that could be used for military purposes.

(B) The acquisition by the People's Republic of China of advanced military or dual-use technologies from the United States by trade (including procurement) and other technology transfers, especially those transfers, if any, that contribute to the proliferation of weapons of mass destruction or their delivery systems, or that undermine international agreements or United States laws with respect to nonproliferation.

(C) Any transfers, other than those identified under subparagraph (B), to the military systems of the People's Republic of China made by United States firms and United States-based multinational corporations.

(D) An analysis of the statements and writing of the People's Republic of China officials and officially-sanctioned writings that bear on the intentions, if any, of the Government of the People's Republic of China regarding the pursuit of military competition with, and leverage over, or cooperation with, the United States and the Asian allies of the United States.

(E) The military actions taken by the Government of the People's Republic of China during the preceding year that bear on the national security of the United States and the regional stability of the Asian allies of the United States.

(F) The effects, if any, on the national security interests of the United States of the use by the People's Republic of China of financial transactions and capital flow and currency manipulations.

(G) Any action taken by the Government of the People's Republic of China in the context of the World Trade Organization that is adverse or favorable to the United States national security interests.

(H) Patterns of trade and investment between the People's Republic of China and its major trading partners, other than the United States, that appear to be substantively different from trade and investment patterns with the United States and whether the differences have any national security implications for the United States.

(I) The extent to which the trade surplus of the People's Republic of China with the United States enhances the military budget of the People's Republic of China.

(J) An overall assessment of the state of the security challenges presented by the People's Republic of China to the United States and whether the security challenges are increasing or decreasing from previous years.

(3) Recommendations of report. Each report under paragraph (1) shall also include
recommendations for action by Congress or the President, or both, including specific recommendations for the United States to invoke Article XXI (relating to security exceptions) of the General Agreement on Tariffs and Trade 1994 with respect to the People's Republic of China, as a result of any adverse impact on the national security interests of the United States.

(d) Hearings.

(1) In general. The Commission or, at its direction, any panel or member of the Commission, may for the purpose of carrying out the provisions of this section, hold hearings, sit and act at times and places, take testimony, receive evidence, and administer oaths to the extent that the Commission or any panel or member considers advisable.

(2) Information. The Commission may secure directly from the Department of Defense, the Central Intelligence Agency, and any other Federal department or agency information that the Commission considers necessary to enable the Commission to carry out its duties under this section, except the provision of intelligence information to the Commission shall be made with due regard for the protection from unauthorized disclosure of classified information relating to sensitive intelligence sources and methods or other exceptionally sensitive matters, under procedures approved by the Director of Central Intelligence.

(3) Security. The Office of Senate Security shall—
(A) provide classified storage and meeting and hearing spaces, when necessary, for the Commission; and
(B) assist members and staff of the Commission in obtaining security clearances.

(4) Security clearances. All members of the Commission and appropriate staff shall be sworn and held appropriate security clearances.

(e) Commission personnel matters.

(1) Compensation of members. Members of the United States-China Security Review Commission shall be compensated in the same manner provided for the compensation of members of the Trade Deficit Review Commission under section 127(g)(1) and section 127(g)(6) of the Trade Deficit Review Commission Act (19 U.S.C. 2213 note).

(2) Travel expenses. Travel expenses of the United States-China Security Review Commission shall be allowed in the same manner provided for the allowance of the travel expenses of the Trade Deficit Review Commission under section 127(g)(2) of the Trade Deficit Review Commission Act [19 USCS § 2213 note].

(3) Staff. An executive director and other additional personnel for the United States-China Security Review Commission shall be appointed, compensated, and terminated in the same manner provided for the appointment, compensation, and termination of the executive director and other personnel of the Trade Deficit Review Commission under section 127(g)(3) and section 127(g)(6) of the Trade Deficit Review Commission Act [19 USCS § 2213 note].

(4) Detail of government employees. Federal Government employees may be detailed to the United States-China Security Review Commission in the same manner provided for the detail of Federal Government employees to the Trade Deficit Review Commission under section 127(g)(4) of the Trade Deficit Review Commission Act [19 USCS § 2213 note].
(5) Foreign travel for official purposes. Foreign travel for official purposes by members and staff of the Commission may be authorized by either the Chairman or the Vice Chairman of the Commission.

(6) Procurement of temporary and intermittent services. The Chairman of the United States-China Security Review Commission may procure temporary and intermittent services for the United States-China Security Review Commission in the same manner provided for the procurement of temporary and intermittent services for the Trade Deficit Review Commission under section 127(g)(5) of the Trade Deficit Review Commission Act [19 USCS § 2213 note].

(f) Authorization of appropriations.

(1) In general. There is authorized to be appropriated to the Commission for fiscal year 2001, and for each fiscal year thereafter, such sums as may be necessary to enable the Commission to carry out its functions under this section.

(2) Availability. Amounts appropriated to the Commission shall remain available until expended.

(g) Federal Advisory Committee Act. The provisions of the Federal Advisory Committee Act (5 U.S.C. App.) shall not apply to the Commission.

(h) Effective date. This section shall take effect on the first day of the 107th Congress.

Amendments:

SEC. 645. (a) Section 1238(e)(3) of the Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001 (as enacted by Public Law 106-398) is amended by adding at the end the following: "The executive director and any personnel who are employees of the United States-China Security Review Commission shall be employees under section 2105 of title 5, United States Code, for purposes of chapters 63, 81, 83, 84, 85, 87, 89, and 90 of that title." (b) The amendment made by this section shall take effect on January 3, 2001.

SEC. 648. DEADLINE FOR SUBMISSION OF ANNUAL REPORTS BY UNITED STATES-CHINA SECURITY REVIEW COMMISSION. Section 1238(c)(1) of the Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001 (as enacted into law by section I of Public Law 106398) is amended by striking "March" and inserting "June".
Background on Commissioners

C. Richard D'Amato, Chairman

C. Richard D'Amato is a delegate to the General Assembly of the State of Maryland and president of a consulting firm representing American corporations on strategic planning and international trade matters. He is a retired captain in the United States Navy Reserve, a position that brought him a variety of assignments, including attaché duty at the U.S. embassy in Beijing, China. Recently, Mr. D'Amato served as a member of the U.S. Trade Deficit Review Commission, a congressionally created commission charged with studying the nature, causes and consequences of the United States merchandise trade and current account deficits.

Beginning in 1988, for ten years, Mr. D'Amato was the Democratic counsel for the United States Senate Committee on Appropriations, responsible for coordinating and managing the annual appropriations bills and other legislation on policy and funding of U.S. international operations and programs, including trade and defense and the full range of foreign activities of the U.S. government. He also served as senior foreign policy counsel for Senator Robert C. Byrd. Between 1980 and 1987, Mr. D'Amato served as the policy director for the Majority Leader, Senator Robert C. Byrd, for political, economic, and security policies. In this position, Mr. D'Amato supervised all work on a number of important legislative initiatives, including the 1988 Omnibus Trade Bill and the "Super 301" provision. Mr. D'Amato also wrote key legislation dealing with U.S.-Japan economic relations. During his career on Capitol Hill, Mr. D'Amato also served as the co-director of the Senate Arms Control Observer Group.

Mr. D'Amato received his B.A. from Cornell University, graduating cum laude in Government. He received his M.A. and M.A.L.D. from the Fletcher School of Law and Diplomacy in Boston, and received his J.D. from Georgetown University Law Center.

Appointed to the Commission by U.S. Senate Minority Leader Daschie, March 1, 2001.

Michael A. Ledeen, Vice Chairman

Michael A. Ledeen is the Resident Scholar in the Freedom Chair at the American Enterprise Institute. From 1981 to 1996, Mr. Ledeen served as a special advisor and consultant to top policy officials in the Reagan Administration, including to the Secretary of State, to the National Security Advisor to the President and to the Office of the Secretary of Defense.

He has spent many years researching and speaking on leadership and the use of power, with books, such as Machiavelli on Modern Leadership (1999), and Freedom Betrayed: How America Led a Global Democratic Revolution, Won the Cold War, and Walked Away (1996). His work has led to appearances on the PBS NewsHour, CNN Larry King Live and Newsmaker. Mr. Ledeen has published numerous articles in publications such as the Wall Street Journal, Washington Times, National Review, American Spectator, International Economy, and Commentary.

Mr. Ledeen received his B.A. from Pomona College in Claremont, California. He received his M.S. and PhD in History and Philosophy from the University of Wisconsin.

Appointed to the Commission by U.S. Senate Majority Leader Lott, February 13, 2001.

George Becker

A second-generation steelworker, George Becker grew up across the street from Granite City Steel in Illinois, where he went to work with an open-hearth labor gang at age 15 during the summer of 1944. From that beginning, Mr. Becker rose through the ranks until elected in 1993 and again in 1997 for two terms as the sixth international president of the United Steelworkers of America (USWA), representing 750,000 industrial workers in the U.S. and Canada.
Following his March 2001 retirement as USWA president, Mr. Becker remains active as a leader on economic and trade policy issues threatening America's workers. He continues to give workers a strong voice in Washington by creating new initiatives to meet rapidly changing political realities.

Prior to being named to the U.S.-China Security Review Commission (USCSRC), Mr. Becker completed a congressional appointment on the U.S. Trade Deficit Review Commission (USTDRDC) in 2000. He also served appointments during the Clinton Administration to the President's Export Council (PEC) and the U.S. Trade and Environmental Policy Advisory Committee (TEPAC).

As an AFL-CIO vice president and executive council member, Mr. Becker chaired the national labor federation's powerful Economic Policy Committee. He was a leader in the 1995 revitalization of the AFL-CIO that elected John Sweeney as the current president.

Mr. Becker was elected two terms in 1985 and 1989 as the USWA's international vice president for administration. While vice president, he headed the union's organizing program and the Aluminum Industry Conference for collective bargaining. Among several corporate campaigns he led involving major labor disputes, the best known was against Ravenswood Aluminum Corp. that achieved the historic firing of 1,300 permanent scab replacement workers and the return to work of 1,600 steelworkers after a twenty-month lockout that ended in 1992.

He was an executive committee member of the Geneva-based International Metalworkers Federation (IMF) and chairman of the world rubber council of the International Federation of Chemical, Energy, Mine and General Workers' Unions (ICEM) in Brussels.


**Stephen D. Bryen**

Dr. Stephen Bryen is the managing director of Aurora Defense, LLC, a consultancy organization, specializing in national security and homeland defense.

Previously, he served as Deputy Under Secretary of Defense from 1981-1988 and before that as a Professional Staff Member and Near East Subcommittee Director to the Senate Foreign Relations Committee. Dr. Bryen was a founder of the Defense Technology Security Administration (DTSA) and served as its first Director.

Dr. Bryen is a member of the Advisory Board of the Jewish Institute for National Security Affairs and serves on the Board of Directors of the U.S.-Israel Business Exchange. He was twice awarded the Defense Department's highest civilian honor, the Distinguished Public Service Medal.


**June Teufel Dreyer**

Dr. Dreyer is a Senior Fellow, Foreign Policy Research Institute; and Department Chair of Political Science at the University of Miami. She received her Bachelor's degree from Wellesley College and her M.A. and Ph.D. degrees from Harvard University. Dr. Dreyer has served as Senior Far East Specialist at the Library of Congress and on the advisory panel of the Chief of Naval Operations. Her research specialties include the Chinese military, cross-strait relations, ethnic minorities in China, and questions of Asia-Pacific regional security. She has published widely on these topics. The fourth edition of her book *China's Political System: Modernization and Tradition* is scheduled to appear in 2003.

Kenneth Lewis

Kenneth Lewis was born in New York, New York. He received his undergraduate degree from the Woodrow Wilson School of Public and International Affairs at Princeton University in 1955, and his J.D. from Harvard Law School in 1958. He clerked for a U.S. Federal judge in New York after graduation from law school, and then moved to Portland, Oregon, where he practiced law. In 1963 he joined Lasco Shipping Co., which operated a fleet of ocean-going vessels carrying cargoes throughout the world.

Mr. Lewis was President of Lasco Shipping Co., from 1979 until his retirement in 1994. He served on the Board of Directors of two international marine insurance organizations: the Britannia Steam Ship Insurance Association, Ltd., of London, England (1986-1994); and the Swedish Club (of which he was Deputy Chairman) of Gothenburg, Sweden (1987-1989). He has traveled extensively in Asia, beginning in 1963 to Japan and Korea and in 1979 to the People's Republic of China, making over a hundred visits to these countries.

Mr. Lewis previously served on the Presidential Commission on U.S.-Pacific Trade and Investment Policy (appointed by President William J. Clinton in 1996), and the Congressional U.S. Trade Deficit Review Commission (1999-2000). He is a past president of the Port of Portland Commission to which he was appointed by both Republican and Democratic Governors.

He serves on the Board of Trustees of Pacific University, the Board of Visitors of the University of Oregon School of Law and the Board of Directors of the Oregon Shakespeare Festival. He was the national Chairman of the "I have a Dream" Foundation of New York, and was the founding Chairman of the "I Have a Dream" Foundation in Oregon. He also served on the Board of Directors of the Oregon Ballet Theatre, of which he was Chairman and President, and the Board of Directors of the World Affairs Council of Oregon, of which he was President. He previously served on the Board of the Oregon Community Foundation.

Mr. Lewis received the President's Public Service Award in 1991 from the Oregon State Bar Association, and the Equal Opportunity Award from the Urban League of Portland in 1997.

Mr. Lewis was appointed to the Commission by Democratic Leader Gephardt, March 1, 2001.

Patrick A. Mulloy

Prior to his appointment to the U.S.-China Security Review Commission, Mr. Mulloy was nominated by President Clinton and confirmed by the United States Senate as Assistant Secretary for Market Access and Compliance in the Department of Commerce's International Trade Administration where he served from 1998-2001. In that position Mr. Mulloy directed a trade policy unit focused worldwide on removing foreign barriers to U.S. exports, and ensuring that foreign countries comply with trade agreements negotiated with the United States. He was also appointed by President Clinton to serve as a member of the Commission on Security and Cooperation in Europe.

Previously, Mr. Mulloy served fifteen years in various senior positions on the United States Senate Banking Committee, including Chief International Counsel and General Counsel.

Before coming to the Senate, Mr. Mulloy served as a senior attorney in the Antitrust Division of the U.S. Department of Justice that supervised participation by U.S. oil companies in the Paris-based International Energy Agency (IEA). Earlier at the Justice Department he represented the United States in a variety of cases related to Federal environmental laws, including criminal and civil enforcement actions in various U.S. District Courts, several Circuit Courts of Appeal, and the U.S. Supreme Court.

Appendix II – Commissioners Biographies   A9
Mr. Mulloy began his public service career as a Foreign Service Officer at the U.S. Department of State where he served in the Office of U.N. Political Affairs, the Office of International Environmental and Oceans Affairs, and Vice Consul in the U.S. Consulate General in Montreal, Canada.

Mr. Mulloy, a native of Kingston, Pennsylvania, holds an LL.M. from Harvard University Law School, a J.D. from George Washington University Law School, an M.A. from the University of Notre Dame, and a B.A. from King's College.

Mr. Mulloy is an Adjunct Professor of International Law at Catholic University Law School.

Appointed to the Commission by U.S. Senate Minority Leader Daschle, March 1, 2001.

**William A. Reinsch**

Mr. Reinsch is President of the National Foreign Trade Council. Founded in 1914, the NFTC is the only business organization dedicated solely to trade policy, export finance, international tax, and human resource issues. The organization represents over 500 companies through its offices in New York and Washington, D.C. As president, Mr. Reinsch oversees NFTC's efforts in favor of open markets, in support of Ex-Im Bank and OPIC, and as head of the USA Engage and Foreign Sales Corporation (FSC) coalitions, among many other international trade and tax issues of concern to U.S. business.

Prior to joining the NFTC, Mr. Reinsch served as Under Secretary for Export Administration in the U.S. Department of Commerce. As head of the Bureau of Export Administration (BXA), he was charged with administering and enforcing the export control policies of the U.S. government, as well as its anti-boycott laws.

From 1991 through 1993, Mr. Reinsch was a senior Legislative Assistant to Senator John D. Rockefeller IV, responsible for trade, international economic policy, foreign affairs and defense.

Earlier, Mr. Reinsch served on the staff of the late Senator John Heinz as Chief Legislative Assistant, focusing on foreign trade and competitiveness policy issues. Mr. Reinsch provided staff support for Senator Heinz in his positions as Chairman and then ranking minority member of the Banking Committee's Subcommittee on International Finance, and membership on the International Trade Subcommittee of the Finance Committee. This included participation in five revisions of the Export Administration Act and work on four major trade bills.

Prior to 1977, Mr. Reinsch was a Legislative Assistant to Representatives Richard Ottinger and Gilbert Gude, acting Staff Director of the House Environmental Study Conference, and a teacher in Maryland.


Mr. Reinsch received a B.A. degree in International Relations from the Johns Hopkins University and an M.A. degree from the Johns Hopkins School of Advanced International Studies.

Appointed to the Commission by U.S. Senate Minority Leader Daschle, March 1, 2001.
Roger W. Robinson, Jr.

Roger W. Robinson, Jr. is President and CEO of Conflict Securities Advisory Group, Inc., a Washington D.C.-based company that offers research and advisory services in the field of global security risk management. He is also President of RWR Inc., a consulting firm established in 1985 which provides strategic planning services and real-time analyses of breaking geopolitical developments that could potentially impact on international debt, equity and currency markets.

Prior to forming these firms, Mr. Robinson was Senior Director of International Economic Affairs at the National Security Council. He worked at the White House from March 1982 until September 1985. Between January 1984 and April 1985, Mr. Robinson also served as Executive Secretary of the Senior Interdepartmental Group-International Economic Policy, a Cabinet-level body which reported through the NSC to the President. As Senior Director, Mr. Robinson had responsibility for all economic, financial, trade and energy relationships of the United States worldwide for NSC.

Prior to joining the NSC staff, Mr. Robinson was Vice President in the International Department of the Chase Manhattan Bank in New York City. As a banker, he had responsibilities for Chase's loan portfolio in the USSR, Eastern and Central Europe and Yugoslavia for five years. He also served for some two and a half years as a staff assistant to former Chase Chairman David Rockefeller and earlier on assignment with the Chase branch in Tokyo.

Mr. Robinson has published extensively on the security-related risk in the global capital markets and East-West economic and financial relations. He has served as an expert witness on numerous occasions before both Senate and House Committees. In addition, he is a frequent radio commentator and has made numerous broadcast appearances.

Mr. Robinson holds a B.A. from Duke University and an M.A. in international affairs from the George Washington University. He served for some seven years on the Board of Visitors at the Sanford Institute of Public Policy at Duke University. Mr. Robinson is also Chairman of the William J. Casey Institute of the Center for Security Policy and is currently Chairman of the Board of the Prague Security Studies Institute in the Czech Republic.

Appointed to the Commission by U.S. Senate Majority Leader Lott, February 13, 2001.

Arthur Waldron

Mr. Arthur Waldron is currently Visiting Scholar and Director of Asian Studies at the American Enterprise Institute and has been the Lauder Professor of International Relations, University of Pennsylvania (1997-present). He is also an Associate in research, Olin Institute for Strategic Studies, Harvard University (1994-present), and Associate in research, Farbank Center for East Asian Research, Harvard University (1994-present). From 1991-1997 Mr. Waldron was a Professor of Strategy and Policy at the U.S. Naval War College. In 1992, he served as an Adjunct professor at Brown University.

His Publications include:
From War to Nationalism: China's Turning Point, 1924-1925, 1995
The Great Wall of China: From History to Myth, 1992
The Modernization of Inner Asia, editor, 1991

Mr. Waldron has also published numerous articles in publications such as Modern Asia Studies, China Quarterly, American Historical Review, Orbis, Journal of Military History, and Chinese Studies in History. He speaks regularly before audiences nationwide and in Europe, Asia, and the Pacific Rim.
Mr. Waldron received his B.A., *summa cum laude*, from Harvard University and his Ph.D., in history, from Harvard University.

Appointed to the Commission by Senate Majority Leader Lott, February 13, 2001.

**Michael R. Wessel**

Michael Wessel is Senior Vice President of Downey McGrath Group, Inc., a public affairs consulting firm offering expertise in government, politics, and international affairs. He served on the staff of House Democratic Leader Richard A. Gephardt for more than twenty years, leaving his position as General Counsel in March 1998. In addition to his duties as General Counsel, Mr. Wessel was Mr. Gephardt’s chief policy advisor, strategist, and negotiator. He was responsible for the development, coordination, management, and implementation of the Democratic Leader’s overall policy and political objectives with specific responsibility for international trade, finance, economics, labor, and taxation.

During his more than twenty years on Capitol Hill, he served in a number of positions: as Mr. Gephardt’s principal Ways and Means aide, where he developed and implemented numerous tax and trade policy initiatives. He participated in the enactment of every major trade policy initiative from 1978 to his departure in 1998. In the late 1980s, he was the Executive Director of the House Trade and Competitiveness Task Force, where he was responsible for the Democrat’s trade and competitiveness agenda as well as overall coordination of the Omnibus Trade and Competitiveness Act of 1988. The National Journal wrote: Wessel is “generally credited in Washington trade circles with having helped to keep Gephardt ahead of the curve on major issues.”

He was intimately involved in the development of comprehensive tax reform legislation in the early 1980s and every major tax bill during his tenure. Beginning in 1989, he became the principal advisor to the Democratic Leadership on economic policy matters and served as tax policy coordinator to the 1990 Budget Summit. In 1995, he developed the 10 percent Tax Plan, a comprehensive tax reform initiative that would enable roughly four out of five taxpayers to pay no more than a 10 percent rate in federal income taxes. It became the principal Democratic tax reform alternative. In 1988, he served as National Issues Director to Gephardt’s Presidential campaign. During the 1992 Clinton/Gore campaign, he assisted on a broad range of issues and served as a Senior Policy Advisor to the Clinton/Gore transition office. After leaving Mr. Gephardt’s staff, Mr. Wessel opened his own consulting firm, where he provided strategic advice to a number of businesses, political, and labor organizations. He also served as a Visiting Fellow at the Washington, DC-based Economic Policy Institute and currently maintains an affiliation with the Institute.

He has coauthored a number of articles with Democratic Leader Gephardt and a book, *An Even Better Place: America in the 21st Century* (Public Affairs, 1999). He was previously a congressional appointee on the U.S. Trade Deficit Review Commission.

Mr. Wessel holds a B.A. and a J.D. from George Washington University.

Appointed to the Commission by Democratic Leader of the House of Representatives Mr. Gephardt, March 1, 2001.

**Larry M. Wortzel**

Dr. Larry M. Wortzel is the director of the Asian Studies Center at The Heritage Foundation, an influential think tank based in Washington, DC. Since 1983, the Center has addressed a broad range of policy issues affecting U.S.-Asia relations.

A leading authority on China, Asia, intelligence, national security and military strategy, Dr. Wortzel
joined Heritage in November 1999 upon completing a distinguished 32-year career in the U.S. armed forces. His last military position was as director of the Strategic Studies Institute of the U.S. Army War College.

Following three years in the Marine Corps and a stint in college, Mr. Wortzel enlisted in the U.S. Army in 1970. His first assignment with the Army Security Agency took him to Thailand, where he focused on Chinese military communications in Vietnam and Laos. Within three years he had graduated Infantry Officer Candidate School, as well as both Airborne and Ranger schools.

After serving four years as an infantry officer in Korea and at Fort Benning, Georgia, he shifted to military intelligence. Mr. Wortzel traveled regularly throughout Asia while serving the U.S. Pacific Command as a political-military affairs analyst from 1978 to 1982. The following year he attended the National University of Singapore where he studied advanced Chinese and traveled in China and Southeast Asia. He next worked for the Under Secretary of Defense for Policy developing counterintelligence programs to protect emerging defense technologies from foreign espionage.

From 1988-1990, Mr. Wortzel was Assistant Army Attaché at the U.S. Embassy in China, where he witnessed and reported on the Tiananmen Massacre. After assignments as an Army strategist and managing worldwide assignments for Army intelligence officers, he returned to China in 1995 as the Army Attaché. In January 1998 he became a faculty member of the U.S. Army War College, serving as director of the Strategic Studies Institute. He retired from the Army as a colonel.


A graduate of the Armed Forces Staff College and the U.S. Army War College, Mr. Wortzel earned his B.A. from Columbus College, Georgia, and his M.A. and Ph.D. from the University of Hawaii.

Public Hearings and Technical Briefings of the Commission

Full transcripts and written testimonies are available online at the Commission’s Website: www.uscc.gov.


Witnesses: Alan Tonelson, U.S. Business & Industry Council; Peter Bottelier, John F. Kennedy School of Government; Greg Mastel, U.S. Senate Finance Committee; Ernest H. Preeg, Manufacturers Alliance; Harry Wu, Laogai Research Foundation; Nicholas Lardy, the Brookings Institution; Kate Brofenbrenner, Cornell University.


Commissioners present: C. Richard D’Amato, Chairman, Michael A. Ledeen, Vice Chairman, George Becker, Stephen D. Bryen, June Teufel Dreyer, Kenneth Lewis, James R. Lilley (Hearing Co-Chair), Patrick A. Mulloy (Hearing Co-Chair), William A. Reinsch, Roger W. Robinson, Jr., Michael R. Wessel.

Statements by Senators: Robert C. Byrd, U.S. Senator from West Virginia; Fred Thompson, U.S. Senator from Tennessee; Paul Sarbanes, U.S. Senator from Maryland; Chuck Hagel, U.S. Senator from Nebraska.


Commissioners present: C. Richard D’Amato, Chairman (and Hearing Co-Chair), Michael A. Ledeen, Vice Chairman, George Becker (Hearing Co-Chair), Stephen D. Bryen, June Teufel Dreyer, Kenneth Lewis, James R. Lilley, Patrick A. Mulloy, William A. Reinsch, Roger W. Robinson, Jr., Michael R. Wessel.

Witnesses: Thomas J. Usher, USX Corporation and United States Steel LLC; Leo W. Gerard, United Steelworkers of America; Peter Davidson, Office of the U.S. Trade Representative; Charles W. Winwood, U.S. Customs Service; Gordon G. Chang, author and attorney; Alicia Zhao; Robert Thayer, International Association of Machinists and Aerospace Workers; John W. Douglass, Aerospace Industries Association of America, Inc.; Steve Beckman, United Automobile, Aerospace and Agricultural Implement Workers of America; Chuck Lambert, National Cattlemen’s Beef Association; Dwayne Ford, American Soybean Association; Henry Jo Von Tungeln, U.S. Wheat Associates and the Wheat Export Trade Education Committee; Robbin S. Johnson, Cargill, Inc.; Edward Fire, International Union of Electronic, Electrical, Salaried, and Furniture Workers Division of the Communications Workers of America; Dave McCurdy, Electronic Industries Alliance; Merritt Todd Cooke, Jr., American Institute in Taiwan.


Commissioners present: C. Richard D’Amato, Chairman, Michael A. Ledeen, Vice Chairman (and Hearing Co-Chair), George Becker, Stephen D. Bryen, June Teufel Dreyer, Kenneth Lewis (Hearing Co-Chair), James R. Lilley, Patrick A. Mulloy, William A. Reinsch, Roger W. Robinson, Jr., Michael R. Wessel.


Commissioners present: C. Richard D’Amato, Chairman (and Hearing Co-Chair), George Becker, Stephen D. Bryen (Hearing Co-Chair) June Teufel Dreyer, Kenneth Lewis, Patrick A. Mulloy, William A. Reinsch, Roger W. Robinson, Jr., Arthur Waldron, Michael R. Wessel.

Witnesses: Kenneth W. Allen, Center for Naval Analyses; Rodney W. Jones, Policy Architects International; Kenneth R. Timmerman, author; Jing-Dong Yuan, Center for Nonproliferation Studies, Monterey Institute of International Studies; Gary Milhollin, University of Wisconsin Law School and Wisconsin Project on Nuclear Arms Control; RADM (Ret.) Michael McDevitt, Center for Strategic Studies, Center for Naval Analyses Corporation.

Appendix III – Public Hearings and Technical Briefings of the Commission

Commissioners present: C. Richard D’Amato, Chairman, Michael A. Ledeen, Vice Chairman, George Becker, Stephen D. Bryen, June Teufel Dreyer, Kenneth Lewis, Patrick A. Mulloy, William A. Reinsch, Roger W. Robinson, Jr. (Hearing Co-Chair), Michael R. Wessel (Hearing Co-Chair).

Opening Remarks: Fred Thompson, United States Senator from Tennessee

Witnesses: Warren Bailey, Johnson Graduate School of Management, Cornell University; Nicholas Lardy, Brookings Institution; Thomas J. Byrne, Moody’s Investors Service; Stephen Harner, S.M. Harner and Co. (Shanghai); Paul S. Wolansky, New China Management Corp.; Robert D. Hormats, Goldman Sachs (International); Marc E. Lackritz, Securities Industry Association; James A. Dorn, CATO Institute; William Patterson, AFL-CIO; Michael Flaherman, California Public Employees’ Retirement System; Rep. Steven R. Nickol, Pennsylvania House of Representatives.


Commissioners present: C. Richard D’Amato, Chairman (and Hearing Co-Chair), George Becker, Stephen D. Bryen, June Teufel Dreyer (Hearing Co-Chair), Kenneth Lewis, Patrick A. Mulloy, William A. Reinsch, Arthur Waldron, Michael R. Wessel, Larry M. Wortzel.


Commissioners present: C. Richard D’Amato, Chairman, Michael A. Ledeen, Vice Chairman, George Becker, Stephen D. Bryen (Hearing Co-Chair), June Teufel Dreyer, Kenneth Lewis, Patrick A. Mulloy, William A. Reinsch (Hearing Co-Chair), Roger W. Robinson, Jr., Michael R. Wessel.

Witnesses: Lisa Bronson, U.S. Department of Defense; James J. Jochum, U.S. Department of Commerce; Vann H. Van Diepen, U.S. Department of State; Michael Garcia, U.S. Department of Commerce; Richard Mercier, Investigative Programs, U.S. Customs Service; Donald Hicks, Hicks and Associates; James Lewis, Center for Strategic and International Studies; Deryl Hatano, Semiconductor Industry Association; Chip Storie, Cincinnati Machines on behalf of the Association for Manufacturing Technology; Kathleen A. Walsh, Henry L. Stimson Center; Gary Milhollin, Wisconsin Project on Nuclear Arms Control; Paul Godwin, National War College.

Commissioners present: C. Richard D'Amato, Chairman (and Hearing Co-Chair), Michael A. Ledeen, Vice Chairman, George Becker, Stephen D. Bryen, June Teufel Dreyer, Kenneth Lewis, Patrick A. Mulloy (Hearing Co-Chair), William A. Reinsch, Roger W. Robinson, Jr., Arthur Waldron, Michael R. Wessel.

Witnesses: Jeffery Bader, Office of the U.S. Trade Representative; William H. Lash, III, U.S. Department of Commerce; Shaun Donnelly, U.S. Department of State; Patricia R. Sheikh, Foreign Agricultural Service, United States Department of Agriculture; Donald C. Clarke, University of Washington Law School; Margaret M. Pearson, University of Maryland, College Park; Jeffrey L. Fiedler, AFL-CIO; Terence P. Stewart, law offices of Stewart and Stewart; Daniel J. Brody, US Information Technology Office, Beijing; William H. Overholt, Harvard University Asia Center; David Hale, Zurich Financial Services; Andrew W. Shoyer, Powell, Goldstein, Frazer & Murphy; Larry Spiegel, Appledown Films, Inc.; Bonnie J.K. Richardson, Motion Picture Association of America; Eric H. Smith, International Intellectual Property Alliance; David C. Quam, International Anti-Counterfeiting Coalition; Roger T. Uren, Phoenix Satellite Television Limited (Hong Kong); Lyric M. Hughes, China Online Inc.; Hurst Lin, SINA.com; Stephen Hsu, Safeweb, Inc.; Laura B. Sherman, Paul, Weiss, Rifkind, Wharton & Garrison.
List of Research Material

The material listed below is included in the Report’s Documentary Annex, and is available online at the Commission’s website “www.uscc.gov.” The research papers were prepared at the request of the Commission to support its deliberations and is intended to promote greater public understanding of the issues addressed by the Commission. However, inclusion in the Report Annex does not imply an endorsement by the Commission or any individual Commissioner of the views expressed in the material.

Commissioned Research Papers


  - Evaluations of Chang’s Paper, by Richard N. Cooper, Ph.D., Harvard University; and Nicholas Lardy, Ph.D., Brookings Institute

- China’s Military Strategy Toward the United States, by Michael P. Pillsbury, Ph.D., National Defense University, November 2001

- China’s Perceptions of the United States. The View from Open Sources, by Michael P. Pillsbury, Ph.D., National Defense University, November 2001

- China’s Research Institutes, by Michael P. Pillsbury, Ph.D., National Defense University, October 2001

- China’s Role in World Trade and Investment, by Allen J. Lenz, Ph.D., April 2002

- Impact of U.S.-China Trade Relations on Workers, Wages, and Employment: Pilot Study Report, by Kate Bronfenbrenner, School of Industrial and Labor Relations, Cornell University, June 2001

- Perspectives Toward the United States in Selected Newspapers of the People’s Republic of China, by The Institute for Global Chinese Affairs, University of Maryland, May 30, 2002
Translated Materials

All but six of the papers and articles by Chinese authors listed below were screened and/or translated by a research team headed by Maochun Yu, Ph.D., U.S. Naval Academy, from open sources on the Chinese Internet; and the six papers from the Journals of the China Institute of Contemporary International Relations (CiCIR) were translated by Liu Bo, Ph.D., CiCIR.

Security Issues

- Circumstances Affecting China’s Defense Budget Increase, by Xia Jiren, PLA Institute of Military Economics, Military Economics Study, December 2000


- Dialogue Among Civilizations: Implications for International Relations, by Sheng Qurong, Former President and Research Professor, China Institute of Contemporary International Relations, Xandai Guoji Guangxi, September 2001

- Don’t Isolate Ourselves, by Sa Benwang, Chinese Institute of International Strategic Studies, The Global Times (Huanqiu Shibao), Beijing, August 1999

- Factors Shaping Sino-Japanese Relations, by Feng Zhaokui, Research Professor, Institute of Asia-Pacific Studies, Chinese Academy of Social Science, Contemporary International Relations, September 2001

- Military Preparation and Possible Models for the Defense Budget Increase, by Liu Yang, PLA Institute of Military Economics, and Wang Cong, PLA Shenyang Military Zone Joint Staff HQ, Military Economics Study (PLA), November 2001

- The Real Purpose of the American March into Central Asia, by Gao Fuqiu, Outlook (Liaowang) Magazine, May 10, 2002

- Strength Gap is the Reality, by Zhang Zhaozhong, Senior Colonel, People’s Liberation Army and Professor, Chinese National Defense University (NDU), The Global Times (Huanqiu Shibao), Beijing, July 30, 1999

- The Upgrading of U.S. Nuclear Deterrence, by Ni Lexiong, The Globe Magazine (Huanqitui), Issue 304, April 15 2002

- WTO and China’s Defense Industry (Parts III & IV), by Ye Weiping, The Chinese People’s University, Strategy and Management, Issue No. 3, 2000

- WTO Entry and Opportunities for a Second Life in China’s Military Enterprises, by Chen Donghua, Wu Jin and Feng Zuxin, The Command Institute of the Second Artillery Troops, Administrative Bureau, General Equipment Department, PLA Military Economic Studies
Economic Issues


- APEC Shanghai Leaders’ Meeting and Prospects of APEC – Notes taken from a CICIR Roundtable, Xiandai Guiji Guanxi (Contemporary International Relations), 2001


- China Faces Financial Crisis at the Turn of the Century, by He Qinglian, 21st Century, Issue No. 6, 1997

  *Translation of articles by He Qinglian appear with her permission and may not be reproduced without her express consent.*

- China’s Latent Economic Crisis and Potential Risks, by He Qinglian, Modern China Studies, No. 2, Vol. 65, 1999

  *Translation of articles by He Qinglian appear with her permission and may not be reproduced without her express consent.*

- The Core Problem of Financial Reforms in China, by He Qinglian, Excerpted from We are Still Watching the Stars Above, 2001

  *Translation of articles by He Qinglian appear with her permission and may not be reproduced without her express consent.*

- Government Control of Market Access in China, by Zhou Qiren, Professor, Center for the Study of the Chinese Economy, Beijing University, China Austrian Review, August 2001

- The Historical Orientation of China’s Reforms, by He Qinglian, Modern China Studies, No. 1, Vol. 64, 1999

  *Translation of articles by He Qinglian appear with her permission and may not be reproduced without her express consent.*

- How Attractive is China’s Market? by Qiu Feng, China Austrian Review, September 1999


- Rural Economy at a Dead End: A Dialogue on Rural China, Peasants and Agriculture, by He Qinglian, Visiting Scholar, University of Chicago, and Cheng Xiaonong, Editor-in-Chief, Contemporary China Studies

  *Translation of articles by He Qinglian appear with her permission and may not be reproduced without her express consent.*

- What are the Benefits of China’s Entry into WTO? by He Qinglian, Excerpted from We Are Still Watching the Stars Above

  *Translation of articles by He Qinglian appear with her permission and may not be reproduced without her express consent.*
PRC Views of the U.S.

- Constantly Yielding to American Demands is No Solution, by Wang Jisi, Director, Institute of American Studies, Chinese Academy of Social Sciences, The Global Times (Huanqiu Shibao), Beijing, September 3, 1999

- Multi-polarity Does Not Equal an Anti-U.S. Position, Wang Yizhou; Research Fellow, Institute of World Economy and Politics, Chinese Academy of Social Sciences, The Global Times (Huanqiu Shibao) Beijing, Summer 1999

- Security Dilemma, Balance of Power Vs. U.S. Policy Towards China in the Post-Cold War Era, by Xin Benjian, Faculty, Luoyang PLA Foreign Language College, China Institute of Contemporary International Relations (Xiandai Guoji Guanxi), September 2001

- “September 11 Event” vs. Sino-U.S. Relations, by Yuan Peng, Associate Research Professor and Deputy Director, Division for North and Latin American Studies, China Institute of Contemporary International Relations (Xiandai Guoji Guanxi), November 2001

- Sino-American Relations: Climbing High to See Afar, by Su Ge, Deputy General Director and Professor, China Institute of International Studies, Ministry of Foreign Affairs, China Institute of Contemporary International Relations (Xiandai Guoji Guanxi), September 2001

Domestic Governance

- A Centrally Planned Economy Will Inevitably Create Inequality, by Qiu Feng, July 1999

- A Different Type of Social Power: Underground Criminal Organizations, by He Qinglian (Translation of articles by He Qinglian appear with her permission and may not be reproduced without her express consent)

- Is it Right to Pirate Software, by Wang Xiaodong, Editor, Strategy and Management, China and the World (Zhongguo Yu Shijie), November 1999

- Privatization is the Right Way to Proceed and Parliamentary Democracy Conforms with the Times, by Cao Siyuan, June 2000

- Turning Everyone Into a Censor: The Chinese Communist Party's All-Directional Control Over The Media, by Wu Xuecan (former editor at the People's Daily Overseas Edition)
Selected Briefings, Papers and Reports

- The Anaconda in the Chandelier: Censorship in China Today, by Perry Link, Princeton University

- Chinese Economy Briefing, by Thomas Rawski, Ph.D., University of Pittsburgh, February 2002

- The Early Infrastructure of U.S. Relations with the PRC during the Carter Administration, Congressional Research Service Report, by Kerry Dumbaugh, April 2002

- U.S.-China Science and Technology Cooperation Report, by U.S. Department of State, May 2002
  - Transmittal Letter from Chairman C. Richard D'Amato and Vice Chairman Michael A. Ledeen to Senator Robert C. Byrd, June 17, 2002
COMMUNICATIONS WITH CONGRESS
March 15, 2002

Honorable Paul S. Sarbanes
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Room 534 Dirksen Building
Washington, DC 20510

Honorable Phil Gramm
Ranking Member
Committee on Banking, Housing and
Urban Affairs
United States Senate
Room 534 Dirksen Building
Washington, DC 20510

Dear Chairman Sarbanes and Ranking Member Gramm:

Congress created the bipartisan, twelve-member United States-China Security Review Commission ("the Commission") in October 2000 for the purpose of monitoring, investigating and reporting on the national security implications of the bilateral trade and economic relationship between the U.S. and the People's Republic of China. The Commission is charged with delivering its first report to the Congress in June 2002, along with its recommendations for legislative or executive action. We have also been asked to alert Congress to any concerns or recommendations we may develop in advance of submitting our report, where appropriate.

Over the past ten months, the Commission has dedicated considerable attention to the extent to which Chinese companies are raising funds in U.S. capital markets and the relationship of this to U.S. national security interests. As part of this review, we have examined the presence of Chinese companies in U.S. markets that are doing business in terrorist-sponsoring or other U.S.-sanctioned countries. While the results of our full investigation will be presented in our first report to the Congress in June, we have thus far agreed, with Commissioner Reinsch dissenting, to one item for legislative action that we would like to recommend to you.

Specifically, the Commission recommends the legislative codification of disclosure guidelines announced by then-Acting SEC Chairman Laura Unger in correspondence to Representative Frank Wolf on May 8, 2001. That correspondence, a copy of which is attached, stated "[t]he fact that a foreign company is doing material business with a country, government, or entity on OFAC's [the Treasury Department's Office of Foreign Assets Control] sanctions list is, in the SEC's staff's view, substantially likely to be significant to a reasonable investor's decision about whether to invest in that company." As a result, the letter continued, the SEC "will seek information from registrants about material business in, or with, countries, governments, or entities with which U.S.

Appendix V – Communications With Congress
companies would be prohibited from doing business under economic sanctions administered by OFAC," and make this information available to the investing public.

Despite this guidance, it is unclear to what extent it reflects current SEC policy. During SEC Chairman Harvey Pitt's confirmation hearing, he expressed some hesitation about this interpretation of materiality. Legislative enactment of the disclosure guidelines set forth in Acting Chairman Unger's letter would codify that interpretation and ensure that this policy is enforced by the SEC.

It is the view of this Commission that a foreign registrant's material business operations in terrorist-sponsoring and other U.S.-sanctioned states could constitute a U.S. security concern and would constitute a material risk that should be disclosed to U.S. and other investors. Some mutual funds and other investors may also wish to be informed of any business activities by foreign registrants in U.S.-sanctioned countries so they can decide whether or not to invest. It is useful to point out that, with some exceptions, U.S. companies are prohibited from doing business in countries under sanctions regimes administered by OFAC.

In the wake of September 11 and the sudden Enron collapse, there is a growing recognition of the need for strengthened disclosure, transparency and accountability in the conduct of the markets. We hope you will consider this important new dimension of material risk to U.S. investors and take action to address this issue through codification of the Unger letter's disclosure guidelines.

We greatly appreciate your consideration of this recommendation. The Commission plans to continue its examination of this important issue and will forward to the Committee any other appropriate ideas we may develop for legislative action in this area.

The Commission very much welcomes your thoughts on this and related issues as we move forward.

Sincerely,

Patrick A. Mulloy
Acting Chairman

Attachment

cc: The Honorable Tom Daschle
    The Honorable Trent Lott
    The Honorable Dennis Hastert
    The Honorable Richard Gephardt
    The Honorable Michael Oxley
    The Honorable John La Falce
The Honorable Frank P. Wolf
U.S. House of Representatives
241 Cannon Building
Washington, D.C. 20515-4610

Dear Congressman Wolf:

This letter responds to our meeting and your letter of April 2, 2001, regarding PetroChina Company, Ltd., Talisman Energy, Inc., and proposed disclosure requirements for foreign firms that seek access to the U.S. markets. I have asked David Martin, Director of the Commission’s Division of Corporation Finance, to review your recommendations for additional disclosure for foreign companies. His memorandum is enclosed.

I would like to take this opportunity to brief you on some of the efforts the Commission staff has undertaken regarding Sudan following our meeting and your letter of April 2, as well as several initiatives we intend to pursue in the near future:

Actions To Date

☐ We met and have had ongoing communications with Roger Robinson of the William J. Casey Institute of the Center for Security Policy. Mr. Robinson provided us with additional information about the recommendations in your letter and offered some useful suggestions for interagency cooperation on issues involving Sudan and, more generally, on issues involving national security, human rights and religious freedom. His ideas have proven useful in our outreach to other government agencies, as discussed further below.

☐ We had a meeting with the staff of the U.S. Commission on International Religious Freedom (“CIRF”). In response to their inquiries we have assisted them in understanding both the fundamentals of the SEC’s disclosure-based system and specific disclosure rules and practices in which CIRF has an interest. We are reviewing carefully CIRF’s reports of March and May 2001.

☐ We received a State Department briefing on both the history of the war in Sudan and current conditions there. It was a comprehensive briefing by representatives of the Bureau of Democracy, Human Rights and Labor; the Bureau of African Affairs; and the Office of International Religious Freedom. Over 20 members of...
the SEC staff attended the briefing, including members of the Division of Corporation Finance staff who are responsible for reviewing filings.

- Last week, we met with the Director and staff of the State Department’s Office of International Religious Freedom. Representatives from other State Department offices attended as well. We discussed some of our efforts to improve disclosure regarding the activities of foreign companies in Sudan, and we raised the possibility of interagency cooperation on Sudan. The Office of International Religious Freedom expressed support for an interagency working group.

- We spoke with officials in the U.S. Treasury Department’s Office of Foreign Assets Control (“OFAC”) to learn more about the existing sanctions regime and its application to transactions with Sudan. We have also begun discussions with OFAC about a possible interagency working group.

- I have met with the Directors of each of the SEC’s divisions to discuss your concerns regarding the situation in Sudan. They are sensitized to this issue and will be looking for creative ways to enhance investors’ access to material information about foreign investment in Sudan and its impact on the human rights situation there.

- Supervisors of the review staff in the Division of Corporation Finance have been made aware of issues concerning Sudan. They are, in turn, working with their staff to be attentive to disclosure in registered offering documents and periodic reports regarding material business or use of proceeds in Sudan and other countries subject to U.S. economic sanctions.

Initiatives to be Undertaken

1. Rulemaking to Require Electronic Filing by Foreign Companies

As you know, foreign companies that seek to register with the SEC may elect to make their filings on paper, rather than electronically through the SEC’s EDGAR system. Paper filings are available to the public through our reference facilities, but they are not available through our website and cannot be searched electronically. To facilitate investor access to filings by foreign companies, as well as the staff’s efficiency in reviewing those filings, I have asked the staff to prepare for the Commission promptly a proposed rulemaking to require foreign companies to file electronically on our EDGAR system.

2. Review of Registration Statements Filed by Companies Doing Business in Countries Subject to U.S. Economic Sanctions

All registration statements relating to public offerings of securities are legally subject to review by the staff of the Commission’s Division of Corporation Finance. The
staff has, however, exercised its discretion to perform only a selective review of such filings, due to limited Commission resources. Because of the complex issues involving national security, human rights and religious freedom that have been raised in connection with countries subject to U.S. economic sanctions, our staff has decided that it will attempt to review all registration statements filed by foreign companies which reflect material business dealings with governments of countries subject to U.S. economic sanctions administered by OFAC, or with persons or entities in those countries.


U.S. sanctions administered by OFAC prohibit American companies from investing or doing business in Sudan. Those sanctions do not, however, prohibit foreign companies from doing so. Foreign companies that do business in Sudan, or any other country subject to OFAC sanctions, may list on U.S. securities exchanges and offer their stock to investors in U.S. markets. The SEC does not have statutory authority to deny access to the U.S. markets to any foreign company on the basis of its involvement with a particular foreign country or government, including Sudan.

The SEC does, however, have statutory authority to require that U.S. investors receive adequate disclosure about where the proceeds of their securities investments are going and how they are being used. The federal securities laws are founded on the principle that the best way to protect investors is to ensure that they have access to material information about the companies and securities in which they are considering investing. While there is no “bright line” test for materiality, the Supreme Court has held that information is material if a reasonable investor would be substantially likely to consider that information significant in making an investment decision.

The fact that a foreign company is doing material business with a country, government, or entity on OFAC’s sanctions list is, in the SEC staff’s view, substantially likely to be significant to a reasonable investor’s decision about whether to invest in that company. Therefore, in accordance with existing disclosure rules and the SEC’s investor protection mandate, the staff of the Division of Corporation Finance will seek information from registrants about material business in, or with, countries, governments, or entities with which U.S. companies would be prohibited from doing business under economic sanctions administered by OFAC. Our aim is to make available to investors additional information about situations in which the material proceeds of an offering could – however indirectly – benefit countries, governments, or entities that, as a matter of U.S. foreign policy, are off-limits to U.S. companies.

4. Communication With OFAC

As a U.S. government agency, the SEC fully supports duly imposed economic sanctions and will cooperate with appropriate U.S. governmental agencies to help ensure that those sanctions are enforced. Accordingly, we will bring to the attention of the
The Honorable Frank P. Wolf  
May 8, 2001  
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OFAC staff any disclosure in registration statements filed by foreign companies which reflect material business dealings with countries subject to OFAC-administered sanctions.

5. Interagency Working Group

We would support formation of an interagency working group on Sudan.

Requests for SEC Action

We appreciate your sharing with us your concerns that PetroChina and Talisman may have failed to make adequate disclosure in connection with their public offerings concerning use of proceeds and risk. As we have discussed in previous correspondence with you, when PetroChina sought to offer its securities for sale, the Commission's staff reviewed the company's registration statement thoroughly and considered all of the disclosure it contained. The staff was, at that time, aware of your concerns about the offering and paid particular attention to the disclosure regarding risks and use of proceeds. We take very seriously the charge in your most recent correspondence that PetroChina and Talisman may have failed to disclose material information in registration statements and other reports filed with the Commission. We have referred your letter to the Commission's Division of Enforcement.

We recognize and appreciate your concern in this matter, and I assure you that the staff will consider carefully the information you supplied in accordance with the Commission's responsibilities under the federal securities laws. As you know, however, SEC investigations are non-public. As a matter of policy, therefore, the agency does not confirm or deny the existence of a pending inquiry. This policy protects the integrity of the investigative process, in both fact and appearance. See generally SEC v. Wheeling Pittsburgh Steel Corp., 482 F. Supp. 555 (W.D. Pa. 1979), vacated and remanded, 648 F.2d 118 (3d Cir. 1981).

With respect to your request that the Commission suspend trading in PetroChina and Talisman, some general background might be helpful. When Congress enacted the federal securities laws, it gave the SEC limited authority to suspend temporarily trading in an individual security. Securities Exchange Act of 1934 § 12(k)(1)(A), 15 U.S.C. § 78l(k)(1)(A). The Supreme Court has warned that "the power to summarily suspend trading in a security even for 10 days, without any notice, opportunity to be heard, or findings based upon a record, is an awesome power with a potentially devastating impact on the issuer, its shareholders, and other investors." SEC v. Sloan, 436 U.S. 103, 112 (1978). The Court viewed a trading suspension as a "somewhat drastic" measure, to be exercised very cautiously. Id. The Commission's approach to the exercise of its trading suspension authority is consistent with the Court's view.

We note, too, that the sudden loss of liquidity resulting from a trading suspension may impose more significant economic hardship on shareholders than on the listed company itself. A trading suspension only halts secondary market trading. That is, the
The Honorable Frank P. Wolf  
May 8, 2001  
Page 5

trading suspension has no effect on the issuers’ use of proceeds from prior offerings. Meanwhile, investors wanting to sell their securities -- for reasons ranging from liquidity needs to disapproval of the company’s use of proceeds -- cannot do so.

Moreover, for a company with dual listings (one in the U.S. and one offshore), an SEC trading suspension has no effect on a home country market. In such situations, U.S. holders of the securities in which trading has been suspended would likely suffer more serious consequences from a trading suspension. Therefore, the Commission rarely exercises its authority to suspend trading in a security absent evidence of fraud.

We appreciate your dedication to working toward a solution to the crisis in Sudan. I will schedule a meeting with you at your convenience to discuss this issue in further detail. Should you have questions in the meantime, please do not hesitate to contact me at 202-942-0100 or David Martin, Director of our Division of Corporation Finance, at 202-942-2929.

Sincerely,

Laura S. Unger  
Acting Chairman

Enclosure
MEMORANDUM

May 8, 2001

TO: Acting Chairman Laura Unger

FROM: David B.H. Martin
  Director, Division of Corporation Finance

SUBJECT: Response to letter dated April 2, 2001 from Congressman Wolf

You have asked for the views of the Division of Corporation Finance on the ten recommendations outlined by Congressman Frank Wolf in his letter to you dated April 2, 2001. We address each of these recommendations below.

1. Global Operations: Foreign companies should disclose their operations – as well as those of their parent companies, subsidiaries and affiliates – in countries which are listed on the following U.S. government lists:

   a) CIA List of Acquiring and Supplying Nations as cited in its annual report to Congress on the Acquisition of Technology Relating to Weapons of Mass Destruction and Advanced Conventional Munitions

   b) U.S. State Department List of Sponsors of Terrorism

   c) U.S. State Department-Designated Countries of Particular Concern for Violations of Religious Freedom

   Companies should also disclose their business relationships – as well as those of their parent companies, subsidiaries and affiliates – with companies from countries which appear on these lists.

SEC rules do not require disclosure about business operations in specific countries. Companies filing registered offering documents under the Securities Act of 1933 (Securities Act) or filing periodic reports under the Securities Exchange Act of 1934 (Exchange Act), however, are subject to certain mandated disclosure requirements about their business, which may include disclosure of their operations in specific countries. The following are examples of specific SEC requirements which could result in such disclosure:

☐ A company must make certain disclosures relating to the various countries in which it conducts business. Most U.S. companies are required to provide a breakdown of revenues and long-lived assets by: domicile country, all foreign countries, and any individual foreign country in which revenues and assets are material. A foreign company must provide a description of the principal markets in which it competes, including a breakdown of total revenues by geographic market.
A company must also make certain disclosures about its recent past and immediate foreseeable future, including any known trends, events or uncertainties -- favorable or unfavorable -- that have had or are reasonably expected to have a material impact on results of the company's operations or to cause a material increase or decrease in the company's liquidity or capital resources. For example, if investors ceased purchasing, or divested themselves of, the securities of a company because of its actions in a particular country, these actions could have a foreseeable material impact on the company's ability to raise cash through the sale of its securities. In this case, a company would be required to disclose these material effects. A consumer boycott of a company might, likewise, have to be disclosed, if it were viewed as having a potentially material impact on the company's revenues.

A company that wishes to sell its securities publicly in the United States must disclose factors that make an offering risky or speculative, which may include risk factors relating to operations in particular countries. Business risks imposed by political instability or the imposition of economic sanctions could be sufficiently probable and have a sufficiently significant magnitude to require disclosure.

A U.S. company must disclose information about material pending litigation which is not routine or incidental to the company's business. For example, a lawsuit claiming environmental, personal, or other damage caused by the way a company performed its operations in a particular country might not be viewed as routine or incidental and might have to be disclosed, depending on its effect on the company's financial position or profitability. A foreign company must disclose litigation that may have, or has had in the recent past, a significant effect on the company's financial position or profitability.

Accordingly, existing SEC disclosure requirements might very well warrant disclosure of a foreign company's operations in, or business relationships with companies from, countries on the CIA's list of acquiring and supplying nations, the U.S. State Department's lists of sponsors of terrorism, and countries of particular concern.

Absent specific disclosure requirements relating to a company's operations in, or business relationships with companies from, countries on those lists, the question of whether disclosure is required will depend on the materiality of the financial impact of those operations and business relationships on the company's conduct of its business. SEC disclosure rules and policies turn on the concept of materiality. The Supreme Court has held that information is material if "there is substantial likelihood that a reasonable shareholder would consider it important in making an investment decision." TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976).

In assessing materiality, the SEC staff takes the view that the reasonable investor generally focuses on matters that have affected, or will affect, a company's profitability and financial outlook. Because securities are financial investment vehicles, the materiality of a foreign company's operations in a particular country and its business...
relationships with companies from that country will generally depend on whether these operations or relationships have had, or are likely to have, a financial impact on the company.

We agree that a reasonable investor would likely consider it significant that a foreign company raising capital in the U.S. markets has business relationships with countries, governments or entities with which any U.S. company would be prohibited from dealing because of U.S. economic sanctions. The staff will, therefore, seek information from foreign registrants about their material business in countries on OFAC’s sanctions list and their business relationships with countries, governments, or entities on those lists. This type of disclosure would make available to investors additional information about situations in which the proceeds of an offering could—however indirectly—benefit countries, governments, or entities that, as a matter of U.S. foreign policy, are off-limits to U.S. companies.

Whether a reasonable investor, as a general matter, would view as material a foreign registrant’s operations in or business dealings with other countries is less apparent. Although generally a company will disclose all countries in which it does business, information with respect to operations in these countries, particularly if immaterial, may be less relevant to investors. If, however, a foreign company’s operations in a particular country and its business relationships with companies from that country have had, or are likely to have, a financial impact on the company, the staff will seek information from the registrant to address any deficiencies in the disclosure. As always, the staff will look to the SEC rule that requires a company to disclose any information if its absence would make the rest of its disclosure misleading. We will, in addition, continue to monitor investor interest in this area and adjust our disclosure practices if it appears warranted.

As a general matter, our disclosure requirements focus on the consolidated operations of the company that is registering securities and the subsidiaries and affiliated companies that it controls. Required disclosures identify parent companies and other major shareholders and explain their control relationship with the registrant. This kind of limited disclosure is material to an investor because the economic return on the investor’s securities will be derived from the operations of the registrant. The economic return will not, however, be derived from operations of the registrant’s parent company or those companies under common control. Thus, extensive information about parent companies and companies under common control with the registrant might be misleading to investors who are not purchasing securities in those companies.

2. **Internal Corporate Risk Analysis:** Foreign companies should disclose steps taken to identify and assess risks associated with doing business with countries and companies referenced above. This should include particular economic risks associated with these countries and companies as well as **U.S. domestic political risks**, including prospective U.S. governmental and non-governmental opposition to these activities (e.g., precedents). The foreign firm should outline what specific steps have been taken to ensure that the company, and its shareholders, are protected from these risks.
When a foreign company initially registers its securities with the SEC, and thereafter in its annual report on Form 20-F, a foreign company is required to prominently disclose risk factors that make an investment in the company speculative or one of high risk. This requirement can be found under “Item 3.D – Key Information; Risk Factors” of Form 20-F, which sets out the disclosure requirements applicable to foreign companies registering securities and filing annual reports with the SEC. These risk factors may include factors relating to the countries in which the foreign company operates. When a company has material operations in countries with developing political and economic systems, there is typically disclosure about the various risks associated with these systems. These risks often include risks relating to exchange rate, undeveloped legal systems, economic uncertainty, high rates of inflation and government intervention in the economy.

As noted above, we will review filings to determine whether foreign companies have material operations in countries that are subject to OFAC sanctions. If it is reasonably likely that U.S. governmental sanctions will be imposed on the company as a result of its operations in a particular country, this risk would need to be disclosed if the sanctions were likely to have a material impact on the company. Likewise, if it is reasonably likely that public opposition to the company would have a materially adverse effect on the operations of the company, this risk would also need to be disclosed.

We note that considerations of materiality include considerations of probability and magnitude. It is often very difficult for a company to assess whether one aspect of its worldwide operations will give rise to the type of impact that would need to be disclosed under the federal securities laws, especially when there are considerations relating to public reaction and governmental responses. We do not believe that a requirement to discuss protective measures would elicit meaningful information for investors because we would expect that all companies would disclose that they take steps to avoid governmental sanctions and adverse public reaction to their operations.

3. Accounting Procedures: While it is understood, and disclosed, that accounting procedures vary from region to region, firms should disclose what steps have been taken to ensure that operations outside their home market are subject to accounting standards that American investors can rely on.

Foreign companies that register securities with the SEC are generally required to adopt U.S. standards on a worldwide basis in connection with the preparation of their audited financial statements. Outlined in the following paragraphs are our requirements with respect to U.S. generally accepted accounting principles (GAAP), U.S. generally accepted auditing standards (GAAS), and auditor independence.

Accounting Principles. The financial statements of a company that registers securities with the SEC must include an audited balance sheet covering the last two fiscal years and audited income statements, cash flow statements and statement of changes in stockholders’ equity covering the last three fiscal years.
A U.S. company is required to prepare these financial statements using U.S. GAAP, which are established by the Financial Accounting Standards Board. Foreign companies that register securities with the SEC may prepare their financial statements using either U.S. GAAP or another GAAP if they include a textual and numerical reconciliation of their foreign GAAP financial statements to U.S. GAAP. In an initial registration statement, a foreign company must provide financial information that is reconciled to U.S. GAAP for at least the two most recent years. In subsequent years, a foreign company must provide U.S. GAAP financial information for up to the past five fiscal years. When a foreign company uses accounting principles other than U.S. GAAP, those accounting principles must constitute a comprehensive basis of accounting.

Audit Requirements. The audit of financial statements included in registration statements and annual reports filed with the SEC must be conducted in accordance with U.S. generally accepted auditing standards. These standards have been developed by the American Institute of Certified Public Accountants and are required to be applied on a worldwide basis to the company that is being audited. As a result, if a publicly traded U.S. corporation has foreign operations, those foreign operations would be subject to the same audit procedures as the company's U.S. operations. Likewise, a foreign company whose securities are registered with the SEC must apply U.S. GAAS to all of its operations.

Until September 2000, the SEC staff had a practice of accepting audit reports for foreign companies that stated the audit was conducted in accordance with foreign auditing standards that were "substantially similar in all material respects" to U.S. GAAS. We have changed our practice and no longer permit this type of report. An auditor's report must state unambiguously that the audit was performed in accordance with U.S. GAAS.

Independence Requirements. A company's auditors must comply with the SEC's independence standards. Over the past year, the SEC has made significant revisions to our independence standards for auditors. The substantive requirements of these new standards is beyond the scope of this memorandum, although we would be pleased to elaborate on these standards if you so request. For purposes of this recommendation, we note that these new standards apply to auditors on a worldwide basis and apply equally to U.S. companies and foreign companies that are registered with the SEC.

4. "Disclosure Goals": While the U.S. should avoid any undue influence on foreign market exchanges, foreign companies should disclose what steps have been taken by their country and home markets to ensure transparency, independent oversight and accountability.

Although our rules do not specifically require a foreign company to disclose factual information relating to its country of incorporation or the country in which it principally operates, many foreign companies do provide this type of information in their disclosure documents filed with the SEC. To the extent a company includes information of this type in a prospectus filed with us, this information generally consists of basic economic
information relating to the relevant country. Often, a company will also include a description of its home country financial market and stock exchange or other trading market.

General information about governmental or private initiatives to improve transparency, oversight and accountability would not appear relevant to an investor except to the extent that these types of initiatives may have an effect on the company. To the extent a company is reasonably likely to be materially affected by these types of initiatives, they would be required to be disclosed. Companies may be liable for misstatements and omissions of material information in their documents filed with the SEC and therefore companies generally are reluctant to include in their SEC registration documents information over which the company has no or little control or means to verify. In addition, we would discourage the inclusion of information that is not directly relevant to a company that is registering securities because investors could be misled with respect to extraneous information.

5. **Board of Directors.** Much like requirements for U.S. companies, the SEC should require full disclosure with respect to the firm’s Board of Directors including: name, age, organizational affiliations, prospective conflicts of interest, whether they own stock in the company and whether they attend Board meetings.

When a foreign company initially registers its securities with the SEC, and annually thereafter for so long as the company continues to be registered, a foreign company is required to disclose information about its directors, officers and significant employees. These requirements are set out in “Item 6 — Directors, Senior Management and Employees” of Form 20-F. These requirements include name, age, areas of experience in the company, principal business activities performed outside the company, and share ownership in the company (unless the share ownership is less than 1%).

Foreign companies are also required to disclose transactions or loans for the last three fiscal years between the company and various related individuals and entities. These include officers, directors, other key management personnel, and major shareholders. This disclosure requirement would apply to transactions with a company that is directly or indirectly under common control with the registered foreign company. This disclosure requirement also applies to close members of the families of officers, directors, key management personnel and major shareholders, and entities in which these individuals have a substantial voting interest. These requirements are set out in “Item 7 — Major Shareholders and Related Party Transactions” of Form 20-F.

U.S. companies are required to disclose in their proxy statements relating to shareholders’ meetings involving the election of directors information relating to whether an incumbent director has attended fewer than 75% of the aggregate of the total number of board of directors and committee meetings in the prior fiscal year. This requirement is contained in “Item 7 — Directors and Executive Officers” of Schedule 14A under the Exchange Act, which governs the form and content of proxy statements used to solicit proxies from shareholders.
Because of differences in corporate law, there are fundamental differences between U.S. companies and foreign companies with respect to shareholders' meetings. For example, the corporation law in most states of the United States permits an extended period of time between setting a record date before a shareholders' meeting to determine holders eligible to vote at the meeting and the date of the meeting. This extended period provides an opportunity for proxies and proxy statements to be distributed to shareholders. The corporation laws of many foreign countries do not permit such an extended period, making the solicitation of proxies impracticable. Some foreign corporation laws do not permit the setting of record dates at all. In addition, some foreign corporation laws mandate that notice of a shareholders' meeting be made by publication in a newspaper or official publication rather than a notice sent to holders.

Because of these substantial differences, the SEC has not regulated the form and content of proxy statements or other shareholder materials used by registered foreign companies in connection with shareholders' meetings. Matters relating to shareholders' meetings generally involve the internal corporate governance of a corporation. It would be impracticable to design proxy regulations that address all of the different foreign corporation laws of the foreign companies that are registered with the SEC.

6. Minority Shareholder Rights: The firm should provide a detailed accounting of its protection of shareholder rights and the process by which grievances and resolutions are presented and considered.

A foreign company that is registering equity securities with the SEC is required to disclose information that describes the rights and restrictions relating to the securities. Matters that are specifically required to be addressed include any limitations on the right to own securities or to hold or exercise voting rights. In addition, to the extent shareholder rights are significantly different in the foreign country from those in the United States, the foreign company must explain the effect of these differences. These requirements can be found under "Item 10.B - Additional Information, Memorandum and Articles of Association" of Form 20-F.

A foreign company is also required to disclose whether investors may bring actions under the civil liability provisions of the U.S. federal securities laws against the company, its officers and directors, and its underwriters and experts that are residents of a foreign country. This disclosure must address enforceability of judgments, service of process, and other matters. These requirements can be found under "Item 101(g) - Enforceability of Civil Liabilities Against Foreign Persons" under Regulation S-K.

7. Governmental Official Ownership. The firm should disclose what government officials, if any, have direct — or indirect — ownership in the company.

A foreign company that is registering securities with the SEC is required to disclose the identities of any person or entities that beneficially own 5% or more of each class of the company's voting securities, unless the company is required to disclose a lesser
percentage in its home jurisdiction, in which case the lesser percentage applies. This requirement extends to foreign governmental entities and officials. We believe that to the extent a company is aware of a material conflict or similarity of interest with a regulatory agency or governmental body that may have an impact on the financial prospects of the company, then the company would be required to disclose this conflict or interest.

8. **Electronic Filing:** Former SEC Chairman Levitt agreed to make foreign filings available electronically on the “EDGAR” website. At this time, this step has not been implemented. Foreign filings should be made available immediately to U.S. investors electronically.

When the Commission first adopted rules in 1993 to phase in electronic filing for U.S. companies, we excluded foreign issuers from the mandatory electronic filing requirement, although we allowed them to file electronically on a voluntary basis (and over 200 foreign companies currently do). We excluded foreign companies from the mandate for a number of reasons, one of which was our belief that foreign issuers might face higher transaction costs from the implementation of electronic filing than would be borne by U.S. companies. Also at the time, there was limited public availability of the Internet and the World Wide Web, and we did not foresee that documents that were filed with us electronically could be made available for free to the public at large.

We agree that the time has come to require foreign issuers to file their registration statements, annual reports and other documents with us electronically so that these documents will be available through our website and through commercial vendors. The technological and costs arguments against mandated electronic filing have been reduced, and investor demand for this information continues to increase.

Under the Administrative Procedure Act, the Commission must first publish proposals in this area for public comment. We expect that the Division of Corporation Finance will be able to prepare a draft release proposing to mandate electronic filing for foreign companies, and recommend that the Commission publish this release, in the early summer 2001.

9. **Annual Risk Disclosure:** Exemption 12g3-2(b) which exempts foreign firms from annual filings (and, instead, allows the company to file those documents required by their home exchange) should be eliminated. The SEC has recently begun to require domestic firms to disclose “Risk Factors” in their annual 10-K filings. The same standard should be applied to foreign firms with respect to their annual 20-F or 40-F filings.

This recommendation requires that we separately discuss Exchange Act Rule 12g3-2, Form 20-F disclosure requirements, and Form 40-F under the multijurisdictional disclosure system for Canadian companies.

a. **Exchange Act Rule 12g3-2.** Companies with total assets of $10 million or more and a class of equity securities held of record by 500 or more persons (wherever
they reside) are required to register that class of securities pursuant to Section 12(g) of the Exchange Act. Registration under Section 12(g) subjects the company to the periodic reporting requirements of the Exchange Act.

Rule 12g3-2 under the Exchange Act contains two exemptions from the Section 12(g) registration requirements. The exemptions are available only to foreign companies.

The first exemption is found under Rule 12g3-2(a). Under this rule, a class of equity securities of a foreign company is exempt from registration under Section 12(g) if there are fewer than 300 holders of the class resident in the United States. This exemption is self-executing and requires no action by the issuer or SEC staff.

The second exemption is found under Rule 12g3-2(b), which is known informally as the "information supplying exemption." This exemption is conditioned on the foreign company furnishing to the public through the SEC’s public reference facilities certain information. This information includes such items as the annual report to shareholders, press releases, statutory filings and other documents that would be material to an investment decision that the company makes public voluntarily or pursuant to home country or stock exchange rules. Foreign companies establish this exemption by sending materials to the SEC, which the SEC staff then makes public through our public reference facilities. SEC staff does not undertake any type of substantive disclosure or accounting review of materials furnished pursuant to Rule 12g3-2(b).

Rule 12g3-2(b) was adopted by the SEC in 1968 in order to provide an exemption from Section 12(g) registration for foreign companies that have not by their own volition accessed the U.S. public capital markets. As a result, the Rule 12g3-2(b) exemption is not available to foreign companies if their securities are traded on the New York or American Stock Exchanges or any other national securities exchange, on the Nasdaq Stock Market, or on the Over-the-Counter Bulletin Board market that is operated by Nasdaq. (There are a small number of foreign companies whose securities are "grandfathered" on those markets because they have been continuously traded on those markets prior to the effective date of various regulations.) The Rule 12g3-2(b) exemption is also not available if the company has previously registered any offering of securities under the Securities Act.

We do not believe that elimination of this exemption is appropriate. We believe there could be jurisdictional and enforcement questions if our rules required a foreign company to register with us even though that company had undertaken no activities in order to access the U.S. public capital markets, particularly since there is no prohibition on U.S. investors purchasing the securities of foreign companies in markets outside the United States. The elimination of Rule 12g3-2(b) could result in many foreign companies restricting
the ability of U.S. investors to purchase their shares, thereby limiting the investment opportunities available to U.S. investors.

We believe that Rule 12g3-2(b) strikes an appropriate balance in this area because foreign companies that rely on this exemption do not have full access to the U.S. public capital markets. These companies:

- May not have their securities traded on a national securities exchange, on the Nasdaq Stock Market or on the Over-the-Counter Bulletin Board;
- May not raise capital through a registered public offering in the United States; and
- May not have acquired in a share exchange transaction another company that is registered with the SEC.

b. **Risk Factor Disclosure in Form 20-F.** A foreign company is required to disclose “Risk Factors” in its prospectus relating to its initial public offering and then at least once a year thereafter in its annual report that is filed with the SEC. This requirement can be found under “Item 3.D – Key Information; Risk Factors” of Form 20-F. This risk factor information is required to be disclosed prominently. This type of disclosure has been required for many years. See Securities Act Release No. 6437 (November 19, 1982).

c. **Form 40-F.** Form 40-F is part of a mutual recognition system that the SEC has in place for Canadian companies. This system, known as the MJDS (or multijurisdictional disclosure system), permits eligible Canadian companies to register and report with the SEC using documents prepared in accordance with Canadian disclosure requirements. Canadian securities regulators have in place a counterpart to the MJDS for U.S. companies.

The MJDS was one of the SEC’s early efforts to address the challenges of the increasing integration and internationalization of the world’s securities markets. The MJDS grew out of a concept release published in 1985 on facilitation of multinational securities offerings. The MJDS was initially proposed in 1989 and, after a repropose in 1990, was adopted in 1991.

The MJDS permits larger Canadian companies to file registration statements and annual reports with the SEC using the disclosure documents they file in Canada. As a result, the contents of documents filed under the MJDS are mandated by the disclosure requirements of the Canadian securities regulators, rather than the SEC’s.

For a variety of reasons, SEC staff has been considering whether to revise the MJDS and has been in discussions with staff at the Canadian securities regulators with a view to narrowing its scope. Any changes to the MJDS would
be subject to notice and comment under the Administrative Procedure Act and Commission approval.

10. **Universal Listing Standards:** The SEC should report what steps it will take to help create universal listing standards for global exchanges.

For over ten years, we have worked with securities regulators in other countries, both directly and through our membership in the International Organization of Securities Commissions (IOSCO), to facilitate the cross-border flow of securities and capital. One of the most important steps taken in this direction occurred in 1998, when IOSCO endorsed a core set of disclosure standards for the non-financial statement portions of a disclosure document relating to equity securities. This core set of standards is referred to as the International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers (IDSs).

The IDSs are intended to be incorporated by IOSCO member countries as part of their disclosure requirements for prospectuses, offering and initial listing documents and registration statements for foreign companies. They represent a strong international consensus on fundamental disclosure topics, and can be used to produce offering and listing documents that contain the same high level of information that the SEC has traditionally required. At the time that it endorsed the IDSs, IOSCO encouraged its members to take whatever steps would be necessary in their own jurisdictions to accept disclosure documents prepared according to those standards. Acceptance by each IOSCO member country of the IDSs enables a foreign issuer to use a single disclosure document in cross-border offerings and listings, subject to the approval or review of the country in which the offering or listing is made. The SEC staff played an instrumental role in drafting the IDSs.

In September 1999, the SEC adopted revisions to its disclosure requirements for foreign private issuers in order to fully incorporate the IDSs. The revisions were made to Form 20-F and took effect on September 30, 2000. Form 20-F is the form used by foreign private issuers that wish to register a class of securities under the Exchange Act and to list a class of securities on a U.S. national stock exchange, and is also used for annual reports under the Exchange Act. The disclosure requirements set forth in Form 20-F also serve as the disclosure requirements in the registration statements used by foreign private issuers to make a public offering of securities registered under the Securities Act.

We believe that our adoption of the IDSs represents a key endorsement of the initiative to improve disclosure standards worldwide, and also represents an improvement in the quality of disclosure made to U.S. investors by registered foreign companies. In particular, as compared to our prior disclosure standards for foreign companies, revised Form 20-F requires improved disclosure in several areas, including with respect to transactions with management and other insiders, major shareholders, and the age of financial statements permitted in an offering document.
In addition to its work in the area of non-financial disclosure, the SEC has also actively supported efforts to develop accounting standards that could be used in cross-border offerings. SEC staff has been very active in working with the International Accounting Standards Board (IASB, formerly known as the International Accounting Standards Committee) both directly and through our participation in IOSCO.

In February 2000, the SEC published a Concept Release on International Accounting Standards which solicited comment on the elements needed to develop a high quality, global financial reporting framework for use in cross-border offerings and listings. The Commission received approximately 100 comment letters in response to this release. In addition, in May 2000, the Technical Committee of IOSCO completed a review and assessment of 30 core standards that had been promulgated by the IASB in recent years. As a result of this review, IOSCO recommended that its members allow multinational issuers to use these core standards, as supplemented by reconciliation, disclosure and interpretation, where necessary, to address substantive national issues in cross-border securities filings. Consistent with this recommendation, the SEC currently accepts international accounting standards issued by the IASB with reconciliation to U.S. GAAP for filings made by foreign companies.
June 16, 2002

The Honorable Robert C. Byrd
Chairman
Committee on Appropriations
United States Senate
S-128, The Capitol
Washington, D.C. 20510

Dear Mr. Chairman:

The bipartisan U.S.-China Security Review Commission, created by Congress in the fall of 2000, is charged with monitoring, investigating and reporting on the national security implications of our bilateral trade and economic relationship with the People’s Republic of China.

One of the issues the Commission has been asked by Congress to address is China’s compliance with the World Trade Organization (WTO) commitments, following its accession late last year. During the course of our review of U.S.-China relations, the Commission held hearings, scheduled special briefings and traveled to China and to Geneva to meet with U.S. and Chinese trade officials and with representatives of other key WTO member countries to assess China’s WTO obligations and its ability and willingness to meet them.

The Commission believes that China’s strict compliance with its WTO obligations is in the national security interest of the United States. Accordingly, we believe that additional U.S. personnel should be assigned to our diplomatic missions in China to help accomplish this goal. We recommend five new slots be allocated to the Department of State this year to assist in capacity building and other technical assistance programs that will facilitate China’s ability to meet its commitments such as legal assistance, education and training programs for Chinese nationals and the creation of an effective legal system in China.

Thank you very much for your attention. We would be pleased to discuss this recommendation at your convenience.

Sincerely,

Michael Ledeen
Vice Chairman

C. Richard D’Amato
Chairman

cc: The Honorable Ernest Hollings
The Honorable Ted Stevens
The Honorable Judd Gregg
The Honorable Frank Wolf
The Honorable Jose Serrano
The Honorable Joseph Biden
The Honorable Jesse Helms
The Honorable Henry Hyde
The Honorable Tom Lantos
March 15, 2002

Honorable Paul S. Sarbanes
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Room 534 Dirksen Building
Washington, DC 20510

Honorable Phil Gramm
Ranking Member
Committee on Banking, Housing and
Urban Affairs
United States Senate
Room 534 Dirksen Building
Washington, DC 20510

Dear Chairman Sarbanes and Ranking Member Gramm:

Congress created the bipartisan, twelve person, U.S. China Security Review Commission in October 2000 for the purpose of monitoring, investigating and reporting on the national security implications of the bilateral trade and economic relationship between the United States and the People's Republic of China. The Commission is charged to deliver its first report to the Congress in June of 2002 along with its recommendations for legislative or executive action. We have also been asked to bring items of importance, if any, to the attention of Congress before that time, if we deem it appropriate.

On January 17, 2002 the Commission held a hearing to examine the administration of our national security export controls related to China. Various officials from the present administration and other experts testified at that hearing. One of the administration witnesses, Mr. Michael J. Garcia, the Assistant Secretary of Commerce for Export Enforcement, brought to our attention a matter that may be of interest to your Committee as you work to re-authorize the Export Administration Act. (Relevant portions of his testimony are attached.) Section 1213 of that Act deals with the issue of post-shipment verifications of the export of high performance computers. That provision requires the Secretary of Commerce to conduct a post-shipment verification of each digital computer with a composite theoretical performance of more than 2,000 million theoretical operations per second (MTOFS) that is exported from the U.S. to Tier 3 countries, including China.

Mr. Garcia testified that such a blanket requirement no longer makes sense. Since its enactment, various Administrations have raised the licensing levels for computer exports. This has resulted in a legal requirement for the
Commerce Department to conduct post-shipment verifications on computers previously licensed for export to China but which are no longer controlled. In Mr. Garcia's view, that blanket requirement overburdens and consequently undermines the Commerce Department's ability to conduct post-shipment verifications of computers that are controlled. We understand that S. 149, the bill that passed the Senate, and H.R. 2581 now before the House, contain an amendment to rectify this problem by permitting more discretion to the Department in conducting post-shipment verifications of U.S. exported computers.

We hope this information is helpful to you.

Sincerely,

[Signature]

Patrick A. Mulloy
Acting Chairman

Attachment: As stated

cc: The Honorable Tom Daschle
    The Honorable Dennis Hastert
    The Honorable Richard Gephardt
    The Honorable Trent Lott
    The Honorable Tom Lantos
    The Honorable Bob Stump
    The Honorable Ike Skelton
    The Honorable Henry Hyde
    The Honorable Fred Thompson
    The Honorable Robert Byrd
    The Honorable Chuck Hagel
    The Honorable David Dreier
"Excerpts from Mr. Garcia's testimony of January 17, 2001 before the U.S.-China Security Review Commission on Export Controls and China."

Mr. Garcia: The attaché works with the Embassy community, educating Embassy personnel on export control issues. He is the point of contact for the Chinese business community and U.S. businesses operating in China who have questions about U.S. export control issues.

The attaché also provides valuable information to BXA officials and licensing officers back in the United States to ensure that U.S. strategic products are safeguarded. The presence of the attaché also signals to the U.S. and Chinese business community that the Department of Commerce places emphasis on stopping any illegal exports to China.

EE's analysts review BXA licenses and shipping documents to determine which transactions should be the subject of end-use checks, both pre-license and post-shipment, and to recommend the denial or conditioning of licenses in light of specific facts and circumstances. In China, we have an end-use visit arrangement, negotiated between the U.S. and Chinese governments in July 1998, regarding end-use checks. In the past 12 months, BXA has conducted 42 such checks. These checks help to ensure that our national security is not compromised by the exports of controlled goods and technology.

For China, as for 50 other countries, post-shipment checks on all high-performance computers above a specified level of performance are mandated by law. This level has been raised as technology advances, reducing the number of PSVs required for future exports. However, as we interpret the law, Export Enforcement is not relieved of the requirement to conduct post-shipment verifications on previously exported computers that met the prior--lower--control level.

This presents Export Enforcement with a problem. We are being required to conduct checks on computers that are no longer considered advanced enough to be controlled, yet were controlled when exported. The sheer volume of these backlog checks combined with our limited enforcement resources diminishes our ability to choose and conduct those targeted checks, which we believe are most critical to our national security interests. We are actively exploring different avenues for relief from this burdensome requirement.

In addition to analyzing specific transactions involving Chinese entities or individuals, Export Enforcement also reviews applications for visas filed by Chinese nationals to prevent such individuals from illegally acquiring controlled U.S. technology while in the United States. Export Enforcement recommends denial of visas to the United States Department of State when it believes that the applicant poses a particular risk of illegally seeking or gaining access to controlled technology or technical data.

COMMISSIONER WESSEL: And Mr. Mercier talked about the Mutual Assistance Agreement with 50 countries--I don't know whether China is one of those.

But what kind of cooperation are you getting?

MR. GARCIA: Commissioner, I'll tell you what I see as my biggest problem with cooperation on end-use checks in China during my brief time in this position. I think that we have such a list of checks outstanding in China, into the 700s, which are primarily mandated checks on high-performance computers that were mandated at a time when the level was beneath 10,000 MTOPS. If you go to a country that may not be inclined to give you free access, and you say we want to do checks of this kind, I would think that the problem is that we are being given checks on a 6,000-MTOP computer that is at a travel agency, and a check is done.

My biggest problem is to get the strategic checks, the checks that our organization would see as the most important to our national security and the ones we should be doing given, as you said, our limited resources, pushed to the front of the line. And in my view, that is not happening.
and I think that that is the biggest improvement we could make in our end-use arrangement and in our end-use cooperation with China.

COMMISSIONER WESSEL: So in part it is a question of the burden you have for the outstanding checks for the low number of MTOP computers. But if you had the strategic ability to choose which products as it applies to Chinese cooperation, do they give you cooperation on the 6,000-MTOP computer but not on the item that you really care about?

MR. GARCIA: Well, here is the example that I would give on that. There is a number, and it is relatively few items, that we have asked for post-shipment verification that do not relate to high-performance computers. We have seen extensive delays in getting those post-shipment verifications done. I think that answers your question.
May 3, 2002

The Honorable Joseph R. Biden  
Chairman  
Senate Foreign Relations Committee  
446 Dirksen Building  
United States Senate  
Washington, D.C. 20510

The Honorable Jesse Helms  
Ranking Member  
Senate Foreign Relations Committee  
446 Dirksen Building  
United States Senate  
Washington, D.C. 20510

Dear Chairman Biden and Ranking Member Helms:

Congress created the bipartisan, twelve-member United States-China Security Review Commission ("the Commission") in October 2000 for the purpose of monitoring, investigating and reporting on the national security implications of the bilateral trade and economic relationship between the United States and the People's Republic of China. The Commission is charged with delivering its first report to the Congress in June 2002, along with recommendations for legislative or executive action. We have also been asked to alert Congress to any concerns or recommendations that may develop in advance of submitting our report, where appropriate.

One issue that has arisen in the Commission's deliberations is the export of goods made by forced or prison labor from China to the United States. U.S. law prohibits the importation of such products from any country. Although the United States and China signed a memorandum of understanding (MOU) in 1992 and a subsequent statement of cooperation (SOC) in 1994 to safeguard against the import of forced labor products into our country from China, that country's cooperation in implementing these understandings that involve on-site inspections has been, at best, sporadic. According to the Department of State, China for the most part has rejected or ignored U.S. requests to inspect alleged Chinese prison labor facilities.

The Commission believes that U.S. law is not being adequately or effectively enforced against the import of forced or prison labor products from China. The Commission recommends that enforcement be improved by shifting the burden of proof from the U.S. government to companies that import such goods into the United States. Such companies would be required to certify, based on good faith efforts, that the products they are importing are not made by forced or prison labor. Once credible charges are made that a particular company is importing goods made by forced or prison labor, such products would not be allowed to enter the U.S. market until U.S. Customs officials complete an investigation of the charges and conclude that forced labor is not being used to make the products. With regard to countries such as China, where forced labor is practiced and with whom we have an inspection arrangement, all goods from a suspect facility will be blocked from entering the U.S. market if requests for inspection are denied or ignored.
Enclosed is a Commission policy paper outlining our recommendations. Commissioner Reisch does not concur in some of them.

Sincerely,

Michael Lefcort
Vice-Chairman

Patrick A. Mulloy
Acting Chairman

Enclosure

cc:

The Honorable William Thomas
The Honorable Charles Rangel
The Honorable Max Baucus
The Honorable Charles Grassley
The Honorable Henry Hyde
The Honorable Tom Lantos
The Honorable Tom Daschle
The Honorable Dennis Hastert
The Honorable Richard Gephardt
The Honorable Trent Lott
The Honorable Fred Thompson
The Honorable Robert Byrd
The Honorable Chuck Hagel
The Honorable Paul Sarbanes

Background:

Many human rights groups allege that the use of forced labor is a common and established practice in China. They assert that products of this forced labor are exported to other countries and that a substantial portion is sent to the United States. Section 307 of the Tariff Act of 1930, 19 USC 1307, prohibits the importation of products of forced labor from any country. Section 1761 of Title 18 of the US Code makes it a criminal offense to knowingly import goods made by convict or prison labor. Moreover, Article XX of the GATT provides that laws prohibiting trade in such goods are GATT consistent. The problem of enforcement lies in the difficulty of proving that specific imported goods are being made by forced labor.

On August 7, 1992, the United States and China signed a Memorandum of Understanding (MOU) to safeguard against the export of prison labor products from China to the United States. According to U.S. officials, China’s implementation of the MOU was “spotty” and China was slow to respond to U.S. requests for information and for requests to visit suspected facilities. On March 14, 1994, to improve the situation the U.S. and China signed a “statement of cooperation” spelling out specific guidelines for implementation of the MOU, including timetables for responding to requests for information and site visits to suspected facilities. According to the President’s report to the Congress in May 1994 on renewing China’s MFN status, China was living up to the commitments it made in these agreements. In 1994 U.S. Customs officials visited five facilities in China to investigate charges that goods being exported to the U.S. from such facilities had been made by prison labor.

That cooperation began to taper off in 1995. Between 1996 and 2001, Chinese authorities approved only three out of eleven requests for site visits, one in 1996, one in 1997 and the last in 2000. In each case, Customs found no evidence of prison labor. According to the Department of State’s 1999 China Country Report on Human Rights, in that year the U.S. Customs was unsuccessful in securing approval from Chinese authorities to visit eight sites suspected of exporting prison labor products to the U.S. The 2001 China Country Report on Human Rights concluded that Chinese cooperation on prison visits is “sporadic, at best.”

According to the Laogai Research Foundation, China’s prison systems (Laogai) are an integral part of the national economy. That Foundation claims to have documented nearly 100-forced labor camps, producing $800 million in sales, and contends that the number of such camps probably numbers well over 1,000. It further contends that goods from Laogai are being imported into the U.S.

The Commission heard testimony that prisoners in China are incarcerated for their political views or because of their religious beliefs. Human rights groups have reported that conditions in the forced labor facilities are brutal, that medical care is poor and that workplace conditions are generally exhausting and dangerous. Some former prison inmates claim that prisoners are fed based upon production quotas and that if prisoners fail to meet their quotas they receive decreased food rations and
physical punishment. The Laogai Research Foundation asserts that, in some instances, prisoners are forcibly and indefinitely retained as workers after they have completed their sentences (a practice called jiuye, “forced job placement”) so that production in their facilities will not be diminished by their departure.

The Chinese government maintains that products made by forced labor are not exported from China to the United States.

Role of the U.S. Customs Service

The U.S. Customs Service has primary responsibility for enforcing the two statutes cited above that ban the importation of goods made by prison labor and make it a crime for a person to knowingly bring such goods into the United States. Between 1992 and 2000, we understand the Customs Service opened eighty-four criminal investigations regarding imports of prison labor and issued twenty detention orders barring shipments of goods from China. Only two cases resulted in criminal convictions. Customs presently has open nineteen prison labor investigations pertaining to imports from China to the United States.

Customs has promulgated regulations spelling out how persons can inform the agency about suspected prison labor imports. If such persons present sufficient evidence to create a reasonable belief among Customs officials that they are correct, the Customs Service can issue a detention order banning a particular shipment of goods.

Despite this, many human rights groups believe the current system for enforcing U.S. laws against the importation of goods made by prison and forced labor in China is not working. The Customs Service itself has told the Commission that it cannot conduct independent investigations in China. Customs investigations in China must proceed pursuant to the 1992 and 1994 bilateral agreements discussed above.

Pursuant to the procedures spelled out in those agreements, we understand that since 1996 the Customs Service has sent thirty letters to the Chinese Ministry of Justice regarding either visits or investigations of prison facilities in China that were suspected of producing goods for export to the United States. In most cases, the Chinese Ministry of Justice failed to respond to such letters.

The Customs Service has told the Commission that the difficulty in enforcing Section 307 to block the importation of goods made by prison labor in China does not arise from the U.S. statutes. The difficulty arises because the PRC is not abiding by the 1992 and 1994 agreements it negotiated with the U.S. government. The Customs Service contends that finding ways to persuade China to live up to the agreements it has negotiated with our government on these matters would assist them in enforcing our laws.

Commission Recommendations

The Commission believes the current system can be improved by shifting the burden of proof in such cases. This can be accomplished with a two-pronged approach.
1. Certification

All importers of record of all goods entering the U.S. should be required to certify, based on good faith efforts, that such goods were not made by prison labor. This puts the obligation on the importers to take reasonable steps to ensure that the goods they import are prison labor-free. It sends a message to foreign manufacturers and their trading and distribution companies that America will not accept goods made under compulsion by prisoners and forced labor. The Certification will also provide an additional legal basis to prosecute violators for knowingly certifying to false or misleading information regarding the source of their imports.

2. Inspection

China is the only country with which the U.S. presently has negotiated a bilateral understanding, which lays out procedures for conducting inspections at suspected prison labor facilities. The Commission recommends that in regard to countries with which we have such arrangements, where credible evidence exists that prison or forced labor is being used at a specific site, facility or factory, Customs be required to make an immediate request to carry out a prompt inspection of the site, manufacturing facility or factory. A prompt inspection is an inspection that will take place within sixty days of the request for an inspection. If the inspection cannot take place in the required time frame, Customs will block the entry of goods from the factory or facility into the U.S. until such time that an inspection takes place. If Customs learns that a delay in authorizing an inspection is linked to “cleaning” a facility so that the prisoners or forced laborers are not present in a future inspection, Customs will take steps to block future imports into the U.S. from that facility. In cases where Customs finds evidence of prison or forced labor at an inspected facility, Customs will block any future imports from that facility into the U.S.

In addition to the above two core recommendations, the Commission also believes the following steps should be implemented to efficiently prohibit the importation of goods made by prison and forced labor.

1. Suspicious Companies

In order to assist U.S. companies to avoid importing products made by forced or prison labor, the U.S. government should maintain a list of suspicious companies which are reasonably suspected of trafficking in such goods. The Commission recommends that a high standard for inclusion on the list of suspicious companies is essential to its credibility and usefulness. Companies in the country where goods are manufactured can get off the list upon successful completion of a Customs investigation. Trading and distribution companies that handle such goods can be removed from the list if they demonstrate that they are not handling goods that originate in prison or forced labor facilities and they have procedures in place to ensure they are not trafficking in such goods.

2. Bonding
The Commission recommends that importers of record of products from companies on the suspicious companies list discussed above be required to post bonds. Use of a bond procedure will accomplish two related goals. It will act as a deterrent to future misbehavior by importers that want to continue operating in the United States; it will also chase out non-reputable companies that are created only to skirt the laws of the United States, by subjecting them to considerable financial risk. The Commission believes that consideration should also be given to awarding forfeited bonds to whistleblowers who expose proven wrongdoing as an incentive for them to come forward and identify manufacturers and distribution companies acting illegally.


The Department of State submits to Congress each February “a full and complete report regarding the status of international recognized Human Rights” in foreign countries, including China. The Commission recommends that the Annual Country Report include a detailed account of the location of Laogai and other forced labor facilities in China and the products produced by them. The Commission further recommends that the Annual Country Report include a full record of cooperation by China, including the current year, on the bilateral 1992 Memorandum of Understanding (MOU) and the 1994 Statement of Cooperation (SOC). The Department of State should conduct its investigation and reporting on this matter in coordination with the Department of Commerce and the U.S. Customs Service. The responsible agencies should receive full support from the Central Intelligence Agency and the Federal Bureau of Investigation.

4. Special Counsel in Justice

In order to ensure that our laws against importing goods made by illegal forced and prison labor are vigorously enforced, the Commission proposes that an appropriate individual in the Criminal Division of the Justice Department be designated a “Special Counsel” with specific responsibility to prosecute such cases in the U.S. District Courts. The Commission believes that designation of such a counsel will focus enforcement attention on this issue at the Justice Department and facilitate prosecutions of these cases.
### Abbreviations

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<tr>
<th>Abbreviation</th>
<th>Description</th>
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<td>ABM</td>
<td>Anti-Ballistic Missile</td>
</tr>
<tr>
<td>ACFTU</td>
<td>All-China Federation of Trade Unions</td>
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<tr>
<td>ADR</td>
<td>American Depository Receipts</td>
</tr>
<tr>
<td>AECA</td>
<td>Arms Export Control Act</td>
</tr>
<tr>
<td>AFL-CIO</td>
<td>American Federation of Labor and Congress of Industrial Organizations</td>
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<td>AIA</td>
<td>Aerospace Industries Association of America</td>
</tr>
<tr>
<td>AIMCO</td>
<td>Allied International Manufacturing Corporation</td>
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<tr>
<td>Am-Cham China</td>
<td>American Chamber of Commerce in China</td>
</tr>
<tr>
<td>AMRAAM</td>
<td>Advanced Medium Range Air-to-Air Missile</td>
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<tr>
<td>APMT</td>
<td>Asia Pacific Mobile Telecommunications</td>
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<tr>
<td>ARF</td>
<td>ASEAN Regional Forum</td>
</tr>
<tr>
<td>ASEAN</td>
<td>Association of South East Asian Nations</td>
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<tr>
<td>ATP</td>
<td>Advanced Technology Products</td>
</tr>
<tr>
<td>AWACS</td>
<td>Advanced Communication and Early Warning/Battle Management</td>
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<tr>
<td>BMD</td>
<td>Ballistic Missile Defense</td>
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<tr>
<td>C3I</td>
<td>Command, Control, Communications, and Intelligence</td>
</tr>
<tr>
<td>C4ISR</td>
<td>Command, Control, Communications, Computers, Intelligence, Surveillance, and Reconnaissance</td>
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<td>California Public Employees' Retirement System</td>
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<td>Confidence Building Measures</td>
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<td>Congressional Budget Office</td>
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<td>China Central Television</td>
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<td>CEPA</td>
<td>Closer Economic Partnership Agreement</td>
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<td>CFA</td>
<td>Court of Final Appeals</td>
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<td>CIA</td>
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<td>CLDP</td>
<td>Commercial Law Development Program, Department of Commerce</td>
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<td>CMC</td>
<td>Central Military Commission</td>
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<td>CMEC</td>
<td>China Metallurgical Equipment Corporation</td>
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<td>CNEIEC</td>
<td>China National Electronics Import and Export Corporation</td>
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<td>China National Nuclear Corporation</td>
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<td>CNOOC</td>
<td>China National Offshore Oil Corp</td>
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<td>CNP</td>
<td>Comprehensive National Power</td>
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<td>China National Petroleum Company</td>
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<td>COSTIND</td>
<td>Commission of Science, Technology, and Industry for National Defense</td>
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<td>Chinese Petroleum Corporation</td>
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<td>CPC</td>
<td>Communist Party of China</td>
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<td>CRS</td>
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<td>Chemical Weapons Convention</td>
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<td>Defense Intelligence Agency</td>
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<td>DOC</td>
<td>Department of Commerce</td>
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<td>Abbreviation</td>
<td>Full Form</td>
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<td>DOD</td>
<td>Department of Defense</td>
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<td>DOS</td>
<td>Department of State</td>
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<td>DSU</td>
<td>Dispute Settlement Understanding</td>
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<td>EDAC</td>
<td>Economic Development Advisory Conference</td>
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<td>ESM</td>
<td>Executive Secretariat Meeting</td>
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<td>EU</td>
<td>European Union</td>
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<td>EW</td>
<td>Early Warning</td>
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<td>Ex-Im Bank</td>
<td>Export Import Bank</td>
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<td>FBI</td>
<td>Federal Bureau of Investigation</td>
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<td>FBIS</td>
<td>Foreign Broadcast Information Service</td>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>GAD</td>
<td>General Armaments Department</td>
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<td>GATS</td>
<td>General Agreement on Trade in Services</td>
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<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GE</td>
<td>General Electric</td>
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<td>Guangdong ITIC</td>
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<td>GLD</td>
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<td>GLONASS</td>
<td>Global Navigation Satellite System</td>
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<tr>
<td>GMO</td>
<td>Genetically Modified Organism</td>
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<td>GPA</td>
<td>WTO's Government Procurement Agreement</td>
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<td>GPS</td>
<td>Global Positioning System</td>
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<td>General Staff Department</td>
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<td>HKSE</td>
<td>Hong Kong Stock Exchange</td>
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<td>HS</td>
<td>Harmonized Standard</td>
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<td>IAEA</td>
<td>International Atomic Energy Agency</td>
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<td>ICBM</td>
<td>Intercontinental Ballistic Missile</td>
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<td>ICP</td>
<td>Internet Content Providers</td>
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<td>IDF</td>
<td>Indigenous Defense Fighter</td>
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<td>IEEPA</td>
<td>International Emergency Economic Powers Act</td>
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<td>International Finance Corporation</td>
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<td>International Labor Organization</td>
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<td>International Monetary Fund</td>
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<td>ITA</td>
<td>Information Technology Agreement</td>
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<td>International Trade and Investment Corporations</td>
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<td>Information Warfare</td>
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<td>Joint Economic Committee</td>
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<td>LAC</td>
<td>Line of Actual Control</td>
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<td>MCTL</td>
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<td>MFN</td>
<td>Most Favored Nation</td>
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<td>MND</td>
<td>Ministry of National Defense</td>
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<tr>
<td>Acronym</td>
<td>Description</td>
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<tr>
<td>MNSR</td>
<td>Miniature Neutron Source Reactor</td>
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<td>MOF</td>
<td>Ministry of Finance</td>
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<td>MOFTEC</td>
<td>Ministry of Foreign Trade and Economic Cooperation</td>
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<td>Missile Technology Control Regime</td>
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<td>NAFTA</td>
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<td>Non Governmental Organization</td>
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<td>NIST</td>
<td>National Institute of Science and Technology</td>
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<td>NMD</td>
<td>National Missile Defense</td>
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<td>NME</td>
<td>Non Market Economy</td>
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<td>NPC</td>
<td>National People's Congress</td>
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<td>NPT</td>
<td>Nuclear Non Proliferation Treaty</td>
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<td>National Security Agency</td>
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<tr>
<td>NYSE</td>
<td>New York Stock Exchange</td>
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<tr>
<td>OFAC</td>
<td>Office of Foreign Assets Control, Department of the Treasury</td>
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<tr>
<td>OPIC</td>
<td>Overseas Private Investment Corporation</td>
</tr>
<tr>
<td>PAP</td>
<td>People's Armed Police</td>
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<td>PLA</td>
<td>People's Liberation Army</td>
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<td>PLAAF</td>
<td>People's Liberation Army Air Force</td>
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<tr>
<td>PLAN</td>
<td>People's Liberation Army Navy</td>
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<td>PNTR</td>
<td>Permanent Normal Trade Relations</td>
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<td>PRC</td>
<td>People's Republic of China</td>
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<td>R&amp;D</td>
<td>Research and Development</td>
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<td>RMA</td>
<td>Revolution in Military Affairs</td>
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<td>S&amp;T</td>
<td>Science and Technology</td>
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<tr>
<td>SAR</td>
<td>Hong Kong Special Administrative Region</td>
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<td>SARFT</td>
<td>State Administration of Film, Radio and Television</td>
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<tr>
<td>SCO</td>
<td>Shanghai Cooperation Organization</td>
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<td>State Economic and Trade Commission</td>
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<td>State Invested Enterprise</td>
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<td>SLBM</td>
<td>Submarine Launched Ballistic Missiles</td>
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<td>SOC</td>
<td>Statement of Cooperation</td>
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<td>SOE</td>
<td>State Owned Enterprise</td>
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<td>TBT</td>
<td>Technical Barriers to Trade</td>
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<td>Theater Missile Defense</td>
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<td>TPCC</td>
<td>Trade Promotion Coordination Committee</td>
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<td>Taiwan Relations Act</td>
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<td>Trade Related Investment Measures</td>
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<td>TRIP</td>
<td>Trade Related Aspects of Intellectual Property Rights</td>
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<td>TRM</td>
<td>Transitional Review Mechanism</td>
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<td>TRQ</td>
<td>Tariff Rate Quotas</td>
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<td>TSMC</td>
<td>Taiwan Semiconductor Manufacturing Company</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Full Form</td>
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<tr>
<td>UK</td>
<td>United Kingdom</td>
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<tr>
<td>UMC</td>
<td>United Microelectronics Corp</td>
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<td>UN</td>
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<td>USAID</td>
<td>U.S. Agency for International Development</td>
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<tr>
<td>USDA</td>
<td>U.S. Department of Agriculture</td>
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<td>USTR</td>
<td>U.S. Trade Representative</td>
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<td>WMD</td>
<td>Weapons of Mass Destruction</td>
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<tr>
<td>WTO</td>
<td>World Trade Organization</td>
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<tr>
<td>ZBB</td>
<td>Zero Base Budgeting</td>
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Documentary Annex Contents

Tab 1. Commissioned Research Papers


- **An Analysis of the U.S. Industrial Base and the People’s Republic of China**, by Pat Choate, Charles McMillion, and Edward Miller; Manufacturing Policy Project, June 2002


  - Evaluations of Chang’s Paper, by Richard N. Cooper, Ph.D., Harvard University; and Nicholas Lardy, Ph.D., Brookings Institute

- **China’s Military Strategy Toward the United States**, by Michael P. Pillsbury, Ph.D., National Defense University, November 2001

- **China’s Perceptions of the United States: The View from Open Sources**, by Michael P. Pillsbury, Ph.D., National Defense University, November 2001

- **China’s Research Institutes**, by Michael P. Pillsbury, Ph.D., National Defense University, October 2001

- **China’s Role In World Trade and Investment**, by Allen J. Lenz, Ph.D., April 2002

- **Impact of U.S.-China Trade Relations on Workers, Wages, and Employment: Pilot Study Report**, by Kate Bronfenbrenner, School of Industrial and Labor Relations, Cornell University, June 30, 2001

- **Perspectives Toward the United States in Selected Newspapers of the People’s Republic of China**, by The Institute for Global Chinese Affairs, University of Maryland, May 30, 2002
Tab 2. Translated Materials

All but six of the papers and articles by Chinese authors listed below were screened and/or translated by a research team headed by Maochun Yu, Ph.D., U.S. Naval Academy, from open sources on the Chinese Internet; and the six papers from the Journals of the China Institute of Contemporary International Relations (CICIR) were translated by Liu Bo, Ph.D., CICIR.

Security Issues

- **Circumstances Affecting China’s Defense Budget Increase**, by Xia Jiren, PLA Institute of Military Economics, Military Economics Study, December 2000


- **Dialogue Among Civilizations: Implications for International Relations**, by Sheng Qurong, Former President and Research Professor, China Institute of Contemporary International Relations, Xandai Guoji Guangxi, September 2001

- **Don’t Isolate Ourselves**, by Sa Benwang, Chinese Institute of International Strategic Studies, The Global Times (Huanqiu Shibao), Beijing, August 1999

- **Factors Shaping Sino-Japanese Relations**, by Feng Zhaokui, Research Professor, Institute of Asia-Pacific Studies, Chinese Academy of Social Science, Contemporary International Relations, September 2001

- **Military Preparation and Possible Models for the Defense Budget Increase**, by Liu Yang, PLA Institute of Military Economics, and Wang Cong, PLA Shenyang Military Zone Joint Staff HQ, Military Economics Study (PLA), November 2001

- **The Real Purpose of the American March into Central Asia**, by Gao Fuqiu, Outlook (Liaowang) Magazine, May 10, 2002

- **Strength Gap is the Reality**, by Zhang Zhaozhong, Senior Colonel, People’s Liberation Army and Professor, Chinese National Defense University (NDU), The Global Times (Huanqiu Shibao), Beijing, July 30, 1999


- **WTO and China’s Defense Industry (Parts III & IV)**, by Ye Weiping, The Chinese People’s University, Strategy and Management, Issue No. 3, 2000

- **WTO Entry and Opportunities for a Second Life in China’s Military Enterprises**, by Chen Donghua, Wu Jin and Feng Zuxin, The Command Institute of the Second Artillery Troops, Administrative Bureau, General Equipment Department, PLA Military Economic Studies
Economic Issues


- APEC Shanghai Leaders’ Meeting and Prospects of APEC – Notes taken from a CICIR. Roundtable, Xiandai Guiji Guanxi (Contemporary International Relations), 2001


- China Faces Financial Crisis at the Turn of the Century, by He Qinglian, 21st Century, Issue No. 6, 1997
  
  Translation of articles by He Qinglian appear with her permission and may not be reproduced without her express consent.

- China’s Latent Economic Crisis and Potential Risks, by He Qinglian, Modern China Studies, No. 2, Vol. 65, 1999

- The Core Problem of Financial Reforms in China, by He Qinglian, Excerpted from We are Still Watching the Stars Above, 2001

- Government Control of Market Access in China, by Zhou Qiren, Professor, Center for the Study of the Chinese Economy, Beijing University, China Austrian Review, August 2001

- The Historical Orientation of China’s Reforms, by He Qinglian, Modern China Studies, No. 1, Vol. 64, 1999

- How Attractive is China’s Market? by Qiu Feng, China Austrian Review, September 1999


- Rural Economy at a Dead End: A Dialogue on Rural China, Peasants and Agriculture, by He Qinglian, Visiting Scolar, University of Chicago, and Cheng Xiaonong, Editor-in-Chief, Contemporary China Studies

- What are the Benefits of China’s Entry into WTO? by He Qinglian, Excerpted from We Are Still Watching the Starts Above
PRC Views of the U.S.

- **Constantly Yielding to American Demands is No Solution**, by Wang Jisi, Director, Institute of American Studies, Chinese Academy of Social Sciences, The Global Times (Huanqiu Shibao), Beijing, September 3, 1999

- **Multi-polarity Does Not Equal an Anti-U.S. Position**, by Wang Yizhou; Research Fellow, Institute of World Economy and Politics, Chinese Academy of Social Sciences, The Global Times (Huanqiu Shibao) Beijing, Summer 1999

- **Security Dilemma, Balance of Power Vs. U.S. Policy Towards China in the Post-Cold War Era**, by Xin Benjian, Faculty, Luoyang PLA Foreign Language College, China Institute of Contemporary International Relations (Xiandai Guoji Guanxi), September 2001

- **“September 11 Event” vs. Sino-U.S. Relations**, by Yuan Peng, Associate Research Professor and Deputy Director, Division for North and Latin American Studies, China Institute of Contemporary International Relations (Xiandai Guoji Guanxi), November 2001

- **Sino-American Relations: Climbing High to See Afar**, by Su Ge, Deputy General Director and Professor, China Institute of International Studies, Ministry of Foreign Affairs, China Institute of Contemporary International Relations (Xiandai Guoji Guanxi), September 2001

Domestic Governance

- **A Centrally Planned Economy Will Inevitably Create Inequality**, by Qiu Feng, July 1999

- **A Different Type of Social Power: Underground Criminal Organizations**, by He Qinglian

- **Is it Right to Pirate Software**, by Wang Xiaodong, Editor, Strategy and Management, China and the World (Zhongguo Yu Shijie), November 1999

- **Privatization is the Right Way to Proceed and Parliamentary Democracy Conforms with the Times**, by Cao Siyuan, June 2000

- **Turning Everyone Into a Censor: The Chinese Communist Party’s All-Directional Control Over The Media**, by Wu Xuecan (former editor at the People’s Daily Overseas Edition)
### Tab 3. Selected Briefings, Papers and Reports

- **The Anaconda in the Chandelier: Censorship in China Today**, by Perry Link, Princeton University

- **Chinese Economy Briefing**, by Thomas Rawski, Ph.D., University of Pittsburgh, February 2002

- **The Early Infrastructure of U.S. Relations with the PRC during the Carter Administration**, Congressional Research Service Report, by Kerry Dumbaugh, April 2002

- **U.S.-China Science and Technology Cooperation Executive Branch Report**, by U.S. Department of State, May 2002
  - Transmittal Letter from Chairman C. Richard D'Amato and Vice Chairman Michael A. Ledeen to Senator Robert C. Byrd, June 17, 2002
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