THE EXTENT OF THE GOVERNMENT'S CONTROL OF CHINA'S ECONOMY, AND IMPLICATIONS FOR THE UNITED STATES

HEARING

BEFORE THE

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COMMISSION

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U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

August 21, 2007

The Honorable ROBERT C. BYRD
President Pro Tempore of the Senate, Washington, D.C. 20510
The Honorable NANCY PELOSI
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR BYRD AND SPEAKER PELOSI:

We are pleased to transmit the record of our May 24-25 public hearing on *"The Extent of the Government's Control of China's Economy and Implications for the United States."* The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, section 635(a)) provides the basis for this hearing, as it requires the Commission to submit an advisory report to the U.S. Congress on "the national security implications and impact of the bilateral trade and economic relationship between the United States and the People's Republic of China." In this hearing, the Commission reviewed the efforts by the government of China to maintain ownership or direct control of a large portion of its own economy while it seeks to use its large holdings of foreign exchange to gain ownership of private foreign assets.

The testimony at the two-day hearing focused on China's intentions to create what it calls "national champion" firms in 12 industries over which Beijing has determined that it will maintain continued state ownership or control. These giant corporations, that China intends to equip to compete successfully on a global scale, will be fashioned from some of the estimated 167,000 companies that are currently state-owned. Today, many of the smaller companies in this group, particularly those affiliated with provincial or municipal governments, either are failing or are poorly run. A substantial number are unable to make payments on their bank loans. However, with a boost from a wide variety of government subsidies, including new infusions of cash from state-owned banks, the new consolidated companies, closely linked to the central government, will be equipped to compete effectively with U.S.-based companies in China, in the United States, and in many third-country markets.

Intensifying concern about this development is the fact that China is regressing in its record of meeting the commitments it made in order to secure membership in the World Trade Organization. China agreed to move its economy toward a more market-based system and away from state control.

Chinese Control of its Strategic and Heavyweight Industries

China has formally designated seven industries as "strategic," and has announced that the state will maintain "absolute control [of these industries] through dominant state-owned enterprises." These industries are armaments; power generation and distribution; oil and petrochemicals; telecommunications; coal; civil aviation; and shipping. It declared five industries to be "heavyweight" industries; the state will retain substantial control of the companies operating in these industries. They are machinery; automobiles; information technology; construction; and iron, steel, and non-ferrous metals.

Mr. Barry Naughton, an economist at the University of California, San Diego, testified at the Commission's hearing that China's actions to retain government control of such a large portion of its economy are "definitely a step backwards" and "clearly violations of the spirit of the WTO." Many of the companies in these industries already are "large, powerful, and wealthy corporations that are a little bit government, a little bit market, and have mixed motives that affect how they operate in many different respects." More ominously, noted Naughton: "The Chinese government is now going to substantially step up the amount of money that it invests in research and development, the activity of the government in using procurement to foster a high-technology sector in China, and the flow of resources from the government to subsidize credit."

Other witnesses interpreted China's highly targeted industrial policy favoring certain industries as an attempt to rewrite the rules of the WTO. China is willing to subject its economy to market determinations only so long as that suits Chinese development goals, Clyde Prestowitz, President of the Economic Strategy Institute told the Commission. "The objective of the game is to be a leader in key industries, to be at the cutting edge of key technologies," he said. "If the market can get you there, great. However, if the market by itself can't get you there, then the players of this game will use other means . . . to get there."

Other witnesses warned that China's emphasis on retaining a strong state-owned and state-controlled industrial sector is part of an overall industrial policy that is spelled out in China's 11th Five Year Plan, which was officially approved in 2006 but which government authorities in Beijing are explaining and clarifying very slowly. Scott Kennedy, a University of Indiana political scientist, agreed with others who told the Commission that, in many ways, the industrial policy is at odds with China's WTO obligations. : "Although China's entry presaged a new era of economic openness, certain segments of China's government and industry, both state-owned and private, have over the last decade promoted protectionist industrial and trade policies rooted in exploiting loopholes in the WTO," Kennedy said.

Another economist, Dr. George Haley of New Haven University, warned that "contrary to U.S. policymakers' beliefs, China is not moving towards a Western-style capitalism-based economy." Rather, he said, the goal of Chinese policy-makers is to meld the government and the economy into an instrument of policy in order to preserve the status quo. "The Chinese government intends to carve out a lion's share of the world's economic power, political power, and prestige while maintaining the Chinese Communist Party's absolute control over China."

The government body that holds responsibility for linking the fate of the Party to the largest State-Owned Enterprises (SOEs) is the State-Owned Assets Supervision and Administration Commission of the State Council, known as SASAC. This organization directly runs the largest of the state-owned companies—originally 197 corporations but now whittled down to a number estimated to be around 167. These are the largest and most widely known companies. They are also some of the most profitable, thanks to a variety of government handouts including forgiveness of debts to government owned banks.

SASAC maintains control of its corporate charges by appointing members, usually Chinese Communist Party (CCP) members, to the companies' boards of directors. SASAC also has the right to "screen, to appoint, to evaluate, to compensate and to dismiss SOE managers."

Some Government Aid to SOEs Violates WTO rules

China's extensive subsidies to business may violate the spirit and the intent of WTO membership and policies, but they do not necessarily violate the WTO's explicit rules on subsidies. Many nations, including the United States, employ subsidies to accomplish economic goals. Various trade remedies such as anti-dumping duties and countervailing duties are employed by nations to level the playing field under such circumstances. The WTO, while not participating in such remedies, explicitly allows their use

The use of subsidies that are contingent on exports, however, is considered an egregious practice. Such export-contingent subsidies are expressly prohibited by the WTO, and for good reason. Subsidies granted to companies that are intended to boost exports or to discourage imports are considered the most trade-distorting subsidies. They interfere far more with the international trading system than, for example, subsidies to one company designed to persuade it to locate in one jurisdiction instead of another. Export contingent subsidies can artificially lower the cost of production, granting an unfair advantage to an exporting company or industry and are prohibited by WTO rules for that reason.

China employs such export dependent subsidies. Many of China's largest SOEs receive such aid and "represent a potential problem for U.S. industries and international trade," according to Thomas R. Howell, a trade attorney with Dewey Ballantine LLP in Washington. He predicted a "rocky road" for relations between China and the United States until the controversy over subsidies to SOEs is worked out.

The United States has brought a formal complaint to the WTO alleging that China employs export-contingent subsidies. That case has not yet been heard by a dispute resolution panel.

China's Sovereign Wealth Fund and Its Potential Effects on the United States

Over the past decade, China has become an immense magnet for foreign direct investment, but has reciprocated hardly at all. As of the end of 2005, China's total stock of outward investment was just $30 billion. The following year, 2006, the pace picked up as Chinese firms added $16 billion in investments abroad. Nonetheless, the contrast is stark: China receives as much foreign direct investment (FDI) in one year as its total accumulated outward investment.[1]

This imbalance is expected to change, however. China has amassed $1.3 billion in foreign exchange reserves, the largest cache of forex in the world. Much of this money—an estimated 70 percent—is invested in dollar-denominated bonds, principally U.S. Treasury securities that pay relatively low interest rates.[2] To seek a higher return and to diversify its holdings, China is creating a sovereign wealth fund. Even before this investment arm has been given a formal name, it has made its first buy— $3 billion in the initial public offering of Blackstone Group, a U.S. private equity firm.

More such investments are likely. China already has said it would issue bonds—to be covered by its foreign exchange reserves—for $200 billion of new investments. But this addresses only a small portion of China's growing reserves; it is now accumulating foreign reserves at the rate of $400 billion a year, according to Dr. Brad Setser, senior economist at Roubini Economics.

This massive currency reserve increasingly is raising concerns in the United States and in other global financial centers. Were China to invest heavily in the United States, it would be the only non-NATO member nation or non U.S. ally investing at this level in the United States, noted David Marchick, an attorney with Covington & Burling. Marchick told the Commission that some might question whether China, through its investments, is seeking to obtain access to military or dual-use technology without having to contend with export controls and other impediments. He noted concerns that employees of Chinese-owned companies in the U.S. might be targets of China's intelligence services gathering valuable technical information.

<u>Government, Not the Free Market, Rules International Steel Trade</u>

According to testimony before the Commission, China's steel policy shows how state ownership and control combined with extensive government subsidies can threaten a U.S. industry—in this case, one that is vital to both civilian and military manufacturing. Beijing has adopted an explicit industrial policy to support steel production using a wide variety of subsidies. The result has been a dramatic increase in steel output in China resulting in production that far exceeds even China's skyrocketing domestic steel consumption.

In just four years, China transformed itself from a large steel importer to a large steel exporter by adding capacity at a record rate. In 2002, imports of iron and steel in China exceeded exports by 400 percent; by 2006, exports of iron and steel from China exceeded imports by 200 percent.[3] As a result, China now produces 35 percent of the

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[1] U.S. China Economic & Security Review Commission, testimony of David Marchick, attorney at Covington and Burling, May 24, 2007.
[2] U.S. China Economic & Security Review Commission, testimony of Dr. Brad Setser, senior economist, Roubini Economics, May 24, 2007.
[3] Trevor Hauser and Daniel Rosen, the Peterson Institute for International Economics and the Center for Strategic and International Studies, seminar on The China Balance Sheet, May 2, 2007

world's steel. According to the American Iron and Steel Institute, "Chinese crude steel production more than quadrupled in the last ten years, growing from an estimated 100 million metric tons in [1996] to approximately 420 million metric tons in 2006… the rough equivalent of building three entire American steel industries in one decade."[4]
Steel industries in more market-oriented nations, such as the United States, face great difficulties in competing against such state-directed capacity expansions. The U.S. industry has been forced to undertake large-scale layoffs and consolidation in order to remain viable, despite enjoying high productivity rates.

The global glut of steel is perhaps the most dramatic example of the pitfalls of government investment in industries that government deems strategic. The potential for repeating this in other industries exists whenever government is too heavily invested in an industry. That potential certainly exists in China in the 12 industries deemed "strategic" or "heavyweight."

Recommendations

- The Commission recommends that Congress urge the Administration to employ all necessary trade remedies authorized by the WTO rules in order to protect vulnerable portions of the U.S. economy from the unfair advantages afforded to some Chinese firms by the government's extensive subsidy regimes. These tools include anti-dumping and countervailing duty penalties as well as temporary escape clause relief.

- The Commission recommends that Congress urge the Administration to press the Chinese government to abandon its intentions to preserve a huge, state-owned corporate sector and, instead, to embrace the tenets of free market economics. The existence of a large state-owned sector of the Chinese economy is in the best interests of neither China nor its trading partners.

- The Commission recommends that Congress and the Administration pay particular attention to the activities of the state-owned sectors of China's economy. That scrutiny also should apply to China's state-directed investments from its foreign currency reserves. While foreign investment is welcome in the United States, monopoly control is not. Nor is it advisable to create government-run businesses able to use the power of government to exclude competition. China's actions should be examined in order to ensure compliance with rules governing international trade.

The transcript, witness statements, and supporting documents for this hearing can be found on the Commission's website at www.uscc.gov. We hope these will be helpful as the Congress continues its assessment of U.S.-China relations.

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[4] U.S.-China Economic and Security Review Commission, *Hearing on the Extent of the Government's Control of China's Economy, and the Implications for the United States*, testimony of Barry Solarz, May 25, 2007

Sincerely yours,

Carolyn Bartholomew
Chairman

Daniel Blumenthal
Vice Chairman

cc: Members of Congress and Congressional Staff

CONTENTS

THURSDAY, MAY 24, 2007

EXTENT OF THE GOVERNMENT'S CONTROL OF CHINA'S ECONOMY, AND IMPLICATIONS FOR THE UNITED STATES

PANEL I: CHINA'S INDUSTRIAL POLICIES AND THE 11TH FIVE YEAR PLAN

PANEL II: STATE-OWNED ENTERPRISES: VEHICLES OF INDUSTRIAL POLICY IMPLEMENTATION

PANEL III: CONGRESSIONAL PERSPECTIVES

PANEL IV: DOES CHINA'S STATE-OWNED SECTOR FOLLOW TRADE RULES?

PANEL V: CHINA'S FOREIGN DIRECTOR INVESTMENTS ARBROAD

FRIDAY, MAY 25, 2007

PANEL VI: INDUSTRY PERSPECTIVES

THE EXTENT OF THE GOVERNMENT'S CONTROL OF CHINA'S ECONOMY AND IMPLICATIONS FOR THE UNITED STATES

THURSDAY, MAY 24, 2007

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION
Washington, D.C.

The Commission met in Room 562, Dirksen Senate Office Building, Washington, D.C. at 8:30 a.m., Chairman Carolyn Bartholomew, Vice Chairman Daniel A. Blumenthal, and Commissioners Jeffrey L. Fiedler, Kerri Houston and Michael R. Wessel (Hearing Co-chairs), presiding.

OPENING STATEMENT OF CHAIRMAN CAROLYN BARTHOLOMEW

CHAIRMAN BARTHOLOMEW: Good morning, everyone. We'll start on time and hopefully our other witnesses will be joining us soon. I want to welcome you all to the Commission's third hearing this year on U.S. policy on the People's Republic of China. Today's hearing follows the bilateral Strategic Economic Dialogue in Washington, and the Commission will be taking up several issues that are in the news, which were also a subject of the negotiations.

For example, the Chinese government announced last weekend that it will be using $3 billion of its foreign exchange reserves to buy nearly ten percent of Blackstone Group, a private equity firm in the United States.

The policy change represented by this private use of China's vast hoard of $1.2 trillion in export earnings for investment in the private sector, much of it resulting from the Chinese trade surplus with the United States, will be the subject of one panel later today.

China has decided to look for other investment opportunities for the dollars it has amassed as a result of its large and growing trade surplus. We need to understand the economic and political implications of such a development.

During Vice Premier Wu Yi's opening remarks on Tuesday at the Strategic Economic Dialogue, she warned against attempts to, quote, "politicize economic and trade issues"--unquote, and said that, quote, "problems and controversies should be handled calmly and addressed according to economic law."

And yet, as we will note, many of China's economic policies are determined by domestic politics in China. Rather than allow market forces to determine the nature of China's economy, the central government is still controlling, and in some cases owning outright, vast portions of its productive capacity.

Even as China is seeking to be granted official market economy status from its trading partners, it is pursuing a policy of strict government control and ownership of important industries including telecommunications, construction, information technology, steel and aviation.

We will also be examining China's industrial policy as explained in its extensive 11th Five-Year Plan issued just last year. The Five-Year Plan is China's blueprint for a detailed industrial policy. It is most certainly a political document despite Madame Wu's protests that politics should not intrude on economic law.

China's overall approach is mercantilist; that is China tries to maximize its exports and minimize its imports without regard to the effect on its trading partners. This was indeed once an economic law in the 19th century, but it has no place in this century or among members of the World Trade Organization.

Just consider the impact on the United States of this approach. The U.S. ran a trade deficit with China last year of nearly a quarter of a trillion dollars, a third of its overall deficit with the world. Much of this imbalance with China was caused by Beijing's insistence on artificially setting the value of the RMB rather than allowing global currency markets to determine the value.

Add to this mix a wide array of subsidies meant to encourage U.S. companies to move their production to China and the harm to America's economy and its workers, caused by trade relations with China, becomes even more apparent.

China has objected recently to complaints brought by the United States to the WTO about its behavior. Specifically, the U.S. is seeking to resolve a number of discrepancies between China's WTO commitments and its performance in the areas of intellectual property protection, the use of subsidies to bolster Chinese exporters, and market access for U.S. auto parts and entertainment software.

But the leadership in Beijing should understand that by using the established WTO dispute resolution procedures, the United States has committed no slight nor undertaken any hostile action, but is simply exercising its dispute resolution rights under the World Trade Organization procedures, to which the Chinese voluntarily agreed.

Clearly, there remain significant gaps between the Chinese and the U.S. positions and the two nations should attempt to resolve their differences. But it turns out that capitalism with Chinese characteristics, which is the way China describes its evolving system, is not a free market. Rather, it is the means by which China intends to gain further economic advantage over the United States.

I'll turn the hearing over to our co-chairs, Commissioners Fiedler, Houston and Wessel, to chair the hearing. I thank them very much for all the work they did putting this hearing together, and I'll turn it over to Commissioner Houston. Thank you.

[The statement follows:]

Prepared Statement of Chairman Carolyn Bartholomew

Good morning and welcome to the Commission's third hearing this year on United States policy on the People's Republic of China.

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During the opening remarks of Vice Premier Wu Yi on Tuesday at the Strategic Economic Dialogue, she warned against attempts to "politicize economic and trade issues" and said that "problems and controversies should be handled calmly and addressed according to economic law." And yet, as we will note, many of China's economic policies are determined by domestic politics in China.

Rather than allow market forces to determine the nature of China's economy, the central government is still controlling, and in some cases owning outright, vast portions of its productive capacity. Even as China is seeking to be granted official market economy status from its trading partners, it is pursuing a policy of strict government control and ownership of important industries, including telecommunications, construction, information technology, steel, and aviation.

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Clearly there remain significant gaps between the Chinese and the U.S. positions and the two nations should attempt to resolve their differences. But it turns out that "capitalism with Chinese characteristics," which is the way China describes its evolving system, is not a free market after all. Rather it is the means by which China intends to gain further advantage over the United States.

OPENING STATEMENT OF COMMISSIONER KERRI HOUSTON, HEARING CO-CHAIR

HEARING CO-CHAIR HOUSTON: Thank you, Madam Chairman. Good morning, ladies and gentlemen, and thank you for coming to this important hearing on China's state-owned sector and its impact on the United States. My name is Kerri Houston and along with Commissioners Fiedler and Wessel, I will be co-chairing, or I guess tri-chairing, this hearing.

The Commission's mandate from Congress requires us to closely monitor the economic and security dimensions of the U.S.-China relationship. While these two elements are typically treated separately, they are not mutually exclusive. The acquisition by foreign governments of domestic companies involved in vital U.S. national security work is of particular concern.

The Committee on Foreign Investment in the United States, or CFIUS, is responsible for assessing the impact on American security of such foreign acquisitions of U.S. companies. The work of this little noticed, interagency committee, which operates beyond closed doors, bears scrutiny by this Commission and by the Congress.

Its work is essential to ensuring that our nation is able to adequately defend itself and we need to be sure that it has the tools and the direction it needs to do its important job. Chinese investment into the United States has grown slowly in recent years, but is expected to increase dramatically as China begins to diversify its vast dollar holdings from government bonds to equities and perhaps even outright ownership of American assets.

Recent acquisition activities by Chinese firms such as Lenovo, Haier, and Chinese National Offshore Oil Company demonstrate that Chinese firms are beginning to recognize the power of U.S. brand names and assets.

In addition, Beijing will soon seeking new investment opportunities for its $1.2 trillion in foreign currency reserves. A new state-run investment institution is being established that could ultimately control up to $400 billion. The specifics of how and where these funds will be invested have yet to be determined by the Chinese government, but it's imperative that the United States government keep a very watchful eye on these new transactions.

I look forward to our two-day hearing and want to thank all of our panelists for joining us and turn it over to Commissioner Fiedler for additional remarks.

[The statement follows:]

Prepared Statement of Commissioner Kerri Houston
Hearing Co-chair

Good morning ladies and gentlemen and thank you for coming to this important hearing on China's state owned sector and its impact on the United States. My name is Kerri Houston and, along with Commissioners Fiedler and Wessel, I will be co-chairing this hearing.

The Commission's mandate from Congress requires us to closely monitor the economic and security dimensions of the U.S-China relationship. While these two elements are typically separate, they are not mutually exclusive. The acquisition by foreign governments of domestic companies involved in vital U.S. national security work is of great concern.

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I look forward to our two-day hearing and want to thank all of our panelists for joining us.

OPENING STATEMENT OF COMMISSIONER JEFFREY FIEDLER HEARING CO-CHAIR

HEARING CO-CHAIR FIEDLER: Thank you. Good morning. I am one of the co-chairs of this hearing. The Commission's interest in state-owned enterprises arises from several concerns. As you've heard, China's intent to retain ownership of a very large portion of its economy contradicts the spirit of the WTO and calls into question its stated goal of moving toward a market-oriented economic system.

But the central government's plans do more than just signal a lack of faith in free market. They also betray a cynical approach to international trade in which the object is to gain advantage over competitors by means fair or sometimes foul, or perhaps inherently foul.

As we already know, subsidies play a large role in China's economy. Low interest rate loans from state-owned banks, loan forgiveness, free land, tax rebates, discounted energy, lax labor and environmental enforcement policies have all created a massive export machine and attracted transnational corporations to move their jobs to China.

The creation of national champions among favored industries will only encourage more subsidies from the Chinese government. China's mercantilism has a profound effect on workers in the United States. As we will hear from representatives of two industries tomorrow, aviation and steel, jobs have already been lost and that loss will likely accelerate.

We'll also hear from a panel on China's foreign investments abroad. China is sitting on the largest pool of foreign exchange ever assembled by a single government, $1.2 trillion, and it appears, some estimates are that it will rise to about $1.7 this year.

This is a large enough sum to purchase nearly nine percent of the stocks in the S&P 500. We know of China's plans to move out of its investments from dollar-denominated bonds into equities only through press reports about the formation of a as of yet unnamed government investment arm. That and its announcement last week that it will purchase $3 billion stake in Blackstone shows the growing change in Chinese foreign investment policy.

Finally, please take note that tomorrow's hearing will begin at 10 a.m. in a different room, Room 385 Russell on the Hill, where we will hear from representatives and experts from the U.S. steel and aviation industries.

Thank you.

[The statement follows:]

Prepared Statement of Commissioner Jeffrey Fiedler
Hearing Co-chair

Good morning and welcome. My name is Jeffrey Fiedler. I am one of the co-chairs of this two-day hearing.

The Commission's interest in state-owned enterprises arises from several concerns. As you have heard, China's intent to retain ownership of a very large portion of its economy contradicts the spirit of the World Trade Organization and calls into question its stated goal of moving toward a more market-oriented economic system.

But the central government's plans do more than just signal a lack of faith in free markets. They also betray a cynical approach to international trade in which the object is to gain advantage over competitors by means fair or foul. As we already know, subsidies play a large role in China's economy. Low interest rate loans from state-owned banks, loan forgiveness, free land, tax rebates, discounted energy, lax labor and environmental enforcement policies have all created a massive export machine and attracted transnational corporations to move their jobs to China. The creation of "national champions" among favored industries will only encourage more subsidies.

China's mercantilism is having a profound effect on workers in the United States. As we will hear from representatives of two industries-- aviation and steel--jobs have already been lost and the loss will likely accelerate.

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Finally, please take note that tomorrow's hearing will begin at 10 am in a different room—Room 385 Russell where will hear from representatives and experts from the U.S. steel and aviation industries.

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

HEARING CO-CHAIR WESSEL: Thank you. I will ask that my written statement be made part of the record and I'll dispense with reading that so that we can get right into the panel.

The hearing today will begin with a broad assessment of China's overall industrial policies, China's 11th Five Year Plan, and the implications of China's planned economy for the United States.

We're pleased to welcome two distinguished experts to share their thoughts on these issues. Dr. Barry Naughton--and thank you for being here; we know it's been a trial getting all of this arranged--is a professor at the San Diego campus of the University of California's

International Relations and Pacific Studies Graduate School.

Dr. Naughton is an authority on the Chinese economy with an emphasis on industry, trade, finance, and China's transition to a market economy. Dr. Naughton recently published a book entitled, "The Chinese Economy: Transitions and Growth."

Mr. Clyde Prestowitz, a good friend, is a founder and President of the Economic Strategy Institute here in Washington, D.C. As a former trade negotiator, Mr. Prestowitz played a key role in the development of NAFTA and in shaping the final context of the Uruguay Round of the World Trade Organization.

He regularly writes for a variety of newspapers, is the author and co-author of several books on China and Japan, and received his M.B.A. from the Wharton School. His latest book is Three Billion New Capitalists: The Great Shift of Wealth and Power to the East.

Gentlemen, thank you for testifying today. We look forward to your remarks. The normal Commission rules are that we ask that you limit your oral statement to roughly seven minutes. We will make any prepared comments a part of the record and then we will have rounds of questioning from the commissioners, hopefully time for some follow-up questions as well. Dr. Naughton, we'll begin with you.

Thank you.

[The statement follows:]

Prepared Statement of Commissioner Michael R. Wessel Hearing Co-chair

Good Morning and thank you for coming.

When China joined the World Trade Organization in 2001, it became a member of a group whose purpose is to promote free and fair trade among nations. There are rules to follow -- often detailed rules -- on such issues as the protection of intellectual property, export subsidies, and many other issues. But the overall point of membership in the WTO is to advance a free market approach to international trade. That's the concept.

But as we shall see today, that's not necessarily the reality for China. The central government is determined to carefully control large segments of the Chinese economy. These favored sectors will remain under government control and will be the beneficiaries of a variety of governmental support programs and policies. China will be the home of "national champions" or mega-companies created from the strongest of the tens of thousands of state-owned enterprises. Just as the central government has already recapitalized its four largest banks with government funds and subsidies, it apparently now intends to create and subsidize global competitors while maintaining central government control.

Today's hearing occurs against the backdrop of the bilateral US-Chinese Strategic Economic Dialogue. Regrettably, the SED appears to have, once again, resulted in no significant breakthroughs to address the problems that exist in our bilateral relationship. The topic of this hearing is one that demands immediate attention.

We'll be hearing from a number of experts on the likely effect of these policies and from some members of Congress with businesses and workers in their districts who are already being affected by China's mercantilist policies.

We will also hear from a panel of experts in international trade law on the implication of China's continued refusal to adopt free market and fair trade principles.

PANEL I: CHINA'S INDUSTRIAL POLICIES AND THE 11TH FIVE YEAR PLAN

STATEMENT OF DR. BARRY NAUGHTON, PROFESSOR, GRADUATE SCHOOL OF INTERNATIONAL RELATONS AND PACIFIC STUDIES, UNIVERSITY OF CALIFORNIA, SAN DIEGO, CALIFORNIA

DR. NAUGHTON: Thank you. It's an enormous pleasure to be here, a pleasure and a great honor as well. I have a prepared statement that I'd like to submit to the record.

Let me just pull out a couple of points from the statement to help us approach the very important issues that will be under discussion throughout today and to tomorrow.

As we try and understand the role of the Chinese government in the Chinese economy and furthermore in the world economy, it seems to me there are two aspects that we should highlight and give a special attention to. The first is the role of Chinese government ownership and the second is that of planning. When we look at ownership, of course, the broad context certainly is the steady shrinkage and withdrawal of government ownership in the Chinese economy.

The overall state-run enterprise sector reached its peak a little over a decade ago. There was at one point slightly over 70 million workers working for Chinese government enterprises. Today it's just a little under 40 million. That includes all of the companies in which the Chinese government has a controlling stake.

So it's down considerably. There is no question that the Chinese government has moved significantly in the direction of a market economy, but still 40 million workers is a lot of workers, and the corporations that make up the Chinese state sector are still a formidable group of companies. In particular, I focus on the 159 companies that are controlled by the central government through its ownership agency, SASAC, the State Asset Supervision and Administration Commission. This represents the core of the state sector today.

When looking at the state sector, one should note a few things above all else. Number one, these firms are primarily what we would think of as natural resource, utility, and defense industry firms.

These five sectors, oil, metallurgy, electricity, telecom and military industry, represent about two-thirds of the labor force and three-quarters of the capital in this state sector core. As such, we really want to pay attention to this core. It's very important, but we should also recognize that these are not the firms that create the exports and the trade that is such an important source of imbalance in the Chinese relation with the world as a whole and, of course, specifically in U.S.-China relations.

In fact, all of these firms produce less than four percent of China's total exports. Foreign-invested firms in China, by contrast, produce 60 percent of China's exports, and in the crucial high-tech sector, foreign-invested firms produce 87 percent of the high-tech exports coming from China.

So the companies in the state sector are important but not because of their direct impact on the trade relation with the United States. Well, why are they important then? Well, of course, they're important for a number of reasons. First, these are the key actors that drive the high investment, rapid expansion of infrastructure inside the Chinese economy.

In essence, the investment policy of China is delegated to these corporations. They're powerful and they're in protected markets. Typically, these firms are in a kind of artificially structured market environment where two or three of these large government firms compete against each other to a certain extent, but of course are protected against competition by new entrants, whether they're private domestic Chinese firms or foreign firms.

Given this protected market, these firms are extremely profitable. 159 firms under SASAC earned profit last year that was equal to 3.6 percent of Chinese GDP, quite a healthy sum of change. Moreover, they're fairly non-transparent, in the sense that there's a tier of ownership in corporations here. At the bottom we see subsidiaries of these firms that are often listed on the Chinese stock exchange. Clearly, these are businesses. They're market-oriented. At the top, there's the government, clearly not a business. It's exercising policy. But in the middle, we have these large powerful and wealthy corporations that are a little bit government, a little bit market, and have mixed motives that affect how they operate in many different respects.

Now, that's the most important piece of the ownership story. When we look at planning, we find a very different kind of story. The most important planning initiative recently has been the 11th Five-Year Plan. It's a very important plan, but I must say it is not the traditional type of industrial policy that we've come to expect in some other East Asian developing countries.

Stripped to essentials, the plan, it's really more like a vision statement than it is a specific plan. It calls for a shift in the development model away from an over concentration in resource and energy-intensive industries and towards a more knowledge-intensive and environmentally friendly path.

It places a great deal of stress on education and social services, particularly on the improvement of those services in the countryside. So the 11th Five-Year Plan really is almost a self-critique of the excessive emphasis on industrialization that has characterized Chinese policy over the last two decades. China has many important ideas and the one thing we would have to say about it is it doesn't have very many good ideas about exactly how to implement these strategic long-run objectives, what instruments can be used, and what policies to approach.

In fact, when we look at some of the ways where planners underneath the top of the government seek to flesh out this plan and seek to make it reality, we find that perhaps the most relevant area is in the area of technology development.

There are now two important technology development plans. One is the long-run plan that goes through 2020, and the other is now a five-year sectoral program that's supposed to combine these two long-range plans.

And the quick take-away from these plans is the Chinese government is now going to substantially step up the amount of money that it invests in research and development, the activity of the government in using procurement to foster a high-technology sector in China, and the flow of resources from the government to subsidize credit through the policy bank system in particular.

We will see offshoots of this in, for example, the development of civilian aircraft and research into very large integrated circuits in particular.

One thing we can say, though, is this is a long-range plan that has the government primarily investing in research and shaping market demand at the end of the tunnel. It's not a plan that relies on the creation of national champions that would be expected to be the flagships for this development in China and outside China. It's a complex set of objectives and, overall, the last comment is to say when we look at the state sector and the planning apparatus in China, what we see is an extremely complex fragmented set of organizations that are simultaneously trying to achieve many different objectives with limited instruments and, in many cases, a significant disconnect between what they're trying to do and what they're actually getting done.

So we need to monitor these developments very, very closely, but also be aware of the complexities and shortcomings of these efforts on the part of the Chinese government.

Thank you.

[The statement follows:][1]

HEARING CO-CHAIR WESSEL: Thank you. Mr. Prestowitz.

STATEMENT OF MR. CLYDE PRESTOWITZ, PRESIDENT, ECONOMIC STRATEGY INSTITUTE, WASHINGTON, D.C.

MR. PRESTOWITZ: Thank you, Mr. Chairman, and I also want to thank the Commission for the invitation and opportunity to speak.

Let me briefly make three or four points. The first one is that it's important to recognize, as I think the Commission does, that China and the United States are playing two different games. The U.S., we might say, is playing soccer and China is playing football. The games have some similarities. They're both played with a ball; people run around the field. But one game is a lot rougher than the other one, and in one game the players wear pads and helmets and the other one they don't.

This is not a new phenomenon. We've seen this before. China has chosen actually to play a game that's played by many other countries in the world today and previously. And the essence of that game in economic terms is that the market is a tool rather than an end in itself. That is to say that the objective of the game is economic development. The objective of the game is to be a leader in key industries, to be at the cutting edge of key technologies, and the market is used as a tool to get there, and if the market can get you there, great. However, if the market by itself can't get you there, then the players of this game will use other means to aid the market to get there.

This, of course, is at variance with what we in the U.S. tend to think of as market capitalism. But it's not a new phenomenon. It's not unique to China.

A second key point I'd like to make is that just taking off from Dr. Naughton's statement, all of these economies in Asia are characterized by very high savings rate. So China has about a 50 percent savings rate. Singapore has about a 50 percent savings rate. Taiwan is around 30 or 40 percent. Even Japan, one of the world's richest countries, has a very high savings rate.

Very strong incentives are built into these economies to save, and in the case of China, one of the aspects of this is the state-owned enterprises and the government-linked enterprises, which as Dr. Naughton said operate without much transparency and have become reservoirs of retained earnings.

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[1] Click here to read the prepared statement of Dr. Barry Naughton

So the interesting aspect of the Chinese economy is that the savings is not so much in the household sector. You read articles frequently talking about China has a high savings rate because there's no safety net and there's no health care and people have to save to take care of these kinds of problems in their lives, and they do, but that's not where the savings is.

The savings is in the corporate sector where the protected enterprises and the guided enterprises operating under or with the support of state elements have become very profitable. They have no requirement to pay back dividends or returns to shareholders and so have begun to just reinvest. And so as you know, half of every dollar spent in China is spent on a new factory, and as a consequence, China is building enormous excess capacity which, in my view, inevitably, will lead to a crisis at some point down the road.

The third point I'd like to make is that China has adopted a variant of the export-led strategy that we see so much in Asia and in other parts of the world. It's a variant which welcomes foreign investment and because it welcomes foreign investment, it appears to be rather open and in many respects it is, as compared to, say, the Korean variant or the Japanese variant, in which foreign investment was held at arm's length.

But because China is so big, because the market is so potentially attractive, and because the Chinese system is non-transparent and not based on the rule of law, and certainly not democratic, the consequence is that, on the one hand, foreign companies, multi-national companies are anxious to be in China to take advantage of the potential opportunity, and also subject to guidance, informal suggestion, from Chinese authorities.

And so in an interesting way, the CEOs of global companies have become more responsive to the policy thinking and the desires of governments in Beijing than, for example, in Washington. In Washington, a major CEO is a player. You all know when the head of a major company comes to Washington, the doors are open. They have PACs. They spend money. They have legions of lawyers and lobbyists. They write legislation which appears eventually before the Congress.

In Beijing, they are supplicants. They kowtow just like everybody else. And so one consequence of the combination of China's size and the game it has chosen to play is that in a sense, to a significant extent, Chinese industrial policy is shaping not only China's economic and trade decisions, but also those of the U.S. and of other major countries.

The final point I'd like to make is that this is very difficult to deal with in conventional terms. We all struggle with how to respond and the language of that struggle tends to be pejorative. It tends to be they're being unfair; they're cheating; we have to retaliate or impose sanctions.

But the problem is that what they're doing is not so easily categorized. They're not doing anything Japan didn't do. They're not doing anything that Israel doesn't do or Ireland, and many countries in the world have adopted this game.

Now, we can argue that elements of this game are at variance with the rules of the WTO, and I believe they are, but we've never challenged that. We've never challenged in the case of Japan or Korea or Taiwan or Israel or Ireland or any of the other guys who play this game. And so by dent of precedent, the Chinese are in a position to argue that, "What are you talking about? We're just doing what people do when they're trying to develop their economies."

And so my view is that until we recognize that this is not a matter of unfairness in the steel industry or cheating in the semiconductors, this is a matter of a whole different philosophical approach to economic development that the United States for reasons of ignorance and naiveté and geopolitics has chosen to ignore and we need, I think, to begin to recognize it on a very broad basis.

Thank you.

[The statement follows:]

Prepared Statement of Mr. Clyde Prestowitz, President, Economic Strategy Institute, Washington, D.C.

For most of the last 50 years, globalization has been a win-win proposition, making America richer while lifting hundreds of millions in the developing world out of poverty and despair. Recently, however, it has begun to operate differently, undermining U.S. welfare while creating imbalances likely to end in a global economic crisis.

In this new mode, globalization is tilting the world like a giant sliding board game on which the "flattening" of old barriers is accelerating the transfer of the supply side of the U.S. economy to the rest of the world, especially Asia. Take Boeing as an example. Long America's leading exporter, it symbolizes the kind of high-tech leadership on which the future of the U.S. economy is widely said to depend. After losing market share to the European Airbus in recent years, Boeing responded by developing the new 787 Dreamliner, which is gathering record orders. Yet these sales may not add a lot to the U.S. economy because much of the work—including production of the critical carbon-fiber wings that Boeing always insisted would be kept at home—will be done in Japan.

Even more telling is the example of the semiconductor king, Intel. When economists and political leaders say American industry should concentrate on producing very-high-technology products where it has a clear comparative advantage, Intel's chips are what they have in mind. Yet company executives recently told a presidential advisory panel that under present circumstances they must consider building more of their new factories abroad. Over the next 10 years, they explained, the cost of running a semiconductor factory in the United States could be $1 billion more than that of running it abroad.

That there is something odd here is not yet widely acknowledged. Indeed, most business, academic, media and political leaders continue to insist that globalization is proceeding smoothly, making the world rich, more democratic and more peaceful. President Bill Clinton called globalization America's strategy, and President George W. Bush describes the American economy as the "envy of the world." Nor is this view entirely unjustified. U.S. GDP and productivity growth are the highest in the developed economies, while inflation, unemployment and interest rates are among the lowest.

Nevertheless, a closer look reveals a dark side. The U.S. trade deficit is now more than $800 billion, or 7 percent of GDP, and grows inexorably as Americans continue to consume more than they produce. The trade imbalance is of unprecedented size and breadth. Economists typically expect the United States to import commodities and cheap manufactured goods while exporting high-tech products, sophisticated services and agricultural goods, for which its land and climate are well suited. In reality, the U.S. high-tech trade surplus of $30 billion in 1998 has collapsed to a deficit of about $40 billion. Agricultural trade is now also in deficit for the first time in memory, and the modest surplus in services is declining as global deployment of the high-speed Internet has made it possible for services to move offshore as easily as manufacturing. In short, U.S. exports are declining versus imports across the board, while its growth depends on foreign lenders (primarily in Japan and China) to finance the excess consumption.

Two factors explain these unexpected trends. The first has been at work for a long time. It is the gradual construction of the global economy in an asymmetrical form. For the United States, globali-zation has meant building its economy into a giant consumption machine. Easy consumer credit, home-equity loans with tax-deductible interest payments, markets largely open to imports, policies that emphasize growth through demand management and accommodative monetary policy, and myriad other incentives have led Americans to save nothing while both households and government borrow at record rates. This is often justly criticized as excessive. But it is important to understand that American buying drives most of the world's growth because the United States is virtually the only net consuming country in the world.

Globalization for most others has meant export-led growth. Particularly in Asia, "catch-up" development policies have focused on creating production and export machines. There are many flavors, but most Asian economies are characterized by relatively low consumption, savings rates of 30 to 50 percent of GDP, government intervention in markets, managed exchange rates, promotion of investment in "strategic" industries, incentives for exports and accumulation of chronic trade surpluses along with large reserves of dollars.

Indeed, the dollar is the key to this whole lopsided global structure. The dollar, of course, is not only America's money, but also the world's primary reserve currency. As long as others will accept it in payment, America can buy and borrow without concern for saving, investment or production. Thus, deficits—whether trade or budgetary—really don't matter and America can get away with fiscal irresponsibility. Oddly, the rest of the world can be just as irresponsible. By managing exchange rates to keep the dollar overvalued and their export prices low, other countries can oversave and overinvest because the excess production can be exported to the U.S. market.

This structure has grown for so long because it has great benefits for both sides. America gets to live above its means, as cheap imports and foreign capital keep inflation and interest rates down and home values rising. The rest of the world, especially Asia, gets to climb the ladder of technology faster than it would otherwise. By accumulating dollars, Asia also gains strategic leverage over the lone superpower—which, by outsourcing management of the dollar, has ceded a degree of control over its own long-term interest rates.

There is a downside, however. By keeping the dollar chronically overvalued and providing investment subsidies to attract strategic industries out of the United States, the Asian export-led-growth approach has long tended to shrink U.S. productive capacity. For some time, this was true mostly of commodity manufacturing, and the significance of the trend was discounted with the rationale that the U.S. economy was moving to the "higher ground" of high-tech and sophisticated services.

This argument was never entirely satisfactory because of the exchange-rate management and the investment subsidies used by export-led-growth countries to attract high-tech production to their shores. For instance, Boeing is outsourcing much of the 787's construction to Japan in part because an overly strong dollar reduces yen-based costs, and in part because the Japanese government will provide production subsidies unavailable in the United States while "encouraging" Japanese airlines to buy the planes if the work is done in Japanese factories. For Boeing, this is all of critical importance as a way to offset the launch subsidies provided by the EU to archrival Airbus.

But if it was always flawed, the argument is now in tatters in the face of the second aforementioned factor: the entrance into the global economy of China and India. Not only do they offer low costs, which the strong dollar further reduces, but—contrary to common assumptions about developing countries—significant portions of their populations are highly skilled. They can thus be competitive across the entire range of manufactured goods and services. The negation of time and distance by the Internet and air-express services makes this all the more true.

Further, the potential size of these markets attracts investment in anticipation of growth, even if the initial production cost is not fully competitive. This is particularly true of China, where national pride and an authoritarian government willing to offer large investment incentives create an environment in which foreign companies are encouraged to engender "trust" by transferring factories and technology to China, regardless of the fact that the comparative cost advantage lies elsewhere.

This, combined with the asymmetric global economic structure, is why the U.S. trade balance is collapsing even in advanced-technology products and serv-ices. The growing trade imbalance, in turn, makes the current mode of globalization unsustainable. To finance the deficit, the United States is already absorbing about 80 percent of available world savings. The value of U.S. imports is now more than double that of exports. To merely stabilize the deficit at its current rate would require that exports grow more than twice as fast as imports.

But this cannot happen if the supply side continues to move offshore. If it doesn't happen and the deficit keeps growing, world savings will eventually be insufficient and a financial crash will be inevitable. Of course, U.S. consumption and imports could be cut, but if that were to occur without a commensurate increase in consumption elsewhere, the whole world economy would suffer recession, if not depression.

Some economists speak bravely of a "soft landing." In this scenario, the United States reduces its budget deficit and excess consumption, while a gradually falling dollar results in rising exports to foreign markets where governments are stimulating consumption. While desirable, this will not occur automatically. Interest groups in all the key nations will defend the status quo.

UNFAIR TRADER?

China and East Asia play by different rules

To show it means business with Beijing on trade, the Bush administration recently threatened duties on imports of some Chinese paper and formally charged China with violation of World Trade Organization rules. The reaction has ranged from euphoric predictions of a reduction of the Himalayan U.S. trade deficit to warnings of a disastrous trade war. In fact, neither will occur because the White House measures are not new, not tough and not relevant.

A U.S. trade negotiator in the Reagan administration, I am familiar with this old ritual. In the background is the U.S. trade deficit that is setting new records and is especially large with a particular country – yesterday Japan, today China. Imports from these countries and elsewhere are flooding the American market, causing complaints of “unfair trade” from U.S. companies and workers losing business and jobs.

The administration – Republican or Democratic, makes no difference – emphasizes the benefits of “free trade” and the dangers of “protectionism” and pledges to “open” the offending foreign market to competitive U.S. exports while also monitoring for any violation of trade rules. A high-level bilateral dialogue on trade, currency and broader economic issues is launched with the big surplus country. The

Americans urge their partner to abandon currency manipulation and other strategic practices and to further “liberalize” markets for the good of their own economy. The talks go nowhere as the partner country blames the problems on lazy, incompetent American companies and U.S. policies that result in excess consumption and negative savings.

Congress and the administration then do a dance within the dance. Some congress persons threaten trade-restrictive legislation if the trading partner doesn't shape up. The administration publicly condemns such “protectionist” talk but privately urges Congress to keep it up as a way of providing leverage to U.S. negotiators who warn their dialogue partners of possible dire acts by the “crazies” in the U.S. Congress if the foreign market is not opened satisfactorily.

Some congressional members, however, mean it, and there is usually some just completed Free Trade Agreement that needs ratification by Congress. With the high-level dialogue going nowhere, the administration du jour announces some formal trade complaint or the imposition of some countervailing duty to stop dumping or some other infraction. This sounds tough and the trading partner obligingly howls as if in pain and hints at possible trade war. The items involved, however, are a trivial part of overall bilateral trade and there is no possibility of trade war because that's the last thing either side wants. The real objective of the whole exercise is to buy time and get the trade agreement passed by Congress while “market forces” hopefully operate to correct the effects of the imbalances: closed factories, and lost jobs.

Thus are the recent White House statements and actions not new. Nor are the Chinese necessarily being unfair, and even if they were the proposed measures will amount to no more than pin pricks in the overall context. So it is misleading to talk about being tough. Most important, however, is the fact that whatever is done will in no way change the situation that increasingly threatens the long-term health of the U.S., Chinese and global economies. The reason is that the whole process is based on false premises and a profound error of conventional economic wisdom. The trade negotiators are busy discussing the last war even as weapons of mass destruction are about to explode.

U.S. negotiators always assume that WTO-member countries are playing the same free-trade game as the United States. That game focuses on maximizing consumer welfare, it allows the dollar's value to float in response to currency markets, seeks market-based results as ends in themselves, has Americans saving nothing while they consume more than they produce, and preaches specialization of production based on what a country's resources enable it to do best while trading for the rest. As one top U.S. economist has said; “potato chips, computer chips. What's the difference? They're all chips.”

In fact, this is not at all the game China, Japan, Korea, Ireland, Israel, Taiwan and many others are playing. Their focus is production and technological “catch-up,” not consumption. They compel their citizens to save at very high levels, pursue export-led growth, foster development of target industries such as semiconductors, aim to accumulate large trade surpluses as a matter of national security, use markets as tools rather than as ends in themselves, and strive to change their resource endowment in order to achieve broader ranges of production and targeted economic structures. They see a big difference between computer chips and potato chips.

While Americans often see this kind of “strategic trade” as unfair, it is important to emphasize that this is the Asian miracle formula and that it has long been accepted as fitting within the technical rules of the WTO. So it is not always clear that there is unfairness. But for sure the two games are quite different. In effect, the Americans are playing soccer while the others are playing football. None of the teams is playing its game unfairly. But the football players have helmets and pads and love to hit each other while the soccer players are nearly naked and try to avoid contact.

Not only is the same-game premise false. So is another set of economic premises. Conventional U.S. trade doctrine is based on the theoretical assumption that most markets are perfectly competitive, that economies of scale are non-existent or largely unimportant, that labor, capital and technology don't easily cross borders, that market entry and exit are essentially costless, and that currency values are not strategically managed. On the basis of these assumptions, conventional economic wisdom holds that if countries subsidize their industries, engage in dumping, or protect their home markets, they are only hurting themselves. The proper reaction is thus deemed to be to avoid retaliation in favor of persuading them to open their markets.

Most of these assumptions obviously are wrong. Recent work by former IBM chief scientist Ralph Gomory and Nobel Prize-winning economist William Baumol has demonstrated that in today's real world, the industrial and currency management and other market-distorting policies of an American trading partner can be very damaging to the long-term health of the American economy as well as to the world economy. Economies of scale, rapid technological change and instant mobility of technology, capital and, increasingly, even labor change the situation dramatically.

As a result, the combination of the soccer/football games in the current mode of globalization is moving American providers of tradable goods and services off-shore. Manufacturing as a percent of U.S. gross domestic product has fallen from about 20 percent to 11 percent of GDP in the past 15 years. Recently, high-tech services and R&D have also begun to move abroad. This could be harmful to long-term U.S. productivity. It is also helping to create an unprecedented trade deficit that has now reached 7 percent of the American economy's total annual output of goods and services, the U.S. gross domestic product.

At the same time, China and the other countries of East Asia have accumulated nearly $3 trillion in hard-currency reserves. The United States has become the world's biggest debtor nation and the health of its economy is dependent on constant and growing lending from Asia to finance the trade deficit. Both sides are locked in an unsustainable embrace. Americans cannot indefinitely spend more than they earn and Asia will not be willing indefinitely to accumulate American paper. Both former Federal Reserve Chairman Paul Volcker and Warren Buffett have warned of the high risk of a global crisis that could make the Great Depression look like child's play. If and when the crisis comes, China and the United States and many others would all suffer damage. One can argue about who would suffer the most, but the real issue is how to prevent the crisis.

For starters, currency management by East Asia (not just China) has to stop. The dollar will have to be devalued by 30-50 percent against most of the East Asian currencies. Ideally that could be achieved through negotiation, but if not, Washington might consider seeking action from the WTO to identify chronic currency undervaluation as an illegal export subsidy or as a nullification and impairment of tariff concessions.

By the same token, the subsidies and tax incentives widely used in both Asia and Europe to entice companies to invest in particular countries must be disciplined along the lines that already exist for export subsidies, and Washington could request similar action by the WTO. Cartels and buy-national policies are common in much of the world and U.S. negotiators should also seek to have the WTO classify them as illegal and subject to sanction.

If the United States cannot obtain adequate action from the WTO and the International Monetary Fund, it might consider declaring a balance of payments emergency under WTO rules. This would enable U.S. authorities to impose temporary measures aimed at achieving adjustment in the trade deficit.

At the same time, Washington should undertake to balance the federal budget, match foreign investment incentives, and reverse American incentives for saving and consumption by such steps as a curtailment of the tax deduction for interest paid on home equity loans and the introduction of a reverse income tax that would progressively tax consumption instead of income.

This won't be easy but if we don't do it now, the markets will do it for us later in what could be the biggest crash of all time.

Panel I: Discussion, Questions and Answers

HEARING CO-CHAIR WESSEL: Thank you, both. I'm going to start with a couple of questions. Thank you for the in-depth work you've done over many years. I've read through both of your works.

Dr. Naughton, you talked about how much of the Chinese state involvement or state control is concentrated in a couple of industries; yet, in December, SASAC had a much broader statement which included aviation. It also included the heavyweight industries, autos, et cetera.

When one looks and talks to many of our industries: auto, et cetera, there seems to be substantial amount of guidance in terms of development of certain sectors, et cetera. Could you talk for a moment about the second tier, if you will, which was machinery, autos, information technology, how state involvement, state control, is evidenced there? Mr. Prestowitz, whatever guidance information you have on that as well, please.

DR. NAUGHTON: Sure. You're absolutely right, Commissioner. The SASAC in the latter part of 2006 laid out seven sectors including civil aviation where it felt that--it declared that state ownership should be retained, which I think is definitely a step backwards. It basically describes the status quo in terms of the sectors where precisely this kind of market structure that I was describing already exists. So the sectors are oil, electricity, defense industry, telecom, air transport and ocean shipping.

The odd thing was they included coal on this list, and coal actually has many small-scale private mines throughout China. So most of that is troubling because it indicates a lack of willingness to continue with the trend of diversification and privatization, but it doesn't represent much change from the present.

In the other sectors, we will really need to watch carefully the most recent trend of industrial policy. There clearly has been a worrisome tendency towards kind of nationalistic declarations that both in steel, cement, and construction machinery has laid out explicit policies restricting the right of foreign companies to essentially take over, be they friendly or hostile in intent, companies from these sectors.

These are not direct violations of the specific commitments to the

WTO, but they are clearly violations of the spirit of the WTO. They are inconsistent, but we should say that they are also extremely controversial within China. I would not characterize these as being settled policy yet. Many people are opposed to them.

I would characterize this really as a kind of power grab by the National Reform and Development Commission which is seeing an opportunity to increase its influence. We should watch this carefully.

HEARING CO-CHAIR WESSEL: Clyde, any comments on that?

MR. PRESTOWITZ: Yes. I would just elaborate a little bit on a point he made about nationalism. I think that we should not underestimate the role of nationalistic feelings. Moreover, this is not limited to China. I think one of the things that we have never fully taken into consideration is that many of these countries, and particularly in Asia, were formerly subject to colonialism. There remains a very, very strong sense of catching up or surpassing former colonial masters, and showing that they can do these things too.

So I think the sense of nationalism is particularly strong in China, and I think that it expresses itself partly in the ways that Dr. Naughton commented upon. However, in my experience, these feelings have affected policy even more subtly and in some ways more powerfully. For example, let’s say that I'm associated with companies that have made or are considering making investments in China. Frequently part of the motivation there is that the companies are recipients of a barrage of informal comments and suggestions from the Chinese government along the lines of, “Gee, shouldn't you, Mr. Company, be contributing to the development of China, and why are you withholding technology?” Or you need to have a good reputation in China, and how do you get a good reputation? Well, you do that by transferring technologies.

So there's a lot of informal pressure brought to bear here to assure that China catches up and becomes a leader in what they identify as critical areas. You can argue as to whether they're critical or not, but in their minds, they're critical. Again, let me emphasize, this is not unique to China.

HEARING CO-CHAIR WESSEL: Commissioner Houston.

HEARING CO-CHAIR HOUSTON: Thank you very much and thanks to both of you for great presentations. I have a question that goes to the sort of overall industrial policy and the SOEs as far as the environment in which they operate, and sort of their level of structure of control.

We hear a lot during our hearings about the difference between command and control from Beijing versus regional interference or efforts to control that which is directed to be controlled by Beijing. So I wondered how the central versus regional picture shakes out in the SOEs. Are they all absolutely under central control from the government or do they have regional applications and interferences from those bureaucrats at the regional level. How would that affect the banking, the gifts from the state and all the things that make SOEs more profitable in China?

DR. NAUGHTON: Yes, that's a great question. I've focused on the central share because I think that's where the issues that we're most concerned with really come into play, and these are issues where national government interests start to get reflected through the chain of command.

There are still lots of local government-run SOEs, but two things are different. One is that sector has been shrinking more steadily; whereas we can say the central sector seems to be stabilizing in these market-power sectors.

As far as we can track, the local sector state enterprises seem to be steadily being privatized and transformed. Even when they're retained under local government control, the way we think of them is--not to say it's without issues; there are still lots of issues--but the local government officials act more like entrepreneurs. They're in it more for money, job creation, and local economic development. So they can be hard to deal with sometimes, but they act more like big politically connected businesses than they act like governments.

HEARING CO-CHAIR HOUSTON: Mr. Prestowitz, did you have anything?

MR. PRESTOWITZ: No.

HEARING CO-CHAIR HOUSTON: Okay.

HEARING CO-CHAIR WESSEL: Commissioner Blumenthal.

VICE CHAIRMAN BLUMENTHAL: Thank you very much, both of you, for your testimony and for your great work on these topics. I've been following closely for years.

I have a question for Dr. Naughton. In your testimony, when you talk about the state retaining absolute control in one of the critical areas, you mention the defense industry. It seems to me that in some ways we sometimes miss the story, the picture, when we discuss the defense budget and so forth. It seems like the big story is the major changes in the structure of the defense industry.

And you mention in absolute control: defense, telecom, air transport and ocean shipping, all of which can actually spin on to the defense industry. Then you also mention the high technology and science and technology plans, and those, too, seem to me can have significant spin-on effects.

Also, you walked us very nicely through a story about a jet engine that China wanted to get and how it was able to do so through specific policies. I guess my question is, if you can give us a little bit more of a picture of the new structure? Will the military be able to buy off-theshelf types of items from high technology companies? Are the research labs going to be servicing military as well?

You know the shipyard or aviation industry, are they going to be serving dual-use purposes? It seems to me that there is a major transformation going on inside the defense sector or what we normally wouldn't even think of a defense sector. I wonder if you could comment on that.

DR. NAUGHTON: Yes, sure. First, let me say I'm certainly not an expert on defense industry and a great deal of what I know I've learned from my colleague Tai Ming Cheung, who perhaps you would be interested in getting up here to talk more specifically about these issues.

VICE CHAIRMAN BLUMENTHAL: Yes.

DR. NAUGHTON: But in the defense industry, rather like as in other aspects of technology policy, the Chinese have looked back over what they've done over the last couple decades and they've realized that many of their initiatives have failed. Moreover, in the defense industry, the record of the '80s and early '90s was pretty bad from their standpoint.

So they have looked a lot at the U.S. and a lot at Japan, and they've recognized that they would be much better off with a vastly stronger civilian capacity that would strengthen their dual-use capabilities. So, in other words, security considerations unquestionably are very important in their minds and they've recognized that a sealed off, you know, top-down command and control defense industry structure just isn't efficient enough to give them the kind of technological and security output that they want.

So they've moved towards a much more open structure. There are a few important non-state- owned firms that have enough of a capability in high-tech sectors that they can start to provide dual-use items to military procurement people. Their hope is that their military industrial sector will evolve to become more like that of the U.S. and Japan so that they'll have a higher capability that can feed into their military.

VICE CHAIRMAN BLUMENTHAL: On the science and technology piece, you mentioned the frustrations among scientists and so forth on basic research. In this country, we didn't really get serious about that sort of thing until the Cold War and Sputnik and the Apollo program. Can you give us a sense for how much of the drive is the feeling that the defense industry, the civilian sector needs to improve in science and technology as well so that the defense industrial base and the defense technological base can provide better items, not only to the civilian sector, but to the military sector as well?

DR. NAUGHTON: I'm not sure I fully understand the question. I think that there's a huge bundle of nationalism, that Mr. Prestowitz described so well, and also this passion to develop across the board. I think it's impossible to separate the national security aspect out of that. It's part and parcel of it. They want very much to feel a degree of military security as well. This is one part of this multi-strand drive for development and for national pride and recognition.

VICE CHAIRMAN BLUMENTHAL: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Shea.

COMMISSIONER SHEA: Good morning and thank you for your comments. I'm just trying to get a handle on this entity known as SASAC, and what precisely are the attributes of ownership? What does it mean to be owner of a company, a government owner of a company in China? I know in the United States, as an owner of a company, or rather a shareholder; you expect to have some role in the major decisions in the company such as choosing the board of directors. Also, at least today, one expects a dividend occasionally on the shares that you own. What precisely are the attributes of ownership?

DR. NAUGHTON: There's a huge disconnect between what SASAC theoretically has and what it actually has. Theoretically, it has all of those attributes that you just spoke of. So it should have control over net revenue and it should have control over operations.

In fact, it shares control over personnel with the Communist Party since the Communist Party has not let go of its traditional role of appointing people to key jobs. So many of those key managerial and executive board posts are actually made by the top politicians, but it's channeled through SASAC.

SASAC does, in fact, appoint the CEOs and the executive board members of these large corporations. What SASAC doesn't do is get the dividends. It's very, very peculiar and of course you can imagine SASAC wants the dividends very much. They'd like to have control of the stream of money. An agreement in principle was reached at the end of last year between SASAC and the Communist Party.

COMMISSIONER SHEA: So the Ministry of Finance gets the dividends?

DR. NAUGHTON: Nobody gets the dividends. They stay within the system. Clyde Prestowitz described it very well, that there was actually an agreement in 1994, at a time when Chinese firms weren't making any money. The government said, “You're not really making any money, so fine, keep what you've got and as long as you're reinvesting that, we're happy.”

Now, that's completely inappropriate to the current situation where the firms are quite profitable, and SASAC has said, the Ministry of Finance has said that everyone had agreed that these firms should start to pay dividends to the government. There's even agreement in principle about how they would be divided between SASAC and the

Ministry of Finance.

But this is China. We're talking about large powerful organizations with their own political connections who obviously don't want to start turning over this large sum of money to the government, and they can each find at least 20 reasons why implementation should start with somebody else. They can think about beginning to do this in a few years, and there's a very intense tug-of-war going on over who will control this money.

COMMISSIONER SHEA: I assume there are government agencies that have some regulatory authorities over state-owned enterprises. How do they interact with SASAC? Does SASAC have veto power over a regulation or a directive issued by a state--?

DR. NAUGHTON: SASAC has a great deal of influence over regulations. So, for instance, everyone has been waiting for two or three years for the third-generation telecom licenses to be issued in China. It's not a decision that SASAC makes directly, but everybody acknowledges that SASAC has close to the final say because it's got three telecom companies under its authority.

The revenue and power of these companies will be enormously influenced by who gets which licenses, and there are so many complex issues entangled. Instead of having arm's-length regulation, they all get bundled up together; the result is they can't resolve the issue and nothing has happened for two years.

COMMISSIONER SHEA: So it's owner and regulator? Or?

DR. NAUGHTON: It's an owner with determining influence over the regulators, who should be independent but aren't.

COMMISSIONER SHEA: Okay. Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Chair Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you and thank you very much to both of our witnesses. You always provide really thoughtful testimony that I think helps us think in different ways as well.

I have one comment and then a question. Mr. Prestowitz, I'm struck by the fact that several times you noted that what China is doing is not unique to China. I think many people would agree with you on that. However, I think that the speed with which it's doing it, the extent to which it's doing it, and the nature of the Chinese government are some of the things that have raised the anxiety level. Obviously, people were concerned about Japan, but there's just a whole bunch of other factors to consider with China.

I'd like to go to this concept that you're saying about that the market is a tool. It's not the objective. Given U.S. participation in the WTO as an example, I have to wonder if these bilateral agreements work. Do they make sense when people don't see the market as the objective, but as a tool?

It explains a lot as to why the Chinese come out of a trade negotiation with one conception and the U.S. comes out of it with another. But do we have the kinds of institutions in place or do they need to be modified in order to address changes like that? Clearly, China is a major economic player and we should adjust accordingly.

MR. PRESTOWITZ: Right. Well, I think the institutions in place are really flawed. I think it's very difficult under the WTO regime or the current IMF regime. I think it's very difficult to deal with this, two-game scenario that I've sketched out because the premise of the WTO is that it is based on the GATT and largely created by the U.S. and the UK. As such, the WTO really came from the ideas of Adam Smith and David Ricardo--open markets, free trade, unseen hand, and so forth--but those are not the premises of the export-led growth strategies of Asia, as I mentioned.

The WTO rules and practices have been formed pretty narrowly in the assumption that if people join the WTO, they would already have established a market economy and there is only one kind of such market economy.

And so the WTO and GATT, its predecessor, and indeed the IMF, never anticipated a country like China or Singapore or even Ireland, for that matter. The three organizations never anticipated the management of currencies for economic development advantage. They never anticipated the use of administrative guidance to entice or to co-opt investment. They didn't anticipate the transfer of technology. The rules don't handle such factors very well.

You can try to attack the anomalies with the WTO rules. I would argue, for example, that investment incentives, special tax rebates and so forth that are used to entice investment, could be attacked as subsidies. But it's an argument; it's not a "slam dunk," to coin a phrase.

[Laughter.]

CHAIRMAN BARTHOLOMEW: Not a very good phrase to be quoting.

MR. PRESTOWITZ: In any case, we've never pursued it. By not pursuing it, we kind of give acquiescence to the continuance of this practice in many places. So given that, I think that the institutions are inadequate.

CHAIRMAN BARTHOLOMEW: Thank you.

HEARING CO-CHAIR WESSEL: Commissioner Fiedler.

HEARING CO-CHAIR FIEDLER: I have a couple of factual questions and then a general question. What percentage of the stock exchange assets are state controlled in China--internal stock exchange--roughly?

DR. NAUGHTON: Roughly 60 percent.

HEARING CO-CHAIR FIEDLER: So it's going in what direction?

DR. NAUGHTON: Heading down, but heading down relatively slowly in the last couple of years. I believe, but we don't quite have the data yet, that it’s heading down much more rapidly today.

HEARING CO-CHAIR FIEDLER: We are actually in some respects narrowly discussing the national champions and the heavyweights, and I don't want to confine ourselves to their construct. So, for instance, that construct leaves out the ITICs, CITIC, formerly run by Wang Jun, is a huge investment vehicle that may be the largest entity in the country by assets.

DR. NAUGHTON: That's possible. That should be included in these. However, CITIC is a financial corporation, so it would not be included in these.

HEARING CO-CHAIR FIEDLER: It's a financial corporation that owns things.

DR. NAUGHTON: Yes.

HEARING CO-CHAIR FIEDLER: So it may own things that are not on this list.

DR. NAUGHTON: Absolutely.

HEARING CO-CHAIR FIEDLER: Okay. And it acts internationally in ways that perhaps an iron and steel company doesn't; right?

So I think a full discussion of this at some point has to include the ITICs and later we're going to get into a panel that discusses the outward investment. I wish that you were here for that.

Then my second, more general, question is do they ever get to a market economy and what do you call what they currently have? Because language is important in the discussion in Washington and I have heard, ad nauseam, for years and years and years that China has a market economy. Do we ever get there with this policy and what do we call it? Some people call it bureaucratic capitalism. Some people call it state capitalism. Some people call it capitalism still. What do you call it?

DR. NAUGHTON: Let me say one thing first that is not quite an answer to your question. When we look at the performance of this state core under SASAC that I described, I think we do need to acknowledge that it has performed very, very well, in the sense that they've taken some enormous risks to invest in an enormously rapid rollout of infrastructure that has powered the most dramatic economic growth episode we've ever seen in the history of the world.

So we can criticize the system. We need to criticize the system and insist on fairness. However, at the same time, what's happened in China in the last 15 years is absolutely astonishing. A lot of it is because these companies said, “We're going to build 35 power plants and we're going to build an expressway network and it's risky and we're building out ahead of demand, but we're going to be a great country and we're going to do it, and it's worked. Now, there are some huge risks in there, and we need to be very vigilant."

Large parts of the Chinese economy have become a market economy. I mean 40 million state employees is a lot. Maybe we add another couple million for the CITICs of the world, but the urban labor force is still 350 million. It has transformed to a predominantly private business structure. However, it's still very distorted. When we look at the debates within China, the debates are focused on these private versus public sectors. The smartest people in China realize that under today's condition, these types of market distortions, monopolies, and political control of the economy are holding back the economy and preventing China from reaching the top tier of global economies.

So there's a vigorous debate about whether or not China's economic reform in danger of stalling out for a period. Some of the brightest Chinese people in the field of economics are saying, "Yes, we're stalling out; we need to go forward faster and more strongly toward a full market economy."

HEARING CO-CHAIR FIEDLER: But you didn't answer my question, which is what do you call what they currently have? And does it get to what any common sense definition of a market economy is? I appreciate the internal dynamism. There's an internal dynamic in every country. But there seems to be a more coherent policy and what do we call it? It's important for us to call the current Chinese policy something real.

DR. NAUGHTON: You're right, and let me hesitate a little because names are so important, but perhaps "a politicized and government-distorted market economy."

HEARING CO-CHAIR FIEDLER: That's pretty good. But that doesn't roll off the end of your tongue.

DR. NAUGHTON: No.

[Laughter.]

DR. NAUGHTON: I wouldn't run for office on that term.

MR. PRESTOWITZ: Let me try. I would call it "state-guided capitalism," and maybe a good way to look at it is, don't think about China, think about Singapore or think about Taiwan.

HEARING CO-CHAIR FIEDLER: By the way, Clyde, the one difference between Singapore and China is size.

MR. PRESTOWITZ: Of course. But don't discount Singapore because I think Singapore is China's model. However, you could recognize the same model for China in Singapore, Taiwan, or Japan. These are all economies that we would normally say are market economies. However, the government in all these places plays a much bigger role in the planning and in the guiding of corporate decision-making than anything that we contemplate as the norm here in the States.

In many countries, the government--not just in China--retains ownership in listed companies. Singapore Airlines is a listed company, but the government owns half of it. The same is true in other places as well.

I think that what we think of as normal here in the U.S. is the outlier. It seems to me that much more of the world is involved in the game of state-guided or strategic economics than in the game of the unseen hand.

HEARING CO-CHAIR WESSEL: Commissioner Brookes.

COMMISSIONER BROOKES: Thank you. This is directed to Dr. Naughton, but if Mr. Prestowitz has something to do add to it, that would be great as well. If I heard you correctly in your oral testimony, you said that about four percent or less than four percent of the exports in China are coming from these seven critical sectors. At what point do you see some of these seven strategic industries begin to compete internationally on a greater scale than they do today? Four percent is small, but when does that increase significantly. Moreover, when might they start to impede in some of these areas such civil aviation or even armaments?

When do you see them competing with the United States or on an international level where exports increase significantly?

DR. NAUGHTON: I don't see any of these core sectors as being on the brink of international competitiveness.

COMMISSIONER BROOKES: I agree with you in terms of now, but can you project? Do you have a--

DR. NAUGHTON: I'm sorry. I can't give you a more definitive answer, but I guess I feel that in most of these sectors--well, a couple of resource sectors, so conceivably coal--

COMMISSIONER BROOKES: Right. Coal is probably not an issue.

DR. NAUGHTON: --is one, and coal playing a bigger role.

COMMISSIONER BROOKES: Right.

DR. NAUGHTON: There are a couple of steel mills under SASAC's control including some of the best ones. Of course, China will try and prevent steel exports from having too negative an impact on the global steel market because it's so dangerous if they do that.

In all of these fields international technology is advancing at least as quickly as Chinese technology. I would say to elsewhere for the impact of Chinese firms. I think there's a newly emerging sort of hybrid high-tech sector, often involving cooperation between Taiwan firms and Chinese firms. That's the area where I think we're going to see some of the first really impressive Chinese firms that we start to worry about as competitors.

COMMISSIONER BROOKES: Okay. Mr. Prestowitz, do you have anything to add to that?

MR. PRESTOWITZ: Well, I agree with that but I would extend that concern to the multinational companies. Increasingly, many multinational companies are not only putting their production in China, but they're moving their R&D and many of the critical elements in China. Whereas you think of them as American companies or German companies or some other based in some other country, but to an increasing extent, they're Chinese companies. What’s more, they're already competitive and at the cutting edge.

They are contributing to the distortions and the imbalances. I don't mean this in a pejorative sense, but they are the executors of it, and I think that it is likely to become much more important as well.

COMMISSIONER BROOKES: Thank you.

HEARING CO-CHAIR WESSEL: Thank you. Commissioner Reinsch.

COMMISSIONER REINSCH: Dr. Naughton, I want to go back to something that you had said a few moments ago. You talked about the internal debate within China about the direction in this area, and I wonder if I can get you to elaborate on that a bit more. I think this is always two steps forward, one step backward, or the reverse. I'm wondering, first, if the debate is really over fundamental direction or over the pace of change with the usual people coming in and talking about breathing space, moving too fast. Or perhaps they are coming in with specific problems that need to be addressed or that they argue need to be addressed in a different way; or that the direction of economic liberalization, for lack of a better term, is unchallenged, or whether there's still a fundamental debate over that? So that's one-half the question.

The other half of the question is how do you see the debate playing out over the next few years looking forward to the next Party Congress? Your statement suggests that we're sort of in stasis right now, and I agree with you. A lot of people think we're in stasis because of the upcoming Party Congress which kind of militates against anything dramatic happening.

Can you look beyond that and look at the people who are likely to take over, and forecast the direction?

DR. NAUGHTON: Well, I'll assume that the Commission would like me to speculate a little because, of course, part of the answer is I don't know, as I’m sure you know. None of us could know that answer yet.

COMMISSIONER REINSCH: Go ahead and speculate.

DR. NAUGHTON: All right. I think right now, partly for political reasons, we are in the run-up to this new Party Congress at the end of this year. Also things are going so well for them economically and the incentives to rock the boat are really small. As such, they're in some sense sort of slowing down the pace of innovation and dramatic change.

The kind of people that I'm referring to are people like a central bank governor and people running some of these top agencies. They clearly see that a China that really is a world-class economy and equal of other developed countries can only occur on the basis of a market economy and an accountable, open system. I think there is very wide spread feeling that this is the only way for China to be what they all want, which is a great country.

So I very much agree with Clyde Prestowitz that in some sense the market is not necessarily the Chinese goal although many people have concluded that the real market economy is the only way that they can achieve those national goals.

My guess is we won't see a further important breakthrough until we start to see some economic problems. We will see problems from excess capacity that's built up in certain sectors, from a kind of a bubble in the Chinese stock market. Maybe after the Olympics and after the Party Congress we'll see much more economic turbulence that we're seeing right now. I think this is the calm before the storm which is not to say that the current development isn't very real and impressive. On the contrary, it is quite turbulent and that doesn't have to be a terrible thing. From recessions, new phases of growth are created.

I think in China we'll see much greater progress a few years down the road when they've had to grapple with some of the downsides of what they're doing right now.

COMMISSIONER REINSCH: Thank you. That's actually very helpful. Clyde let me switch gears for just a second. You had talked about the usefulness, if you will, of the WTO and other institutions with China. I'd like to turn that comment around. Do you see these institutions, as China integrates itself into them or attempts to integrate, having any influence on China in changing their behavior? In that they demand that they conform to the structures of whatever it is that they belong to?

MR. PRESTOWITZ: Yes. I think that China joined the WTO because it wanted to use that institution as a weapon in its own internal debate. I do believe that the institution in many respects has had a positive impact, at least from our perspective, in introducing practices and policies in China that are more market oriented and more compatible with our views.

At the same time, as China becomes more integrated and a more powerful economy, its influence in the organization becomes much stronger. From 1948 until about the end of the century, the GATT and the WTO were really a U.S.-European club. That's just not the case anymore.

So the ability of the U.S. and even the U.S. and the EU together to kind of dictate where the WTO goes or to influence its movement is reduced. In my opinion, this is due to the thinking of the Chinese, even those who are very convinced of the importance of markets, which is much more strategic than ours in terms of economic development. Their thinking about how the WTO should act is going to be very different from ours. As such, I think it's going to be harder and harder for us to operate in a way we'd like to in the WTO.

HEARING CO-CHAIR WESSEL: Before we go to a second round of questioning, are there any commissioners on the first round I've missed that want to go?

I'll begin for a second round and we will limit our questions. We have five of us so far who have asked for a second round and we'll try and get through all of that.

I want to make sure that we're not underestimating the impact of the state control. As we've looked at, and I think the chair indicated in her opening statement, we've had the CNOOC transaction, we've had the Lenovo, and we now have the Blackstone transaction which has $3 billion, if I remember correctly, of state funds that are involved in that. Are we seeing a potential new phase of China's state control? If so, what influence will that have on foreign markets as it enters its go-out strategy that it's seeking to engage in transactions that may buy much more market-oriented firms or assets that have significant value? Both panelists please.

DR. NAUGHTON: I think the primary difference right now is China has a lot more money than it used to have. Although the role of state firms in the Chinese domestic economy is arguably declining, the Chinese economy is growing very rapidly and it's got much higher level of surpluses. I would say that the Chinese will come out as a financial and economic actor in world markets over the next five to ten years in a way that we have never seen before.

HEARING CO-CHAIR WESSEL: Clyde.

MR. PRESTOWITZ: I completely agree with Ed. Anybody who has got 1.2 or three trillion dollars growing at the rate of three or 400 billion a year has a lot of clout. It's going to be deployed and it's going to have an impact that we haven't anticipated and they're going to be very big players.

HEARING CO-CHAIR WESSEL: Commissioner Blumenthal.

VICE CHAIRMAN BLUMENTHAL: Another question for Dr. Naughton that is from your testimony about the science and technology plan. You said it's provoked criticism from those that it neglects basic science, is too centralized, and too bureaucratic. What is the focus? What areas of science and technology is the centralized bureaucracy focusing or trying to get researchers to focus on and how are they going about that?

DR. NAUGHTON: Well, there's a whole list available and I recommend it to you. The list includes priority areas, and within priority areas, specific research objectives, and it's pretty much what you would come up with if you were making a list for the National Science Foundation. It's integrated circuits, aeronautics, aerospace, biosciences, advanced materials, pretty much the whole range.

VICE CHAIRMAN BLUMENTHAL: Do those criticisms about the lack of basic science have any merit behind their claims?

DR. NAUGHTON: Well, I am not knowledgeable enough to know. There is often kind of a quarrel between scientists and economists where scientists argue more for basic research and economists argue that China's comparative advantage is more in adapting and accessing world basic research and just contributing to a few niche areas.

Some of the criticism really is from scientists. So the scientists are saying there's not enough basic research, and that there's too much applied engineering in the science and technology program.

VICE CHAIRMAN BLUMENTHAL: Are scientists complaining about lack of protection as far as intellectual property rights are concerned? What's the culture like in the sense that we hear all of the complaints about IP protection? It doesn't seem to me that you can have a basic research program or an applied research program without those basic protections of intellectual property.

DR. NAUGHTON: I don't hear that much coming out of the science community in terms of intellectual property protection. I hear lots coming out of the science community in terms of fraud, weak assignment of responsibility to the creative scientists who really deserve it. I think there's a lot of dissatisfaction with the sloppy attitude towards credit and responsibility which is not that closely linked to the parallel discussion among economists about intellectual property rights.

VICE CHAIRMAN BLUMENTHAL: Could I ask you to speculate about possible breakthroughs coming from China, because we haven't really seen any Nobel Prize winners or that sort of thing. We've seen them in other countries. I wonder what areas of science do you think that might come from.

DR. NAUGHTON: Probably plant science and biotechnology areas.

VICE CHAIRMAN BLUMENTHAL: Thank you.

HEARING CO-CHAIR WESSEL: I'm going to allow

Commissioner D'Amato to jump the queue.

COMMISSIONER D'AMATO: Thank you very much, Mr. Chairman. I think this is very, very important testimony. Thank you both for coming again to share your thoughts with us. I want to see if you can elaborate a little bit more on the question that Commissioner Wessel asked about the Chinese go-out strategy in terms of the use of their surplus or their use of their financial resources. Also, see if you can speculate a bit more about how they're going to behave in terms of making decisions? Who's going to be making those? What kind of tug-of-war is there in China about that decision-making process?

The CNOOC is one model of resource control of a strategic asset. Certainly Blackstone is a totally different consideration. One that might be recommended by Goldman Sachs should the Chinese government want to get a big equity firm.

Is there a debate in terms of how they're going to structure their purchases and who is going to control that policy in terms of making those decisions? It seems to me the amount of money we're talking about and the kind of acquisitions and emphasis that could occur will have a dramatic effect on their movement toward a more capitalist market-oriented economy or toward control of resources, strategic assets that they're most concerned about.

So could each of you speculate for a minute or so about how you see those decisions evolving in terms of who’s making them and their impact on development?

DR. NAUGHTON: That's a great question. So far the group of technocrats in the financial system which extends through the banking system and also the Foreign Exchange Reserve, the State Administration of Foreign Exchange, and also the Ministry of Finance are the people driving these decisions who argue that they should be made on an almost purely financial basis.

Technically, the position that will run this corporation as the head decision maker has not been created as of yet. Even so, they've already made the decision to invest in Blackstone, for which the decision came from Lou Jiwei from the Ministry of Finance. The people who have making the financial decisions under the current institution, like Lou Jiwei were behind the restructuring of the banking system, absorbing a strategic stake from multinational banks and listing on the stock exchanges, which has been a tremendous success from their standpoint and, of course, has been very lucrative.

These same people have been arguing, successfully so far, that we have enormous social security burdens coming down the road. They continue to argue that they absolutely need to have these invested in a financially sound process so that we've got competing transparent fund management groups who are going to be in control of these funds and are getting adequate returns. So far they've prevailed in getting their way.

Now, it's awful lot of money. The temptations of corruption are great. There are all kinds of things that people can do with that money. As such, it will take enormous vigilance on their part to maintain this kind of attitude, but so far these people have done a good job.

MR. PRESTOWITZ: I agree with that, but let me point to another interesting aspect of this. This $3 billion investment in Blackstone has been greeted here very favorably, as a positive thing for the U.S. economy. It's not entirely clear that that is the case.

For example, these technocrats have been investing until now in U.S. Treasuries, and that's been really good for us. It finances everything we do. It finances Iraq, finances Katrina, and everything else we do. Moreover, it prevents the dollar from falling.

Now, what's Blackstone going to do with that three billion? Well, it's certainly not going to invest in Treasuries. You know a lot of private equity has gone to Europe and to other places. That means then that these Chinese reserves are not going to be invested in U.S. dollar assets. This could be interpreted as a kind of little step away from the dollar and if that were to become a bigger step, that could create a real problem for us.

However, if you put yourself in the position of the Chinese who are managing this investment, it makes a lot of sense. But it's not necessarily the good thing that we've been greeting it as.

HEARING CO-CHAIR WESSEL: Commissioner Bartholomew and then if we can fit in the several people left. Please, try and keep it to three minutes per round.

CHAIRMAN BARTHOLOMEW: Thank you very much and thank you, gentlemen. It seems the more you talk, the more questions I have. I'm going to try to knit some of this into what I hope is a coherent whole. Mr. Prestowitz, I think another interesting thing about this investment in Blackstone is not only it might be a small step away from the dollar, but it's another step away from transparency too.

I mean it's still uncertain what private equity firms are investing in, what the impact of private equity investment will be on American firms. I was really struck by this passion to develop concept, but I wonder whether the passion to develop in China has been transformed into a passion to get wealthy? There's a significant difference between those two things. When you look at the Chinese government, the Chinese economy has done extraordinary things lifting people out of poverty, which would indicate leaning towards a passion to develop.

However, when you look at the Gini coefficient, meaning when you look at who is getting wealthy, and you look at the lack of development that continues in some part of the country, how can we not point out where this passion to develop is not fulfilling the needs of the country? Are people still trying to get attention and focus on the people who really need the development in order to be lifted out of poverty? Or perhaps this passion to develop, this interest in getting technology, however it happens, is only going to increase the profits that are going to a handful of people? That's one piece of the puzzle.

The second is the question as to whether or not the Chinese should use some of that hard currency from their reserves to fuel the development in their own country rather than looking to some of the multilateral institutions?

MR. PRESTOWITZ: Right. I think the answer is all of the above. I think China has a passion to develop. I think an awful lot of Chinese also want to get rich. The two are not necessarily mutually exclusive. However, you're right, the gap between rich and poor, the Gini coefficient, has widened substantially. Again, this is not just true in China; it's true in virtually the entire global system.

One thing that impresses me about China is that they're aware of that. A good deal of policy attention and debate in China has been given to how to deal with the widening gaps and there are a number of steps aimed at trying to reduce that. Whether they'll work or not, I don't know, but I'm still impressed by the fact that it seems that the Chinese are more aware and working more on dealing with those gaps than we are.

Obviously, it would be nice if China used its reserves to develop its own economy which would then help raise more people out of poverty. But the reserves, of course, accumulate because they are pursuing this export-led growth strategy, which is making them rich and, of course, also developing their economy. It would be nice if China would invest less in export-led industries and more in domestic consumption, and it would be nice if they would adopt more of domestic consumption-led growth strategy than they have.

However, all of our experience tells us that this is not likely to happen. All the countries that have adopted this strategy, beginning with Japan and then Korea and then Taiwan and Singapore and so forth, wind up with relatively low domestic consumption. It doesn't mean they don't consume. On the contrary, they do consume a lot because they get richer and richer, and so people have more money at their disposal. But as a percent of GDP, they remain relatively low consumers. They continue to accumulate trade surpluses.

Japan just hit a record trade surplus last month, after 50 years of becoming rich and being the world's second-richest economy. This just further shows us that these structures don't change easily. It's probably not going to happen unless there's a crisis, and that is a point I'd like to hit on.

I think there is going to be a crisis. Of course, no one knows what's going to trigger a crisis or when it will happen, but I think that these imbalances are not sustainable. I think there are both a crisis of excess capacity in China and an incipient crisis in the global financial markets as a result of the mushrooming of derivatives and increasing lack of transparency, increasing deterioration of bank lending standards that is coupled with these enormous current account imbalances.

HEARING CO-CHAIR WESSEL: Commissioner Fiedler.

HEARING CO-CHAIR FIEDLER: I have one quick follow up question on Commissioner Reinsch's discussion with you on internal debate and one back to my earlier question about is it ever a market economy. Where do the politics and the economics collide in this decision-making process?

So the Party wants to maintain control and a full market economy doesn't allow them to maintain full control. I'm speculating in the discussion. We don't read it in the Chinese version in the Congressional Record to know what the debates are, but what is your knowledge of that political-economic collide? How much is motivated by politics and how much is motivated by economics?

DR. NAUGHTON: That's a tough question. Most of the economic decision-making gets concentrated at the level of the Premier Wen Jiabao, who I feel gives too much authority to his own subordinates. As such, we see a little bit too much bureaucratization of policymaking and not enough vision.

However, I know you're asking a bigger question which is really the question of will the Communist Party ever allow a competitive and transparent economy? That's really I think the question you're most interested in.

I think it is possible but we don't expect people to give up tremendous power unless there is some dramatic challenge and we just don't know what going to trigger that down the road.

HEARING CO-CHAIR WESSEL: Commissioner Houston.

HEARING CO-CHAIR HOUSTON: Thank you. I have a quick question that, Mr. Prestowitz, came into my head when you used one of the most important and overlooked phrases of the day in talking about the $1.2 trillion overflow in China. You said the money would be deployed. I thought that was a really interesting turn of phrase. Most people would talk about investing or spending, but in the Chinese economy, it is certainly something to be deployed.

I have a question about the next Five-Year Plan, the 12th Five-Year Plan. At the inception of the 11th Five-Year Plan, there wasn't $1.2 trillion jingling around in the pockets of China. What effect do you think that will have on the next economic plan, both for outward investment as well as investment of that money within China and how will it change?

MR. PRESTOWITZ: I don't know is the answer. However, I can speculate a little bit on one of the problems that I think China will have to face soon. It has been accumulating an awful lot of dollars, and what in effect is really happening is that the U.S. is buying goods, mostly goods, from China and giving them paper. Now, the paper has a commitment to pay off, but as you accumulate a lot of this paper, the likelihood that the commitment to pay will be honored at the end of the day becomes a little questionable.

So the holders of the paper become more nervous about the value of their paper promises. Pressure grows on them is to convert this paper into a form that won't lose value. I think we're already seeing that China is using its reserves to make big investments around the world in raw materials, energy, and now into private equity funds. I think that we're going to see a lot more of that.

I think that's inevitably going to strengthen China's hand globally because it will become invested to a very large extent in many countries. Secondly, it raises the interesting question of competition for resources with the U.S.

After all, we're a big resource importer as well, and our sources of supply are not guaranteed. As such, there's a kind of implicit competition and given that China has the money and given that China actually has this huge reserve, China has control over the value of a dollar to a significant extent. If China were to dump its reserves, the dollar would collapse tomorrow.

Now, that would also hurt China so that China is not going to do that. However, China actually has the ability to control the terms of the competition for resources with the U.S. I don't know exactly how that plays out, but I think it's something that we should be thinking about.

HEARING CO-CHAIR WESSEL: We've gone just a couple of minutes over, but thank you. This has been extremely helpful and interesting.

We're going to take a couple of minute break as the next panel gets seated and we look forward to hearing from you in the future again. Thank you.

[Whereupon, a short break was taken.]

PANEL II: STATE-OWNED ENTERPRISES: VEHICLES OF INDUSTRIAL POLICY IMPLEMENTATION

HEARING CO-CHAIR HOUSTON: Let's get going on our next panel of the morning, State-Owned Enterprises: Vehicles for Industrial Policy Implementation. We'll get going quickly. I'm sorry we cut a few minutes into your time this morning.

In our next panel, we are pleased to welcome two distinguished academics to discuss the role of Chinese state-owned enterprises in furthering Beijing's central industrial policies.

Dr. Scott Kennedy is an Associate Professor of East Asian Languages, Cultures and Political Science at the University of Indiana in Bloomington. He is currently writing a book on the ways that economic factors affect corporate lobbying of their respective governments and the impact such lobbying has on public policy.

We're also welcoming Dr. George Haley, who is a Professor and Coordinator of Marketing and International Business Programs at the University of New Haven. Dr. Haley has taught throughout the U.S., Mexico, Asia, and Australia, and has written several books including the Chinese Style of Business: The Logic of Successful Business Strategy, and New Asian Emperors: The Overseas Chinese, Their Strategies and Competitive Advantages.

Both panelists have a strong understanding of the SOE issues at hand, and we look forward to their remarks. As always, if you could keep your comments to about seven minutes and then we'll go to questions after that, and Dr. Kennedy, if you'd like to begin, please proceed.

STATEMENT OF DR. SCOTT KENNEDY, ASSOCIATE PROFESSOR, DEPARTMENTS OF EAST ASIAN LANGUAGES & CULTURES AND POLITICAL SCIENCE, INDIANA UNIVERSITY, BLOOMINGTON, INDIANA

DR. KENNEDY: Members of the Commission, thank you for inviting me here today to testify before you. It's an honor to testify about Chinese government involvement, their economy, and the implications for American interests. I'm a political science professor at Indiana University where I'm also the Director of the Research Center for Chinese Politics and Business. I've conducted research on government-business relations and China's economic policy process for the past ten years.

Although China's economic policy process has become more transparent, particularly for those with a direct interest in the outcome of policy, understanding the origins and evolution of Chinese policy is still a daunting challenge to outsiders.

China's media devotes enormous attention to publicizing Chinese policies, but provides scant coverage to the debates that produce these policies to begin with. Due to the paucity of information about these topics in the Chinese press or scholarly world, my research is based primarily on interviews with executives from Chinese and multinational companies, business association representatives, Chinese and foreign government officials, the staff of international organizations, and lawyers and industry analysts.

Over this period, I've conducted almost 500 interviews in China and elsewhere with the aim of better understanding both the process and substance of China's economic policies including its foreign trade and investment policies.

I want to make three points in my testimony today. Since you have my written testimony already, I'll just briefly summarize those points now.

The first point is that China's economic policy process has evolved substantially over the last two decades. That process was originally monopolized by political elites and the bureaucracy, and as you heard in the previous panel, they're still deeply involved. However, there are now non-state actors, particularly from the business world, and even the scholarly community, are playing a greater role.

Hence, although China's economic policies may appear to reflect a comprehensive and coherent strategy, they are more often the product of contentious debates during both the drafting and implementation phases.

As a result, Chinese policies develop gradually and do not have an internal consistency one would expect of a top down system.

Now, there are a few points I want to make to emphasize the policy process and the changes. The first is that companies of all ownership types and nationalities lobby in China to affect the policy process.

That includes even state-owned companies in which we know there's a lot of control exerted by the government and the Communist Party over the personnel and investment decisions of SOEs. Even so, they often still have disagreements with government policies and seek to influence them.

This is also despite the fact that there are still tight controls on business associations and other types of collective action. Business associations have to be approved by the government, registered, and have a government overseer. Oftentimes the staffs of business associations are former government officials, even sometimes current government officials. So that makes it hard to be an association that exclusively represents your members' interests.

That doesn't mean that lobbying doesn't occur in China. Associations in China are like pedestrian overpasses when busy people come to an intersection, that pedestrian overpass is too difficult so they cross directly across the street. Similarly, companies primarily lobby the government individually or in informal groups, bypassing government controlled associations.

Foreign industry does lobby in China as well, sometimes through national chambers of commerce and public relations firms. There are foreign industry associations operating in China, but they are not formally approved. So therefore they operate in a gray zone.

The last point is that the composition of policy coalitions in China doesn’t conform to traditional expectations about how you would see the lines drawn in the sand. Now, I think in areas of finance, banking, you do see a big difference usually between state-owned enterprises. On one side, you have private and foreign companies. On the other, you have the banking system and stock market, and the bond market basically is the big cash register of state-owned enterprises and not easily accessible by the others.

However, in other areas of policy and industrial policy, there's a lot of crossover, where you see private state-owned and foreign companies on one side of a debate and state-owned private and foreign companies on the other side. That's largely because of China's integration into global business networks. There are currently about 300,000 foreign-invested enterprises on the ground in China, employing 25 million people.

There are also detailed supplier relationships between Chinese companies and their foreign partners. As a result, the policy interests of many Chinese companies have evolved in ways that are distinct from other Chinese companies and distinct from the Chinese state.

The second point I want to emphasize is that although China's WTO entry presaged a new era of economic openness, certain segments of China's government and industry, both state-owned and private, have over the last decade promoted protectionist industrial and trade policies rooted in exploiting loopholes in the WTO.

This includes developing their own antidumping regime, a regime for dealing with countervailing duties or subsidies, and safeguards adopting regimes related to standards for health, safety, the environment, labor and product design. These can be used in protectionist ways.

You obviously know about their foreign exchange regime and how that can be used. China is currently in the last stages of drafting an anti-monopoly law which could be directed primarily at large foreign multinationals that threaten Chinese business interests.

Now, the other half of this, though, is that these efforts are regularly thwarted by those in China and elsewhere who favor continued liberalization. These proponents of liberalization come not from just foreign businesses and their governments, but among Chinese industry as well.

As a result, Chinese protectionist efforts like the ones I just listed oftentimes don't work. Sometimes they do, but China's protectionism is what I call porous. They have many holes and can be adapted to market conditions. China's most successful industrial policies of late typically are ones that give due recognition to markets and China's place in the global economy.

Let me just give you a couple examples before I end. China's antidumping regime is a good place to start. China, as we all know, has been the world's most common target of antidumping cases, but it's also now the third largest initiator of antidumping cases. It developed its regime in the late '90s, revising it again a few years ago, and over that period it's initiated 48 cases involving 150 countries. However, Chinese applicants who apply to the Chinese government for relief lose. Foreigners win a full or partial victory in 57 percent of the cases that have been completed in China.

This is, in part, because the foreign companies and their governments lobby in these cases, but it's also because the Chinese downstream customers of these companies also lobby in these cases. When those customers are large economically and politically powerful, sometimes the foreigners don't get penalized.

China is also trying to develop technical standards and information technology. Many of these standards have the potential to be quite protectionist. So far China has yet to successfully develop and issue any technical standard and information technology that has achieved market success. That's because of the opposition of other parts of Chinese industry that are integrated into global networks. There are lots of cases I could list.

My final point is that given the relative success of fighting against some of these protectionist efforts, I think that the basic regimes in place at the bilateral or multilateral level are doing a pretty good job in taming some of these efforts. I don't think that we need new legislation to deal with these. The rules of the WTO and others aren't perfect, but so far they seem to be doing a satisfactory job. Thank you.

[The statement follows:]

Prepared Statement of Dr. Scott Kennedy, Associate Professor, Departments of East Asian Languages & Cultures and Political Science, Indiana University, Bloomington, Indiana

Members of the Commission, thank you for inviting me here today. It is an honor to testify before you about Chinese government involvement in their economy and the implications for American interests. I am a political science professor at Indiana University, and I have conducted research on government-business relations and China's economic policy process for the past ten years. Although China's economic policy process has become more transparent, particularly for those with a direct interest in the outcome of policy, understanding the origins and evolution of Chinese policy is still a daunting challenge to outsiders. China's media devotes enormous attention to publicizing Chinese policies, but provides scant coverage to the debates that produced the policies to begin with. Because of the paucity of information about these topics in the Chinese press or scholarly world, my research is based primarily on interviews with executives from Chinese and multinational companies, business association representatives, Chinese and foreign government officials, the staff of international organizations, lawyers, and industry analysts. Over this period I have conducted almost 500 interviews in China and elsewhere with the aim of better understanding both the process and substance of China's economic policies, including its foreign trade and investment policies.

I want to make three points in my testimony today. **First**, China's economic policy process has evolved substantially over the last two decades. The process was originally monopolized by political elites and the bureaucracy, but now non-state actors, particularly from the business world and the scholarly community, are playing a greater role than ever. Hence, although China's economic policies may appear to reflect a comprehensive and coherent strategy, they are more often the product of contentious debates, during both the drafting and implementation phases. As a result, Chinese policies develop gradually and do not have an internal consistency one would expect of a top-down system. **Second**, although China's WTO entry presaged a new era of economic openness, certain segments of the Chinese government and industry, both state-owned and private, have over the last decade promoted protectionist industrial and trade policies rooted in exploiting loopholes in the WTO agreements. However, these efforts are regularly thwarted by those who favor continued liberalization, not just foreign businesses and their governments, but among Chinese industry as well. As a result, Chinese protectionist efforts have proven to be quite porous. China's most successful industrial policies typically are ones that give due recognition to markets and China's place in the global economy. And **third**, as a consequence, it would be a mistake for the US Congress to pass legislation that would restrict imports from China across the board or would sanction China for areas where greater liberalization is still needed. By and large, existing bilateral and multilateral frameworks are proving sufficient for defending American economic interests. While being vigilant against Chinese transgressions, the best way to meet the Chinese challenge over the long term is for the US Congress and Executive branch to focus more attention on developing policies that strengthen America's economic fundamentals and improve the country's competitiveness in the global economy.
The rest of my testimony elaborates on these points. I have also provided the committee with several of my publications, which go into these issues in more depth.

China's Changing Policy Process

In the 1970s and 1980s, it was common for Americans to speak of "Japan, Inc." in the belief that the Japanese government and industry cooperated in a unified front to promote the country's economy at the expense of foreign industry. The metaphor has recently begun to be applied to China, another East Asian country with a government deeply involved in the economy and a large trade surplus vis-a-vis the United States. Despite these similarities, terms such as "China, Inc." overstate the Chinese government's control over China's economy or the level of consensus between Chinese authorities and industry about the country's most appropriate industrial policies.

This impression may be the result of at least two factors. The first, as suggested above, is the very limited reporting by Chinese and foreign media on China's economic policy process. Since China's formal political system has not changed, one would not expect the policy process to have changed either. The second may be because the Chinese government and the Chinese Communist Party (CCP) still have important sources of leverage over China's state-owned enterprises (SOE). The management of SOEs are formally approved by the supervisory government agency and the Communist Party Organization Department. SOEs often need government approval for investments over a certain size, and they raise money from Chinese banks and the stock market, both of which are state-controlled. It is also common knowledge that the CCP often has a role in some of the day-to-day management functions of SOEs. Since the early 2000's, much of the direct regulation of SOEs has been shifted to the State-Owned Assets Supervision and Administration Commission (SASAC) at both the national and provincial level. Given such intervention, one would expect SOEs to be docile and obedient and rarely, if ever, challenge government policies.

What is striking is that despite the continuity in the political system and the continued official intervention in SOEs, China's economic policy process has changed considerably during the past two decades. The impetus for this change has been China's move to the market and the associated need to create a regulatory structure to replace the planned economy. The national government has passed thousands of laws and regulations governing every aspect of business behavior, including starting a company, raising capital, engaging in product development, manufacturing, labor, distribution, sales, and taxes. It is this web of regulations that have become increasingly important to the life chances of firms. As a result, firms, Chinese and foreign, have taken a greater interest in shaping policy.

There are four aspects of China's national economic policy process that should be highlighted:

First, although China's top central leadership has a veto over major economic policies, it typically does not involve itself in day-to-day economic policy decisions. Most policies are debated among the different parts of the bureaucracy and the National People's Congress. These bodies regularly have conflicting interests, and policies require extensive negotiations between different bureaucratic actors before they are adopted.

Second, companies of all ownership stripes and nationalities regularly lobby the central government bureaucracy and legislature on economic policies that affect their interests. Despite their natural links to the state, SOEs surprisingly do not always agree with policies governing their sectors, and they regularly speak up when their interests are at risk. Large domestic private companies and multinational firms, which obviously also have a stake in China's regulatory regime, have developed their own lobbying capacity as well.

Third, lobbying has emerged despite the government's tight controls on all forms of non-governmental organizations, including industry associations. Industry associations must register with the government and have a supervisory agency, and they are supposed to have monopoly representation of an industry. Although there are some significant exceptions, particularly in sectors and localities dominated by small, private companies, most Chinese companies lobby the government individually or in informal groups. Foreign industry is represented by their national chambers of commerce and public relations firms, but foreign industry associations are officially unable to register. Despite the lack of formal approval, some foreign associations do operate openly with the de facto recognition of Chinese officialdom. Due to these constraints, the largest multinational firms depend primarily on their own in-house government affairs capabilities.

And fourth, the composition of policy coalitions varies by industry and issue area. SOEs are most often in disagreement with private and foreign interests on questions of banking and financial regulation. That makes sense since state banks overwhelming lend to SOEs, the stock market is dominated by SOEs, and the vast majority of corporate bonds have been issued by SOEs. It is clear who would and who would not want to break up this cozy relationship. But there are many instances when policy disagreements do not neatly break down by companies' ownership or nationality. One can regularly find companies of different types on competing sides of debates on policies related to intellectual property rights, pricing, standards, taxes, and trade.

The blurring of policy positions based on ownership and nationality is the result of the growing interdependence between Chinese state-owned and private firms as well as between Chinese companies in general and foreign businesses. The latter is the product of Chinese companies in many industries becoming deeply embedded in global production networks. Between 2001 and 2006, China absorbed $343 billion in foreign direct investment. In 2006 alone, over 41,000 new projects by foreigners were initiated in

China with funds of over $69 billion. At the end of 2006, there were almost 300,000 foreign-invested firms in China employing almost 25 million Chinese. Most investment has originated in Taiwan and Hong Kong, but Japan, the US, South Korea, and the EU are growing sources of capital. This foreign investment is the dominant reason for the rapid expansion of China's exports. Foreign-invested companies account for around 60% of China's overall exports and over 85% of its exports of information technology. Where foreign firms do not invest directly, they typically contact out production to Chinese suppliers, who in turn, also source a significant proportion of their inputs from global markets. The consequence is that companies' policy preferences have evolved along with their changing business interests. Hence, Chinese and foreign companies some times find themselves in what I call, "transnational political alliances" (TPA), where they either coordinate their policy positions or engage in parallel lobbying activity.

China's Porous Protectionism

The evolution of government-business relations has important implications for China's foreign economic policy. China has instituted a wide range of potentially protectionist policies, but they have run into extensive opposition from both foreign and domestic interests.

In the process of joining the World Trade Organization (WTO), China reduced a wide range of traditional trade barriers, including tariffs, bans or quotas on imported products, explicit subsidies, licensing systems for imports, and limits on product distribution. China today is far more open to international trade and investment than it was 10 years ago or even five years ago, and it is more open than most other countries at a similar level of development, now and in the past. At the same time, China has kept in place some traditional barriers; and more importantly, it has tried to exploit loopholes in the WTO governance regime and adopt more sophisticated forms of protection. Such efforts are meant to help not only state-owned enterprises, but private industry as well. China has created regulatory frameworks for antidumping measures; anti-subsidy (counterveiling) measures; safeguard measures; and standards for health, safety, the environment, labor, and product design. In addition, the lax enforcement of intellectual property rights (IPR) serves as a trade barrier to IPR-based foreign industries. Although international rules are less clear, China has created a foreign exchange regime that gives the government significant latitude in controlling movement of the exchange rate; and China is close to adopting an anti-monopoly law which could be used to target foreign companies. Chinese efforts are not unique; in some instances, they are borrowing tactics straight out of the playbook of other WTO members, including the United States, such as in its adoption of antidumping rules as a way to slow imports that supposedly unfairly threaten domestic Chinese industries. But collectively, these tactics cumulatively add up to serious obstacles to American and other foreign companies trying to do business in China.

That said, the success rate of these efforts has been far less than what one would expect, particularly if one looks at China through a "China, Inc."-type lens. Chinese seeking protection have been stymied in part by other governments who, at the behest of their companies faced with protection, lodge complaints through diplomatic channels. Also, as noted above, foreign companies have developed their own lobbying capacity. Besides maintaining good relations with different parts of the bureaucracy, foreign firms have become adept at meeting with officials from the Ministry of Commerce and other agencies when disputes arise. But in addition, Chinese protectionist efforts have run into opposition by liberal-oriented parts of the bureaucracy and domestic industry (state-owned and private), whose interests lie in expanding, and not hindering, international trade and investment links. Hence, China's post-WTO protectionism has been decidedly "porous," thwarted by a combination of pressures.

One area where this true is China's antidumping regime. First adopted in 1997 and then revised in 2004, China has come from no where to become one of the most active initiators of antidumping cases against foreign exporters. Between 1997 and 2005, China launched investigations into 42 products involving 136 countries, including 22 cases against American companies. These cases have been pushed by several

Chinese law firms, who are the international trade equivalent of "ambulance chasers." However, the foreign respondents have won a partial or complete victory in over 48% of all concluded antidumping cases. American firms have been successful in avoiding significant penalties in at least 7 of the 19 cases completed as of the end of 2005. In addition, the average antidumping tariffs instituted by China is relatively low compared to those adopted by other regular antidumping users, such as the United States and European Union. Although foreign respondents do not win a majority of cases, their victories are important and surprising. Why does foreign industry regularly escape punishment despite the fact that these cases are adjudicated by the Chinese government, an obviously biased referee? To some extent, it may be that the charges are frivolous, but antidumping cases typically do not turn on an unbiased reading of the facts anywhere. They are highly political actions. More likely, foreign firms have done relatively well because of lobbying by themselves and their Chinese downstream customers. When those customers need the imported product because of high quality requirements and the importer is economically and politically powerfully, they usually are effective in helping the foreigners avoid sanction.

A good example is a 1999 case brought against Japanese and South Korean stainless steel producers. They seemed unlikely to win at the outset because the Chinese applicants were three important steel producers (Taiyuan Steel, Shaanxi Precision Steel, and Pudong Specialty Steel), and Pudong had just been merged into Baoshan Iron & Steel, China's most advanced and politically influential steel manufacturer. Despite being the world's largest producer of steel, in the 1990's China became a large importer of high-quality stainless steel that its firms could not produce themselves. It was, therefore, in the domestic applicants' interest to lock foreign firms out of the market while they developed a greater independent capability in this area. Behind the scenes the applicants and Baoshan lobbied hard for an affirmative ruling, which they at first obtained. Several Japanese respondents paid antidumping duties, while one Japanese and six South Korean firms agreed to a price undertaking in which they raised the prices of their goods an amount equal to the dumping margin.

Despite the apparent ruling in favor of the applicants, the respondents won a partial victory. Many of their goods were granted exemptions from the penalties, and any of the goods they sold to duty-free zones in China were exempted from having to pay any tariff whatsoever. The compromise was reached because the respondents persuaded their Chinese customers to submit briefs to the Chinese authorities in their defense. They argued that the domestic stainless steel producers did not produce precisely the same goods as the foreigners and that the imported goods were critical to their final products, which were to be exported. In addition to the vital role of these products to their businesses, the end-users that complained were famous large home appliance and auto manufacturers that could gain the ear of senior trade officials and could also mobilize local and national officials to carry their banner. Feeling pressure from both sides, the government decided on a compromise that largely left the imports uninterrupted.

Another good example is China's safeguards regime. In March 2002, the Bush administration adopted safeguard duties against a supposed glut of foreign steel it claimed injured American producers. At the behest of domestic manufacturers, China joined other steel exporters in challenging the US action before the WTO, and it invoked its own safeguard measures (quotas and duties) against foreign steel, claiming that the US tariffs had led others to suddenly redirect their steel to China. Before long, though, Chinese steel importers and large downstream users in the automobile, oil, and consumer appliance sectors complained loudly about shortages in critical types of steel and rising costs. In a September 2002 public hearing, lawyers for the Chinese oil drilling industry claimed that their clients had to buy imported equipment because the domestic machinery they had previously used led to the deaths of several workers. As a result of public and private complaints, the Chinese government drastically reduced the number of products against which the measures applied and then suspended the safeguards altogether.

A final example comes from the area of technical standards. Over the past decade Chinese industry has tried to develop unique product standards in information technology. Historically, Chinese firms have assembled products developed elsewhere; being at the bottom rung of the value-added chain, they have been required to pay royalties by foreign patent holders (though they have not always done so). The effort to develop their own standards, which is part of a strategy to promote "indigenous innovation" and move up the value-added chain, has presented a genuine challenge to firms from the United States and Europe in areas where they are supposed to be world leaders. The Chinese have developed standards on dozens of technologies, including for video players, broadband wireless networks, photography, computer operating systems, third-generation mobile telephony, radio frequency identification (RFID), home networking, and digital television.

Despite the efforts of numerous agencies and thousands of people, China has yet to achieve any substantial successes. So far, American and other global leaders have not lost market share in any of these product categories. Whenever the Chinese government has endorsed a unique Chinese standard, foreign companies and their Chinese partners have successfully lobbied against such moves. The only Chinese standards that have had any chance of success have been those that include significant foreign involvement and cooperation. When the Chinese government in 2004 anointed WAPI as their their own wireless local area network standard, the foreign developers of the globally used standard, Wi-Fi, rose up in vocal opposition. But major Chinese hi-tech firms who have Wi-Fi as part of their own business plans also quietly signaled that they were unenthusiastic about WAPI. When Vice Minister Wu Yi announced in April 2004 that China would suspend mandatory implementation of WAPI, she was doing so in the face of widespread industry opposition, foreign and Chinese. Wi-Fi is the only wireless local area network standard used in China today. Recently, some Chinese firms announced they would develop their own metro-area wireless standard, McWill, to compete against the more widely used WiMax. But most of China's major telecom producers already are deeply invested in WiMax and are unlikely to switch to McWill even if pressed by the Chinese government.

The same story line is playing out in numerous other standards cases, from third-generation telephony to home networking. Whereas the Chinese originally hoped to blocked foreign participation in these markets, they have increasingly accepted international standards or invited foreign producers to join Chinese standards consortia, allowing foreign parties more institutionalized access to shape these technologies in ways that benefit themselves and their Chinese partners.

There is no doubt that the Chinese government will continue to attempt to promote domestic Chinese industry, both fairly and unfairly. However, foreign industry has been far from powerless and has been able to thwart many of these efforts. Case-specific intervention by foreign governments and lobbying by the multinationals have both been important. Yet involvement by the Chinese partners of foreign businesses has been just as critical on occasion. Americans and others have the best chances to fight protectionism in the People's Republic of China when there is a substantial domestic Chinese interest in maintaining openness. As my colleague Andrew Mertha of Washington University in St. Louis has shown, the primary reason China has reformed its intellectual property rights (IPR) laws has been due to foreign pressure. Consistent with the position put forward here, there has been less success on the implementation front because only a small proportion of Chinese industry depends on protecting IPR for the business success. Only as their importance to the economy increases will IPR-based industries make substantial headway. (There are some small tentative signs of improvement. The Business Software Alliance reports that software piracy in China has dropped from 92% to 82% in the last three years. This may in part stem from the emergence of China's own software sector as well as computer producers who have bundled legal software with their machines. Chinese trademark and patent holders are also increasingly going to court or seeking administrative relief for IPR violations.)

Implications for American Policy

The United States government needs to be concerned about Chinese industrial policies. But the record to date suggests that case-by-case vigilance of foreign governments along with lobbying by multinational producers and their Chinese partners are in general successful at hindering many Chinese protectionist efforts. In addition, bilateral and multilateral efforts to cooperate with the Chinese government, industry associations, and producers to develop more even-handed and sophisticated governance regimes is also paying off. For example, the American National Standards Institute, the National Institute of Standards and Technology and their European counterparts have engaged in extensive cooperation with the Standardization Administration of China and other parts of the bureaucracy to improve China's standards-setting system and make it less vulnerable to protectionist manipulation.

Yes, China will continue to try to employ protectionist policies; yet the mechanisms currently in place have been remarkably successful at defending American interests. Consequently, I think it would be a mistake to adopt pending legislation which would raise tariffs on Chinese products across the board or institute other comprehensive sanctions against the PRC. Instead, I would encourage continued case-by-case vigilance by the Administration and Congress and the use of existing bilateral and multilateral mechanisms, such as the WTO dispute resolution process. Over long term, the greatest way to meet the challenges (and opportunities) from China and other countries does not center on bilateral trade strategies but rather involves strengthening America's economic fundamentals and improve the country's competitiveness in the global economy. This includes: 1) Investing more in education in the sciences, math, and foreign language and area studies; 2) Providing industry with more incentives to engage in research and development to encourage continued innovation; 3) Improving thee various components of America's physical infrastructure; and 4) Reducing our country's dependence on inefficient and polluting fossil fuels.

The economic relationship between the United States and China has been highly beneficial to both of our countries and to the world economy, and that understanding needs to be kept forefront in our minds as we consider policies today and in the future.

Thank you for the opportunity to testify. I look forward to answering your questions.

HEARING CO-CHAIR HOUSTON: Thank you, Dr. Kennedy. Dr. Haley.

STATEMENT OF DR. GEORGE T. HALEY, DIRECTOR, CENTER FOR INTERNATIONAL INDUSTRY COMPETITIVENESS, COLLEGE OF BUSINESS, UNIVERSITY OF NEW HAVEN, WEST HAVEN, CONNECTICUT

DR. HALEY: First of all, I'd like to thank the members of the U.S.-China Economic and Security Review Commission and in particular the CO-CHAIRs, Mr. Michael Wessel, Ms. Kerri Houston, and Mr. Jeffrey Fiedler, and their staff for the opportunity to address the USCC today.

My testimony is based on over 15 years of research on the business environments in China. In my testimony, I'll show that the Communist Party, CPC, through the Chinese government, thoroughly dominates China's economy and seeks to continue dominating it through maintaining and enhancing control of its major state-owned enterprises, or SOEs.

The State-owned Assets Supervision and Administration

Commission of the State Council, which is SASAC, exists to manage the CPC's efforts to control more effectively China's SOEs, while increasing the SOEs' economic returns and maintaining the political returns to the government.

Our research has shown that despite permitting the growth of the private enterprise system in China, over the last decade, the Chinese government's share of consumption in China has increased substantially, going from approximately one-quarter of consumption to one-third of consumption.

Now there are a few things, based on the questions that were asked in the previous session, that I'm going to include in my talk. I'm going to restructure it just a bit to make sure that these subjects are covered.

First of all, I think there are several misconceptions that U.S. policymakers have, among them is the Chinese economic system. No true market socialism exists in China today. Market socialism presumes guarantees of minimum subsistence level benefits to the citizenry, yet no such guarantees exist in China.

Contrary to U.S. policymakers' beliefs, China is not moving towards a Western-style capitalism based-economy. Today's economic situation in China and the economy towards which China is moving bears a greater resemblance to the Confucian economy of the Imperial era.

There are several similarities between Confucian economics and communist economics. First of all, like communist economic systems, Confucian economic systems were subsistence economies. The masses were entitled to sufficient income to provide themselves and their families with housing and food modified sufficiently by additional income to sufficiently honor their ancestors. All national income above this became the rulers’ rightful property.

Second, while Confucian economies did possess capitalist elements, the rulers retained control of all strategic technology and production.

Third, the rulers’ Mandarin bureaucrats viewed the merchant class with suspicion and actively persecuted merchants. Most Chinese merchants, regardless of how successful and wealthy they became, died as paupers due to the Mandarin’s harassment.

Everything China has sought to do with SASAC confirms that, whether it is doing so purposefully or not. It is seeking a return to China's Confucian roots. SASAC seeks to control the large SOEs and in so doing control the economy. Control the large SOEs, you control the economy.

Given the CPC's intention to retain control of China's society and economy, the Confucian economic and political system would appear extremely appealing. Not only did the Confucian system seek to maintain the rulers' control of the economy, but Confucius believed no possible justification existed for rebelling against the rulers or limiting the rulers' freedom to act independently of any restrictions such as laws and constitutions.

Hence, the rulers enjoyed absolute political power. Today the CPC desires nothing less than maintaining its own approximation of absolute political and economic power.

As a final observation, I would like to add that President Hu is not President Gorbachev. He will tolerate neither his fall from power nor the CPC's fall from power. Indeed, if past behaviors offer the ability to predict, Hu will do whatever is necessary to maintain his and the CPC's power. His willingness to employ ruthless brute power if necessary was demonstrated as the Party Secretary of the Tibet Autonomous Region when he put down the free speech movement in that region.

Now, I'll go back to the prepared statement. Beijing sets non-profit oriented goals for SOEs to accomplish and thereby uses SOEs to further its industrial policies. These goals may require that SOEs make suboptimal decisions for political rather than economic developmental purposes.

For example, SOEs may be required to establish multiple plants in different geographic locales rather than consolidate production to gain economies of scale or to take advantage of transportation facilities better suited for distributing production.

Though the focus of this hearing is on SOEs, I would like to add that China's private companies are also often used to further its goals. The natural resource sector provides an example of this extortion.

Husky Oil, Canada's fifth largest company but controlled by Hong Kong entrepreneur Li Ka-Shing, has major holdings in Canadian oil-sand deposits. Until Husky Oil decided to ship oil from the deposits through an all-Canadian, yet to be built, pipeline, rather than through the more economically desirable and justifiable Northern tier of the U.S. pipeline system, rumors had the Chinese government giving indications of wanting to acquire Mr. Li's controlling interest in Husky. Once Mr. Li agreed to the all-Canada pipeline, the rumors ended.

Those who doubt China's determination to create economically efficient SOEs and those who feel that an economically efficient SOE is an oxymoron should remember several things.

First, Chinese policymakers do not accept Western economic thought as the only road to success. Second, Chinese expectations of acceptable profitability do not necessarily correspond to Western expectations. Third, Chinese policymakers view the bottom line very differently than do Westerners. Technology acquisition is a key goal in the operation of any Chinese SOE.

Chinese policymakers also view successful use of SOEs as instruments to obtain foreign policy goals as part of those SOE's profits.

Finally, historically, any Chinese SOE, especially the major ones, has been able to rely on government bailouts whenever it got into trouble, just as BOE Technology Group, China's largest flat-panel display maker, is lobbying to obtain at this time.

The 15th Communist Party Congress formed a policy known as "grasping the large and letting the small go" to guide management of SOEs. As I've said before, the Chinese government is determined to maintain control over its economy and society. The slogan developed by then Chinese Premier Zhu Rongji showed the government's dramatic recognition that in the more complex world it was moving into, China's bureaucrats could not control every single detail, so they should focus on controlling the details most important to the success of the state.

China's ambitions, both industrial and political, remain the same. The Chinese government intends to carve out a lion's share of the world's economic power, political power, and prestige while maintaining the CPC's absolute control over China.

SASAC's original purpose was to introduce and promulgate capital-budgeting procedures in China's governing bodies and SOEs. SASAC follows a typical Confucian and CPC structure for a Chinese bureaucracy. A national agency governs the largest Chinese SOEs and similar provincial agencies govern the larger provincial municipal and township SOEs. The provincial SASACs receive guidance from the Center's SASAC, but remain relatively independent of it.

Since being named founding chairman, Mr. Le Rongrong has successfully increased the scope of SASAC's duties and powers to make it more akin to a highly powerful, intrusive and activist holding company's board.

To an extent, SASAC's governing board evaluates and supervises clones of itself. The short bios of SASAC's chairman, vice-chairmen, and vice chairwoman, presented in Exhibit 1 of the additional documents, will demonstrate what I mean. Three board members including Chairman Le started their careers working in China's SOEs. Four of them have experience in several of the CPC's Discipline Committees, the primary tool the CPC uses to root out corruption and ensure good governance.

SASAC's board is well connected politically and some of these connections are quite old. Primary ties are SASAC's Chairman Le and his ties to Premier Wen, without whose very strong support SASAC would have not likely won the bureaucratic battles it has, especially in the competition with the Ministry of Finance from which it's gained most of its duties.

There are also likely ties through the Communist Youth League, President Hu's primary base of power, between SASAC Vice Chairpersons Ms. Huang Danhua and Mr. Wang Ruixiang.

SASAC's power to control executives in both the Center and the provinces should be unchallenged. First of all, the qualifications of SASAC executives and SOE executives include that they have been screened and found loyal to the CPC. Company directors appointed by SASAC remain loyal to SASAC and to the CPC, sometimes through SASAC if they do not have higher connections in the CPC,.

They are basically supervising clones of themselves. Virtually all senior SOE executives are loyal Party members. SASAC is not likely to have much trouble enforcing loyalty to the CPC among managers of Chinese SOEs.

Promulgation No. 378, issued on May 27, 2003 and is titled The Interim Regulations on Supervision and Management of State-owned Assets and Enterprises, grant SASAC the right to screen, to appoint, to evaluate, to compensate and to dismiss SOE managers.

HEARING CO-CHAIR HOUSTON: Dr. Haley, can I have you just finish up quickly in a minute or so, and then we'll go to questions?

DR. HALEY: Okay. Insofar as threats to SASAC rising, the largest threat is competence of their managers, not their political loyalty. In order to offset this, SASAC has started two programs. One of them was established in 2006 through the PRC Embassy in Canada. SASAC has hired 81 overseas Chinese to enter management positions in SOEs.

Additionally, SASAC has contracted with one of Europe's best business schools, France’s HEC, to provide executive MBA programs for SASAC's managers and Chinese SOE managers.

Finally, another threat to SASAC rising is a new political faction called The New Left. Its program is based on the claim that SASAC, which it attacks specifically, and other reform agencies are creating a draconian, harsh form of capitalism in China that does not sufficiently care for workers and peasants and the poor.

[The statement follows:][2]

PANEL II: Discussion, Questions and Answers

HEARING CO-CHAIR HOUSTON: Thank you very much. We really appreciate the benefit of your wisdom and investigations and interviews. The two panels we’ve had already this morning have provided a great discussion of market socialism or state-guided markets

[2] Click here to read the prepared statement of Dr. George T. Haley

or whatever you want to call the current form of market in China.

What we need to look at is how those state-owned enterprises affect U.S. trade, U.S. economic policy and U.S. businesses. I love analogies and I'm thinking of this whole market socialism thing reminds me of a good one. Like an SOE is one of those new-fangled leashes that allows the dog to run and run and it thinks it's going to run forever, and the spool reaches the end and all of a sudden it realizes it is a dog and it is still on a leash.

My question is what about all the other pets around including U.S. multinationals? What exactly are the barriers? What exact harm do the SOEs pose to foreign-direct investors, particularly from the U.S.? Do these SOEs create barriers to foreign entry into the Chinese market? Do you believe, and this is for both of you, that this is a direct command and control calculation, if indeed it does keep U.S. business out of China, or limits its capacity there? Or is it just sort of a byproduct of the nature of the SOE?

DR. KENNEDY: My sense is that SOEs that are challenging multinationals are doing so perhaps in part to achieve a nationalistic goal, and at the behest of the leadership, which Mr. Haley described before. I think SOEs are also trying to make money in the same way that other large corporations are.

However, I think foreign companies that are trying to conduct business in China have more to worry about than just SOEs. China's domestic private economy also has many firms which are competing against multinationals. I guess I'm a little bit hesitant to just make my comments strictly about the SOEs because I don't know if defining the discussion just about SOEs really gets us to the heart of how the competition occurs.

Until the late 1990s, three-quarters of foreign investment in China was in joint ventures. Almost all those joint ventures were with Chinese state-owned enterprises. Today, only a quarter of foreign-invested enterprises are through joint ventures, but even those are still primarily through state-owned enterprises.

Quite often, you'll find state-owned enterprises trying to compete against foreign businesses as best they can, using the tools that they are familiar with and standard management practices, which are common in the United States. At the same time, they are also pulling on the tools of the government to do whatever they can do fair or foul to help.

Private companies do that as well, and as such American businesses face a lot of challenges in China, some fair, some not fair. They come largely from state-owned enterprises, but also from the other competitors who are there as well.

HEARING CO-CHAIR HOUSTON: Thank you very much. Dr. Haley.

DR. HALEY: I think it can go both ways actually. If you look, for instance, at General Motors, GM in China has been more successful than virtually any other GM unit around the world. That's been primarily due to the assistance and guidance of Shanghai Automotive.

On the other hand, you have companies that have been hurt extremely. Qualcomm has seesawed back and forth as different Chinese factions gain control for periods of time. Qualcomm sometimes gets approval for its activities and then the decision gets reversed and they lose approval for those activities. This has led to it being whipsawed back and forth and that's been very harmful to Qualcomm over the last five, ten years.

Another good example lies in the case of Microsoft. In an effort to curry favor with the government, Microsoft has agreed to invest $750 million in the training of personnel and people in China basically to compete with Microsoft. They've not only done this, but they have surrendered some of their proprietary code to the Chinese government. Code which they have not permitted even the United States government to obtain, they have given over to the Chinese.

Given these harsh conditions, companies suffer badly because of harassment, because of Chinese pressure for them to provide benefits to the country and provide benefits to state-owned companies. My other thing, and I think it goes back to one of the things Dr. Kennedy mentioned, is that you're not just dealing with one government.

Provincial governments have independent authority. The provincial governments have controls and they have authority to enforce what the central government misses out on. If you don't have the provincial government's enforcement going along with the central government's ruling, you're not going to get the ruling enforced in China.

Occidental has suffered badly. It's the largest coal extraction mine in the world and they've put it into China. They had the approval of the central government. They had Beijing's very strong support, but because of the harassment of the provincial governments in which that mine falls, they have never been profitable.

HEARING CO-CHAIR HOUSTON: Thank you very much. Commissioner Wortzel, you have a question?

COMMISSIONER WORTZEL: I do. Gentlemen, thank you very much for taking the time to be here and sharing your knowledge with us. I actually have a couple of questions so if you can answer, I have five minutes total.

Dr. Kennedy, you testified about the lack of central control over the economy in China. Now, Dr. Naughton and Dr. Haley have testified that the Chinese government has decided to retain absolute control over coal, oil, electricity, defense, telecommunications, air transport and oceans shipping. So do you see more central control in these seven sectors in your research?

Second, what form of lobbying is used by Chinese companies? Do they approach the National People's Congress or do they lobby individual Central Party authorities?

I'm going to assume that I can get a minute or so afterwards, so I'll have one for you, Dr. Haley. Dr. Kennedy, do you have a response on this?

DR. KENNEDY: I don't think that there is really much difference between the research of myself and Dr. Naughton. Yes, these seven sectors are where they want to concentrate their efforts and make sure that state-owned enterprises are dominating those sectors or leading those sectors.

However, I have two caveats. One is that in those sectors, there will still be room for other players. So although the fixed-line telecom providers will be state-owned companies; companies that provide telecom equipment or value-added telecom services aren't state-owned necessarily.

In addition, even state-owned enterprises which are under SASAC control at the central level don't always follow the direct orders of a unified policy from the center. China's telecom companies, the three that Dr. Naughton mentioned, have been fighting with each other over China's 3G standard. Not only that, but they've been fighting with different parts of the bureaucracy on top of fighting each other. That kind of infighting is going to continue despite the controls.

In terms of lobbying, Chinese companies primarily lobby the different parts of the bureaucracy under the State Council because they have direct daily responsibility for policy from the State Council itself and its offices in the National Development Reform Commission, the Ministry of Commerce, and Ministry of Finance. You named one of the 45 that are there. They also increasingly are diverting their attention to the debate within the National People's Congress and individual deputies who sometimes can get them a voice when they don't find it with the regular bureaucracy.

COMMISSIONER WORTZEL: Dr. Haley, your use of the term the "New Left" intrigued me. I wonder if you can talk a little bit about who they are and what they stand for when you're already dealing with a Communist Party which is considered to be the left?

DR. HALEY: Well, the thing about the New Left and their antecedents is that there is no real uniformity of vision within the CPC. You have your reformers and you have your so called dinosaurs.

Now, the New Left may be called the New Left, but they are basically the faction that used to follow Li Peng. Li Peng, if you think back to the political situation just prior to the change of government, had been thoroughly defeating Zhu Rongji's reformers. Without Premier Wen after the changeover, the reform movement would probably have been dead in the water.

One of the things you should consider at when you start looking at what faction is in control is to look at the prosecutions for corruption. Are they reformers? If they're reformers, the reform movement is on the retreat. If they're not reformers, then the reform movement is advancing.

Our research has shown that insofar as lobbying in China, you need three separate networks to be successful in China. These findings have been backed by several business executives who also agree that it’s quite different from the traditional business network that people see in overseas Chinese business.

One is the political network, which entails the lobbying through the bureaucrats and through the agencies. The second is the business network. The final network is the personal and familial networks, and to be successful, the businessmen we've interviewed have argued you have to be successful in all three of those networks simultaneously.

That's how you do your lobbying: by going to friends, by going to people you know. This has been active in China from time immemorial. You have to have connections between business networks and the bureaucracy. It was regular for bureaucrats in Imperial China to move, to leave the bureaucracy with a guarantee of their return, go into commerce, build fortunes with the assistance of their allies in the bureaucracy, and then take those fortunes back into the bureaucracy to help their allies there further their influence and power within the bureaucracy.

If you look at SASAC, Li Rongrong and two of the other board members started their careers in the SOEs and then they moved into the bureaucracy. So we’re still seeing continuations of historical trends.

HEARING CO-CHAIR HOUSTON: Thank you. Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Thank you both for being here today. It's very helpful. I'd like to first go off on the issue of lobbying if I could because I'm somewhat intrigued by it. We have had various comments over the years that we've been in operation about how China may be seeking to direct certain lobbying activities here. You'd talked about the three levels of lobbying, I’m wondering whether you see lobbying of the U.S. government by U.S. multinationals in terms of what kind of direction they may be getting from Chinese leaders as they seek to expand their activities in the Chinese market?

Are they given any kind of indicators of what they may seek, what may be sought from them in terms of influencing U.S. policy?

DR. KENNEDY: Most of my research is about lobbying in China, but I've tried to learn a little bit about what the Chinese do abroad and what multinationals do abroad, sometimes for China, although this is unintentional.

I think the best case for saying that multinationals have acted with China's interests at heart, in ways consistent with China's interests, is during the 1990s MFN debate, when large multinationals were told directly that MFN was extremely important to China and that it needed to be maintained. My sense is that maintenance of MFN, given PNTR, was also consistent with those companies' interests.

When they came to Washington for the door knock or in hearings, they were reflecting both their own interests and the interests of China. I don't think that's necessarily nefarious, but it's an accurate reflection, I think, of history. I know these conversations definitely occurred.

However, there is not necessarily one big issue today like MFN that multinational companies are supposed to turn around and lobby for the Chinese, or in ways that are consistent with the Chinese. I don't think we have any type of example like that, but multinationals need to keep the door to business open in China. They need good U.S.-China official relations and I think that type of lobbying is common.

Actually, since PNTR, the part of the business community that was most active in trying to maintain MFN each year, and then the final push, is less organized than it was before PNTR. It is less prepared today to defend its interests in Washington and elsewhere. I don't know if that fully answers your question, but that covers at least part of it.

HEARING CO-CHAIR WESSEL: Dr. Haley, any thoughts?

DR. HALEY: Well, I don't honestly think it's less prepared today. I think in many respects it's more prepared. For instance, it is more prepared in the respect that it follows what we see as traditional lobbying efforts. You have American law firms working for the Chinese government representing them. Also, you have American public relations firms working for the Chinese government and representing them.

Currently, the Trade Reform Act of 2007 (H.R. 708) is passing through the House Ways and Means Committee for consideration. In today's environment, you will find that there are public relations companies, law firms, legal companies, presenting against this bill, which they view as targeted against China.

There are also industry groups, especially industrial purchasing groups that depend heavily on purchasing cheap goods from China for their present profitability. Their representatives were there for the protest.

They follow the same scope, but I think the important point is with respect to the businesses, in that though they lobby on behalf of China or on behalf of Chinese interests, they're also lobbying on behalf of their own commercial interests. As such, it's more a confluence of interests than, from their perspective, acting against the interests of the United States.

HEARING CO-CHAIR WESSEL: Thank you.

HEARING CO-CHAIR HOUSTON: Commissioner Fiedler.

HEARING CO-CHAIR FIEDLER: Dr. Kennedy, I'd like to pursue the policymaking process and lobbying with you. Have you ever heard of a prominent or significant role of the All China Federation of Trade Unions in lobbying effectively for anything in this process?

DR. KENNEDY: I think that they have probably only been involved in regulations and laws directly related to the governance of labor, specifically in relation to China's labor law. However, I have never heard them having an effective representative for Chinese labor interests, though I have not investigated this thoroughly.

HEARING CO-CHAIR FIEDLER: Have you ever met anybody in the Chinese technocratic elite that considered them as significant or serious players?

DR. KENNEDY: Not that I'm aware of.

HEARING CO-CHAIR FIEDLER: Number two, I asked the previous witnesses in this to define what form the Chinese economy takes? What could it be described as if not a market economy or a simple non-market economy? What would you call it and where do you think it's going?

DR. KENNEDY: The Chinese call it socialism with Chinese characteristics. I guess we could call it capitalism with Chinese characteristics, but that would also be too vague because it really wouldn't tell you what that meant.

HEARING CO-CHAIR FIEDLER: Too ambiguous, right?

DR. KENNEDY: I don't think that Confucian capitalism to me fully describes China or any single term for that matter. I'm not trying to avoid answering. I think China has multiple political economies simultaneously given the size and diversity of the country. Parts of China look like a free market economy. Go to the southeast of China, go to Wenzhou, Guangdong, you'll see parts of the economy that look like that, but then you'll also see very well organized, highly regulated sectors with government policies that promote Chinese industry in the a developmental state would, just like Japan.

But then you'll also find parts of the economy which are extremely corrupt and not productive whatsoever that look like the Philippines of Indonesia, and so you've got all of that going on right now, and so to think of one term that describes all four of those scenarios right now.

HEARING CO-CHAIR FIEDLER: Let me do it in a different way because everybody all says in the discussion, in the literature, in the op-eds, that China is moving towards a market economy. All right. And you argue that it's more complicated than that.

DR. KENNEDY: Yes.

HEARING CO-CHAIR FIEDLER: So is it accurate to say that they're moving towards a market economy?

DR. KENNEDY: I'd say it would be wrong to say China is moving toward a free-market economy, but if you allowed the definition of a market economy to encompass extensive government regulation, then that would be a justified statement because I think government regulation helps define who the market players are, what the market rules are. It's not only about intervening or distorting markets.

DR. HALEY: Well, first of all, as I stated before, it's not moving towards a market economy. It has no intention of letting the market overturn the Communist Party. It's moving towards a system, I'll try to avoid the term Confucian economics, moving towards a system where the government has absolute control through its government-owned companies over those sectors of the economy which are must crucial to its continuation.

It also does not accept the right of personal property or business property. The property of any businessman, private or otherwise, especially of Chinese origin, though he doesn't have to be ethnic Chinese, is considered to be fair game. If they refuse to follow orders, they will be broken, they will be imprisoned, and they will be brought under charges.

In the late 1990s to the early 2000s, 50 percent of all Australian overseas Chinese businessmen doing business in China were sitting in prison without being charged. They have no regard to this issue of private property. They consider all Chinese whether they are Chinese citizens or not to be Chinese.

I would call what the Chinese have an economy with private elements, but under as much government control as it can extend. I would also add that that government is not unified, meaning that the government does not have one overriding vision. It has several competing factions and those factions have their own corporate, both government-owned corporate and private corporate, champions which they tend to protect.

Also, in my view, it's basically the Chinese who invented outsourcing. What they outsourced was their provincial governments. Throughout history, with very few exceptions, the center has had very limited control over its provinces. There are provinces in China today that have issued their own currency in order to force their companies within the province to buy locally rather than to buy from companies outside the province.

Further still, there are provinces, in an effort to build their own silk industry, that are refusing to sell raw silk to the Shanghai silk industry. As such, the Shanghai silk industry actually buys most of its silk from overseas because they cannot buy it locally. The supplier provinces will not permit it to be sold to them.

It is under these conditions that you have a highly competitive, highly fragmented government seeking to control the economy.

HEARING CO-CHAIR HOUSTON: Commissioner Shea.

COMMISSIONER SHEA: Thank you again for participating in this hearing. It's been very interesting. Is there any focus within SASAC or the state-owned enterprise sector on raising the domestic consumption in the domestic market in China? Is that a focus? Is that a concern? Do you have any thoughts on when Mr. Prestowitz, who testified in the last panel, mentioned that he was impressed by the Chinese government's efforts at trying to reduce the income inequality that is emerging in the country?

DR. HALEY: Well, SASAC's purview is not to raise domestic consumption. Rather, it is to increase the economic returns to the government while maintaining the political returns. If that creates a situation where domestic consumption increases, domestic personal income increases, then it's a side effect, not an actual policy objective.

Could you just repeat the second half of the question?

COMMISSIONER SHEA: Yes. Mr. Prestowitz mentioned in the previous hearing--

DR. HALEY: Okay.

COMMISSIONER SHEA: --that he was impressed by the efforts of the Chinese government to reduce income inequality in the country, and I was wondering if you shared a similar view?

DR. HALEY: The only thing I would add to Mr. Prestowitz's comment is that the policy is in contention. There are factions such as the New Left which are making it a primary element within their platform. Other factions don't necessarily have it as a primary element in their platform. I would also point out that there's a big difference between what the Chinese bureaucrats and government say and what they do.

Consider the history of the Chinese Communist Party and it's the policies that it has enacted, all supposedly in the effort to create higher personal income, it's abysmal. The Soviet-inspired First Five-Year Plan was a disaster. Mao decided that centralized production was foolishness, and under this assumption he ordered that every peasant commune build a small steel smelter. They were then to turn over control of their produce to the CPC cadres. The end result was useless steel being produced which destroyed the economy in China and led to massive starvation in agricultural regions in China.

While it's nice to hear what they say about reducing poverty in parts of China, the likelihood is that they don't really care about it and what they care about is their faction's relative power within the system.

DR. KENNEDY: Overall one could say that at an absolute level, poverty has been reduced substantially through the process of reforms of the last quarter century if you look at the baseline, meaning the literacy rate, basic quality of life and so forth. However, I would agree that there are policies the Chinese have adopted to increase consumption, to spread the wealth, but I think they're paddling up a roaring river.

COMMISSIONER SHEA: Okay.

DR. KENNEDY: You've got the idea, most Chinese are relatively poor, and China’s per capita income is $1,500 a year. You're not going to create a consumption-based economy when per capita income is $1,500 per year. Under these conditions, you're projecting 10, 15, 20 years out before you're going to get anywhere near that. China's growth is primarily investment driven right now.

Inequality is going to continue to expand despite the real large extensive investments in central and western China and in reducing taxes for agriculture, et cetera. Moreover, the larger dynamics of the economy and the political dynamics of what it takes to stay in power are going to continue to lead to a continued expansion of inequality. China just also lacks the funding to create the social safety net which they need to stop that gap from widening. I expect it to continue to widen.

COMMISSIONER SHEA: Thank you.

HEARING CO-CHAIR HOUSTON: Commissioner Blumenthal, you get an extra minute.

VICE CHAIRMAN BLUMENTHAL: Dr. Kennedy, I'm going to ask you a philosophical question because the empirics are probably not there yet. I'm not a lobbyist, but some of my best friends are. It's an old American practice. It's my perception that in the open and reform period that we Americans brought it to China. In the sense that you take your big names, former Secretary of State and such, and they form a company, such as a consulting firm, and they lobby on behalf of private businesses and United States private businesses.

The Chinese are, as you pointed out, are doing the same, using some of the same lobbying practices. I guess the question then, is that these are private interests in every respect, and what sort of good or what sort of distortion is it doing to general economic growth and welfare in China? Increase in lobbying? The fact that your Secretary of State goes and pushes the Chinese government on particular private interests, we have the same issue back here. However, it's in our law, it's in our Constitution.

Do you know? Could you give us a sense of the distortions? I mean it's not necessarily all a good thing that private interests--

DR. KENNEDY: No. Well, I don't think lobbying is an entirely bad thing here. I have some friends who are lobbyists, too.

VICE CHAIRMAN BLUMENTHAL: Yes, I don't either.

DR. KENNEDY: However, I would say that if there are people who need more information, it's Chinese bureaucrats. They don't have enough information about their economy, about different industries. I think that the more interaction they have with the companies they regulate, whether they're Chinese or foreign, the better, so long as it's relatively transparent and doesn't involve a quid pro quo.

To date there have been some policies to further this spread, but of course from the lobbyist perspective, they don't necessarily care what about the greater good. However, sometimes the two interests can coincide. For instance, what’s good for GM is good for America. What's good for Baoshan Iron and Steel is good for China. As such, Baoshan Iron and Steel has lobbied extensively, and they've benefited a lot. They're China's leading steel company. They can make an argument that that their interests are in China's better interest.

VICE CHAIRMAN BLUMENTHAL: Do you buy that argument?

DR. KENNEDY: No. I think to some extent in their industries if they want to be competitive, they need large consolidated companies to do well, but there are other industries where the players are smaller, and economically have less political voice, and as a result they have less political influence. One of the reasons that China's software industry is so weak, economically, is that it's very weak politically. It's so weak politically because it's small. One perpetuates the other and it becomes this vicious cycle.

What China wants is a semiconductor industry, very large scale things, such as telecom producers.

VICE CHAIRMAN BLUMENTHAL: Is there anything out there about what the costs to growth and GDP might be from big business, whether it's multinational or Chinese lobbying? Do you think there is any way to discern that sort of number?

DR. KENNEDY: I think that there are too many moving variables in this. Since China has been growing at an astounding double-digit clip for the past 20 odd years, they probably don't care that it's been distortionary.

VICE CHAIRMAN BLUMENTHAL: But of course some people do care.

DR. KENNEDY: Oh, yes, but they don't have political influence.

VICE CHAIRMAN BLUMENTHAL: On that issue, we have big business lobbyists here; we have consumer welfare lobbyists here. We have Ralph Nader. We have hundreds of different kinds of lobbyists. This is sort of a follow-on to Commissioner Fiedler's questions, are you starting to see any organization on issues of public health and safety on products? There are outcries over here on food safety, but back in China are you starting to see any organized lobbying besides big business lobbying?

DR. KENNEDY: You do have the Chinese Consumer's Association, but it's government controlled. Occasionally it does stick its neck out for consumers in the way the ACFTU sticks its neck out for labor. Sometimes it makes a splash and there are some news reports. There are individual activists who have blogs and lawyers who go around defending consumers and bringing cases, but not in an organized consistent fashion.

There are some industries in coastal China or some dominated by small private companies where the industry associations are somewhat better and really do help organize their members. In some of the cases such as dealing with cigarette lighters or shoes or socks that the EU had brought before the WTO has generated organizational activity at the local level in some of these industries. But by and large, it’s about size. If you're big, you win.

VICE CHAIRMAN BLUMENTHAL: Okay. Thank you.

HEARING CO-CHAIR HOUSTON: Commissioner Videnieks.

COMMISSIONER VIDENIEKS: Dr. Haley, I may have misunderstood this. I think you said that government consumption, I'm assuming it was SOEs, has grown at 30 percent over some period of time. It's actually increasing. It's my understanding that SOE participation in GDP has been falling. Is there an inconsistency or am I misunderstanding something? This is a question for both of you.

DR. HALEY: Well, there are no inconsistencies. However, other elements within the government are increasing their consumption. There's been a tremendous increase, for instance, in defense purchasing. There's been a tremendous increase in the bureaucracy, the numbers basically in the bureaucracy as well.

As to the extent SOEs have fallen as a share of the economy, it's been more than offset by government expansion in the military. It's been more than offset by government investment in infrastructure, elements of the economy, and so actual government participation has gone up. It's gone up from about one-quarter of the total consumption in China to one-third.

COMMISSIONER VIDENIEKS: Understood. But SOEs can be falling as--

DR. HALEY: Yes.

COMMISSIONER VIDENIEKS: --just as government expenditures are increasing?

DR. HALEY: Yes.

COMMISSIONER VIDENIEKS: Fine. Dr. Kennedy, any comments?

DR. KENNEDY: I could see those two statistics being separate and not tied together with each other. I think the overall trend of the last two decades is a declining share of the economy in state-owned hands, on the investment side, the spending side and on the consumption side. However, I don't expect it to disappear at all so I wouldn't draw a straight line out in any direction like that.

COMMISSIONER VIDENIEKS: The term, "foreign-invested enterprise" and "state-owned enterprise," is there an overlap? Can a state-owned enterprise also be foreign-invested? I think the question was answered but I want to clarify. Then the follow-up question would be: what percentages are instrumental? What is a foreign-invested enterprise? For example, does five percent foreign ownership qualify it for being called such? This question is to both of you.

DR. HALEY: Well, I think to the extent that they've invested overseas, you've got a foreign-invested enterprise. Now the question is are you referring to the Chinese SOEs investing overseas?

COMMISSIONER VIDENIEKS: Chinese enterprises. Also a question, what is an enterprise? A plant, a company, a sector?

DR. HALEY: It can be a plant. It can also be a distribution. Li-Ning Athletic Wear, for instance, has an R&D area in Hong Kong. It has production overseas. It has distribution overseas. It has retail outlets, company-owned retail outlets, all overseas. They operate in Europe. They operate in the Middle East. They operate in Latin America, and in Africa.

COMMISSIONER VIDENIEKS: I was going to say primarily in China, is there a conflict in terms by saying a foreign enterprise, foreign-invested, and can a foreign-invested enterprise in China may also be a state-owned enterprise?

DR. KENNEDY: As far as I understand it, if a foreign-invested enterprise, if a foreign company, a wholly foreign-owned company, were to invest in a state-owned enterprise at ten percent or more, then that would make that a foreign- invested enterprise.

However, most of the time, the joint ventures between a wholly foreign-owned subsidiary of a multinational and Chinese company forms a new joint venture, in which both sides share a certain amount, and so there may be a state-owned portion of that company owned by a state-owned enterprise and a portion of it owned by the multinational. That would be a foreign-invested enterprise, and in part a subsidiary of both partners.

I think one of the sources of confusion that you and others may have is that Chinese statistics continually evolve in regards to this question. If you open up the China Statistical Yearbook, the word "state-owned enterprise" appears but so do nine other terms and break down in various categories.

I think that there could be reasons for that because China has developed a company law, revised a company law, and have proprietorship law, and so those old categories in real terms don't make sense anymore. However, there could be an underlying political logic to it, in that if you're a reformer and you want to diversify the economy, but you've got The New Left that Professor Haley mentioned impeding your efforts. To fix that, you muddy the waters by creating a whole bunch of terms that you don't entirely know what it means. As such, the Chinese end up talking about public versus private companies or things like that. So I appreciate your confusion because I'm equally confused.

DR. HALEY: There is just one other thing. It's actually in my written testimony. From 1986 to 2005, Chinese SOEs invested in a minority investment with a foreign company, a joint venture, 30 times. They obtained control of a foreign company joint venture 76 times.

HEARING CO-CHAIR HOUSTON: Thank you very much.

COMMISSIONER VIDENIEKS: Thank you.

HEARING CO-CHAIR HOUSTON: Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you, Madam Chairman. I want to clarify something you said, Dr. Kennedy, to the effect that you see that there will be a continued expansion of inequality in this process. I got the impression that you felt that the authorities did not consider that overly worrisome.

However, my understanding is that the amount of disruption in the rural countryside over the last few years has been of concern to the leadership. If the social safety net is not going to be constructed in such a way to erode that and there's going to be more inequality, then what is your assessment of the effect on rural stability? Furthermore, what would the political impact be of that continued instability? I assume growing instability if there's going to be growing inequality? Do you see that as a matter of concern to the government or not?

DR. KENNEDY: I do. I think you need to distinguish between economic inequality and people's perceptions of why things are unequal. People are oftentimes willing to accept inequality. I'm willing to make as a professor a hundred times less than an American CEO because they're contributing more to the global economy.

HEARING CO-CHAIR FIEDLER: 3,000 times less.

DR. KENNEDY: Yes, 3,000 times less. But when I feel that they're making money, their income is coming unfairly, then I get upset and I'll go into the streets. However, I'm a professor so I don't do that.

To be more direct, I think that the Chinese leadership is worried about rural instability or those who aren't doing as well. They are increasing their investments to help them, but I think their goal is to get them up to a sustainable level, but nullify their chances to be part of the leading elite themselves.

There are winners in this process, and there are those who have lost relatively, I think we're seeing a continued divergence of that despite the fact that Premier Wen and Hu Jintao have been investing more to reduce the inequality.

I don't expect the macro statistics to change much. Right now, I think the Gini-coefficient is about .5, .48 or something like that. I don't expect it to move in the other direction significantly soon.

I guess they're also thinking that if they can institute regulatory changes, legal changes that make it look like the center is trying to hold corrupt local officials accountable. That then takes the pressure off Beijing. Even if there's economic dissatisfaction, I think they're trying to make people feel less upset about that.

COMMISSIONER D'AMATO: Do you think they feel less upset, Dr. Haley?

DR. HALEY: I think what the government is trying to achieve is a situation where people in the rural areas, people in the interior, have the ability to gain a subsistence income where they can pay for food, medical, they no longer have free hospitalization, and pay for the education of their children.

They're not out to make them wealthy or help them become wealthy. I think what they're trying to do is give them the feeling that they actually have the opportunity to make a living, that their jobs are not being removed from them unfairly, and that they are working very hard towards this with several infrastructural efforts. The Great Canals they're building to transport water from the south to the northern rivers. In drought times, 80 percent of China's northern rivers run dry. They're trying to build three large canal systems up from the south to transfer water to northern rivers and have them actively flowing again so that the fishermen will be able to fish again, so that the farmers will be able to draw water again, and in that working towards the greater Chinese good they feel is going to reduce any kind of significant strife.

However, they're not out to get them up to the levels of income that you find in say the southeast where the industrials and most of your foreign companies are located. No.

COMMISSIONER D'AMATO: Thank you.

HEARING CO-CHAIR HOUSTON: Okay. We have a little under ten minutes for round two, and I have two very specific questions that I hope are simple answers and sort of quantifiable answers.

Dr. Kennedy, you mentioned before that there are significantly fewer joint ventures than there were, in the past. Question number one: is that because they phase out over time as a joint venture or was there at one point a situation where if you were a foreign investor, you really had to have a joint venture to enter China? Is it because that requirement has gone away?

Then my second question is for both of you. If I'm a Chinese SOE, what are the three main benefits to me of being a state-owned enterprise and would we consider under our standards or under WTO regulations that those benefits are cheating or legitimate?

DR. KENNEDY: To answer your first question, I think it's primarily the latter. There were significant obstacles to wholly foreign-owned enterprises operating in China until the late 1990s. As those barriers have declined, companies have run in droves to create wholly foreign-owned enterprises.

Also, the longer you're in China, the better connections you have with the Chinese regulators, with your Chinese partners. The better you understand the country, the less you need a partner. I think there were lots of joint ventures where the managements just couldn't see eye-to-eye on many different things, and so the ability to be independent but still be able to operate and learn is what I think is driving that.

What benefits does an SOE have? I would say much higher likelihood of access to credit from state banks. If two companies are of equal size, then the state-owned enterprises probably have an easier time picking up the phone and calling a Vice Premier if they have a problem, and that happens quite frequently.

If you're a state-owned enterprise, you probably have, depending on the industry, greater chances to invest in some sectors; that private and foreign companies don't have a chance to. You're not going to see in China any private company compete with China Telecom or with Baoshan Iron and Steel even though there are private steel companies.

I think those are three benefits. Do they violate the WTO? Some of these probably do. I don't know enough about bank credit because it depends on how you define a subsidy. I don't know if easier access to bank credit would meet those criteria.

In terms of access to officials, no. I don't think the WTO governs lobbying practices. It may, but there are rules in the WTO that could be cited about areas that are off limits, that foreigners or private companies couldn't invest in.

HEARING CO-CHAIR HOUSTON: Dr. Haley?

DR. HALEY: Well, I think one of the primary reasons why you're seeing many more non-joint ventures is the fact that it's now legal to enter as a fully foreign-owned company. You hear about the great success General Motors has had with Shanghai Auto, but many joint ventures were thoroughly dissatisfactory.

At one time, the largest single investment in China was by a French starch manufacturer. They formed a joint venture with a Chinese SOE. They depended upon the Chinese SOE for guidance. They built the largest single investment in China to produce starches there for the domestic market. They then found when the plant was built that the Chinese SOE didn't tell them that the starches that were intended to be produced in that plant were not consumed in China. They didn't tell them the fact that the roads in the area wouldn't permit trucks, the traditional trucks that the plant's products were being shipped out in, to drive over them. They were too heavy for the roads. They didn't tell them that the correct equipment to actually ship the starch in China did not exist to ship the plant's full production even if they ever got up to full production.

So you had some very, very dissatisfactory joint ventures, which has led to foreign companies moving towards a fully-owned investment as the primary form of entering Chinese markets today.

Insofar as the primary benefits, I think the greatest benefit is actually the fact that the Chinese SOEs get their shares listed on Chinese stock markets; private companies generally do not get approval. It's not just low interest loans that Chinese SOEs receive. They get loans that they don't have to pay back. They traditionally have not paid back those loans, and that is against the WTO rules.

They also get assets transferred to them. You have assets such as bridges transferred to Chinese SOEs where they can charge tolls for transportation over those bridges in order to give them greater revenues, and that is granted to them almost for free. The prices they pay for these are abysmally low.

Another thing that you see is the energy subsidies and land subsidies. They also receive those. They also have put much greater effort into controlling their labor and labor problems. Private companies generally have their labor problems settled in favor of labor. The SOEs have them settled in favor of the SOE.

HEARING CO-CHAIR HOUSTON: Great. Thank you very much.

DR. KENNEDY: Can I just add one point?

HEARING CO-CHAIR HOUSTON: Sure.

DR. KENNEDY: SOEs do get lots of benefits, but it's not a cakewalk being an SOE. There are lots of problems that come with it; the management of SOEs doesn’t like the control that SASAC and others in the Communist Party try to hold over them. Moreover, it's not just one institution; it's multiple state institutions trying to eat into their pockets all the time. Being an SOE is like walking around a bad neighborhood. You have to put your hands over all your pockets at once.

HEARING CO-CHAIR HOUSTON: That sounds like the American tax collecting.

DR. KENNEDY: So it's not all great. You know it's not all great.

HEARING CO-CHAIR HOUSTON: Thanks. Commissioner Wessel.

HEARING CO-CHAIR WESSEL: A quick question. I understand that several of our auto companies who had had joint ventures there now find that the benefits of having that joint venture have been gradually decreased as the Chinese have gained access to the technology, have been taught how to get up to ISO-9001 so that the reduction in the JVs is because we've already supplied the Chinese what they were seeking.

Have you been seeing that, both in the auto industry and in other sectors? I hear it's happening in the aerospace industry as well.

DR. KENNEDY: I guess the original question was asked from the perspective of the foreign enterprises. What you're pointing to is an amicable divorce. Both sides being willing or rather both sides achieving what they wanted or having reasons to go their own separate ways.

HEARING CO-CHAIR WESSEL: I don't know how amicable it is when some of our auto companies had hoped to reap more profits and find out that they've created their worst competitors.

DR. KENNEDY: Well, from some companies' perspectives, especially multinationals, the ability to go alone, to have wholly foreign-owned enterprises is something they strongly prefer now.

Chinese companies that have benefited by obtaining technology, management know-how, et cetera, are happy to do so as well.

I think, that is a natural evolution of the process. Creating competitors isn't always a bad thing for a company. If the competitors are acting unfairly, then yes; but to the extent that there are Chinese companies, auto parts' companies which are doing relatively well, they're improving the health of the market overall from the perspective of the industry as a whole. To individual companies who are selling less brakes or things like that, I'm sure they'd be quite dissatisfied.

HEARING CO-CHAIR HOUSTON: Do you have a quick addition, Dr. Haley?

DR. HALEY: Yes, I think that the big problem is that the American companies had in view a long-term joint venture relationship such as General Motors and Toyota with their plant for Nova in California. They are dissatisfied in that respect.

The other problem that arises from this is not only that they have acquired the technology to compete with Western companies, not just American companies, you find that the component parts, especially for repairs, get copied by pirates.

Instead of customers buying the parts that were meant for the product, they buy the pirated parts. In so doing, the pirated parts, not living up to the quality standards necessary for the Western cars, basically destroy the automobile, and then the autos get returned to the manufacturer and the manufacturer is pressured into repairing those automobiles for free.

As an example, the Santana, which is the largest selling automobile in the history of China and produced by Volkswagen, has never been profitable for Volkswagen because of all the damage caused by pirated parts that they've been forced to fix at their expense.

HEARING CO-CHAIR HOUSTON: That's a very interesting point. Thank you very much for that, and thanks to both of you. You have provided us with a lot of answers and as always we end up with more questions. Thank you very much, and we will reconvene at a quarter to the hour. Thank you.

DR. KENNEDY: Thank you.

DR. HALEY: Thanks.

[Whereupon, a short break was taken.]

PANEL III: CONGRESSIONAL PERSPECTIVES

HEARING CO-CHAIR WESSEL: Thank you. We'll get started. Two of our commissioners are still filing in, but we're honored to have Congressman Manzullo here today with us. He's been a good friend of the Commission over many years. He's appeared before us and we're honored to have him here once again.

Congressman Manzullo represents the 16th District of Illinois. He serves on the House Foreign Affairs Committee, was the ranking Republican on the Subcommittee on Asia, the Pacific and Global Environment and a member of the Subcommittee on International Terrorism, Nonproliferation and Trade.

He also serves on the Financial Services Committee where he sits on the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises and the Subcommittee on Domestic and International Monetary Policy, Trade and Technology.

Congressman Manzullo has testified at several Commission hearings including hearings on China's counterfeiting, China's overall adherence to WTO commitments, and the effects of U.S.-China trade on the U.S. defense industrial base. We are honored to have you with us today. Please proceed.

STATEMENT OF DONALD A. MANZULLO
A U.S. REPRESENTATIVE FROM THE STATE OF ILLINOIS

MR. MANZULLO: Thank you very much. Thank you for your time. I'm delighted to have the opportunity to appear before you this morning and as always enjoy the opportunity to share with you some of the life experiences that I've had as a member of Congress and especially representing the 16th District of Illinois which has over 2,500 factories. Winnebago County is the largest county, and, aside from Wayne County, Detroit, we have the second-most intense manufacturing presence in the country.

One out of four jobs in Winnebago County is directly related to manufacturing. That means one out of four people works in a factory, and the rest that have the coffee shops and the tea shops, et cetera, are not even counted in that factor. So manufacturing is obviously extremely important in the district that I have the opportunity to represent.

We have continuous complaints from China in the past several years, but at the same time we've been able to develop a relationship with the Chinese ambassador especially as I've had the privilege of chairing the first U.S.-China inter-parliamentary exchange which the Speaker appointed me to in 1999.

As problems have come up in the past, we've been able to talk to him. I give him a letter, and he's intervened. I know that he's very much concerned over piracy issues. In fact there was a piracy issue going on that severely impacted one of my constituents. He actively became involved in it and is trying to resolve it.

But he's only one person. He's reacting because he's a good diplomat and he's a good man, but China is a big country, and one person simply cannot be responsible for everything that is going on there. I come from the persuasion of being a free-trader. I've voted for every free trade agreement that's ever come before the Congress in my now 15th year in Congress, not that free trade is perfect, but it's a lot better than the alternative.

We have to realize that in the economy in which we're living, 80 percent of all airlines will be purchased by Asian countries in the next 20 years. So the stakes are immense. China has four times the population of the United States, but only one-tenth of the aircraft. Of their 135 cities in excess of one million people, approximately a quarter of those have airports, and the rest are in the process of trying to construct the airport.

You can see that China is still an emerging nation. At the same time, China has placed itself in the position of saying that they're an emerging nation and you have to be very careful with them. They claim that they're not ready to assume responsibilities of a developed nation. For example, one thing that hinders them is a severely underdeveloped capital market system in order to make the RMB float. At the same time, this is the nation that could use a multi-stage rocket to knock a satellite out of the sky.

China really has to decide whether it's going to hide behind the, “impoverished me” model or whether it's going to grow up. What particularly bothers me, and we've been following the summit that just finished here in Washington, are the headlines like "China Concedes Little at the U.S. Summit."

They came over with $30 billion in checks, supposedly. I inquired into what they you looking for? They said maybe cowhides and soybeans? I said, “Well, you're already buying all the cowhides there are because you're making shoes.” In our attempts to try to get the Chinese to buy stuff, which I've been trying to do for 15 years, I have yet to settle one contract.

I feel I should note that I have the experience and background to discuss Chinese trade relations. Along with Matt Semanski who chaired the Small Business Committee, we’ve interacted with the Chinese government a lot. I’ve been there several teams and my colleague Mr. Semanski has been there over 25 times.

I'm just tired of memorandums of understanding and the memorandums of agreement. The Chinese have to understand that when you live in a corporate world, that you have to grow up. Actually, they understand that very well because they go to the same schools and universities and study in the same economics classes as the American guys that are running American companies.

This is a very difficult situation than we’re used to in dealing with the Chinese. They're great people to work with. We've had very, very warm relationships, extraordinary talks. Many of them are quite frank, and obviously would like to see them continue. When I met with Madame Ma, whose in charge of trade delegations, and Wu Yi this past week, I told Madame Ma, I said, “You know, you guys bypassed Rockford, Illinois, and I explained the same to the ambassador and he really wants to do something sincerely.”

The ambassador said, “Well, tell us what you make?” I said, “No, no.” I said, “We can do that. I said with 2,500 factories, you tell me what you want. And when you come over, I don't want any press, I want no press conferences. Only bring people that have a contract and a check in hand to make a deposit to buy some of the good stuff that's manufactured in my congressional district.”

We do have a lot of stuff that's going to China but not nearly enough. Let me end with this point. There's a lady that makes a switch, and she has 12 or 13 employees in Rockford, Illinois. I asked, “Are you exporting?” She said, “Yes, I export about a tenth of that to China.” I said, “What's that switch do?” She said, “It controls the brake on cranes.”

I said, “Is anybody trying to make it over there?” I had this conversation a couple years ago. She said there was not. She added that they've never had a failure. Well, a brake on a crane is extremely important. I said, “Have you gone to China to see if they want any more products?” She said she’s terrified to go there. I said, “They're not going to eat you.”

I told her that if they have confidence in your product, they will give you other contracts even though they're not directly related because the Chinese place a real emphasis upon personal relations. As such, we have this incredible diplomatic challenge on our hands. We have to be firm with the Chinese, and yet respectful, because they love their country as much as we love ours.

They've got a huge problem with trying to resettle 100 million peasants into an area where manufacturing is already going on.

I would commend the U.S.-China Economic and Security Review Commission for the extensive hearings that you're doing and the exhaustive research that you do. This material, we read a lot of it. The Chinese also read it.

Hopefully by next year, China will concede at the U.S. Summit. Most of all, the Chinese need to know this: that this Congress is ticked. This Congress is really, really upset. The Hunter-Ryan bill, or Ryan-Hunter now, says that manipulation or misalignment of currency will now to be considered unfair trade practice and that proposal has got legs to it.

Those two guys would be deemed protectionists. I'm a free-trader. It's a bill we put in last time that changes the definition of manipulating the currency. Now you don't need both a unilateral edge to the complaining country and an overall trade deficit in order to be considered a manipulator of the currency.

That bill, if passed, would really bring home to the Chinese that we're serious. Plus if the USTR, an extraordinary case, helped bring countervailing duties against a non-merchant country on the glossy paper, the message would be quite strong. I mean Americans have just had it. The Chinese really need to make dramatic, immediate changes in their trade policy or we may have too much of a swing this way that could lend up hurting both countries.

I'd like to have my complete testimony made part of the record.

HEARING CO-CHAIR WESSEL: We will do that and thank you. You have had a clear and consistent voice on this. We also appreciate the staff work that has been done on your behalf. They've worked closely with us over the last several years and that's been very helpful.

I know you have a difficult schedule on the House side.

MR. MANZULLO: I have to leave, and I don't want to keep my colleague here waiting while you ask me questions.

HEARING CO-CHAIR WESSEL: We appreciate your being here. Our chairman, Carolyn Bartholomew, regrets that she could not be here. I think she’s worked with both of you in the past, and hopes to be able to be at your next participation here.

Congresswoman Carolyn Cheeks Kilpatrick represents the 13th District of Michigan. She serves on the House Appropriations Committee where she sits on the newly created Financial Services

Subcommittee and the Homeland Security Subcommittee. The Congresswoman was unanimously elected Chairperson of the Congressional Black Caucus for the 110th Congress.

In 2005, Representative Kilpatrick introduced legislation that would have blocked the sale of Chevron to the Chinese oil giant CNOOC, arguing that it threatened U.S. energy independence and jeopardized U.S. national security.

Today's testimony is her first appearance before the Commission, but we've worked closely with her staff over the years and look forward to your testimony today. Thank you.

STATEMENT OF CAROLYN CHEEKS KILPATRICK A U.S. REPRESENTATIVE FROM THE STATE OF MICHIGAN

MS. KILPATRICK: Thank you very much, sir, and thank you to the Commission, too, for your responsibility here. It is an awesome responsibility. The world is changing. We're a global community, and to be around the world in two clicks of the mouse makes your job extra special. I commend you for your service.

I also want to thank you for coming to Michigan last year during the summer. I was not able to be there. I was out of state, but my colleagues, Senator Stabenow, Congressman Dingell, as well as Congressman Sander Levin, did testify and told you of some of our concerns.

I would like to offer my full testimony for the record and just summarize for the next five minutes or so.

There are probably three major issues, and I think you'll hear it over and over again. You've seen it in Michigan and I'm sure as you move around the world, and particularly throughout our country, the concerns that we have. China has been a good neighbor for many years. For many years, our country and other countries of the world have been very helpful to China as they become a 21st century leader in our economies around the world.

Three major areas of concern that we have: intellectual properties is one of them. We've got to do something about that. I think China must live up to its WTO obligations, as it came into the WTO in 2000, and many of us feel that they have not done so. We also are concerned about the obligation to the WTO in regards to the devaluation of their currency.

As was mentioned, I represent the 13th District of Michigan. It is the headquarters of the General Motors Corporation, as you came to Michigan, I’m sure you heard much of this. In Michigan, we've lost 250,000 manufacturing jobs, over three million across this country. Manufacturing, unfortunately, has moved to other parts of the world.

We now have become more of a service/technology country, and I want you to know that in Michigan and in the Detroit proper, where GM's manufacturing base is, we are moving to new technologies.

We believe in strong support for alternative energy. As I'm sure you read, we were very involved in that last year. We wanted more to happen. We didn't think the CFIUS did not represent our country as well as it should have. We wanted to better look at that.

China is all over the world in various countries in the oil business, trying to take care of their two billion people. Of course, we would not deny them that opportunity.

I also want to take care of the 300 million who live in this country. So it is our responsibility as members of the United States Congress, as well as yours, to see that we maintain opportunities for God's children here and to strengthen American families so that your children can compete in a global setting.

I'm a grandmother. I have two children. My son is the mayor of the city of Detroit and my daughters both have twin children. I have two sets of twin boys, 11 and 9, and I know some of you have children and grandkids of your own. It is our responsibility for those who left this country to us to make sure that they have access and opportunity as they move forward.

China must adhere to the obligations of the World Trade Organization. They must protect intellectual property rights and they must abide by the human rights laws that are expected of others nations who have developed that far.

We have entered a new phase of economic development. The auto industry must be better. They must be better international partners. Ten years ago, GM partnered with China in a 50/50 percent deal, Ford did as well, I might add. Today, GM is the number one auto company in China. Ford is the number two auto company in China. In those plants, the Wall Street Journal just reported a couple of weeks ago on its front page that China has announced because they now have the intellectual properties of those two companies, they can manufacture cars better, cheaper and produce more of them for the entire international market, even more so than in their own domestic market.

I think we need to take a look at that because what that ends up doing is putting our own country and our children's future at risk.

We have to partner with China, but they have to also open up their markets. As you know, the trade deficit with China, India and other countries is incredibly high. I'm a free-trader as long as you don't trade away the freedom of the people of America. I think we have to pay much better attention to that as we move on.

I don't think China has done that as you look out and receive testimony and do your own research, I'm sure you'll see the same thing.

General Motors lost $5.6 billion of its North American operation. Ford lost $5.5 billion during the 1990s. General Motors had 36 percent of the market. Today it's 26 percent and diminishing. Ford had 24 percent during that time. Today it's 17 percent and diminishing.

Ford and Daimler-Chrysler, though I know you know by now that the Chrysler part of Daimler is separating. We do believe, and Bob Eaton was a personal friend of mine during that time, ten years ago as well, when we thought that was a partnership of equals. However, that was not the case. It was a buyout, and we know that now. It has been documented as such.

I'm born in a labor town and I believe that labor has provided the middle class for America. One in eight jobs in America is tied to the auto industry. When Michigan suffers, we suffer first; but the entire American family suffers as we move our good-paying, good-benefit jobs offshore.

I want to say just a couple of things that I think we have to do. We have to ask China what steps they will take to stop the WTO banned trade practices, including some of its governmental industrial subsidies aimed at export promotion, undervaluing its currency, and violation of intellectual properties, among others.

Comment [j1]: Is this right? Don't we subsidize certain industries here?

We also have to ask China in terms of counterfeiting from auto parts to other consumer items like purses and so forth. Whenever they do that, they devalue our own authentic products. I keep going back to auto because that's the basis of America's middle class, but there are other things as well.

What steps will China take to end their requirement for domestic manufacturing of a 40 percent content requirement in American-made vehicles? I find this curious because at the same time we don't have that same requirement for their vehicles? It's a disadvantage that I think we can no longer take.

So people of the Commission, you have your work cut out for you, and again I thank you for that. I know how hard it is. We juggle all these balls in the air just to make sure that we stay strong as a nation, as states and as families. We have that responsibility and I commend you for the job that you're doing. I ask that you reach out to all of us across this Congress, all 435 of us in a bipartisan way. Geographics in the country dictate that we do that.

If America is to remain the strong nation that it is, we have to remain strong on these issues. I've had an opportunity to go all over the world in my posts, 18 years in the state house and now my 11th year here in the Congress, six terms, to see other parts of the world. We're the best country in the world. I don't think we should forsake that for anyone. The children deserve better.

It's been a pleasure to talk with you today. I ask that you put my full statement in the record. I'm available for any questions and beyond that. As member and chairperson of the Congressional Black Caucus, we are 43 members from 26 states; we represent 40 million Americans. 17 of our members have districts with less than the population majority of African Americans. We represent Asian Americans, Indian Americans, Latino Americans, European Americans; the gamut in our country, the diversity in our country.

We come to you this morning representing them as well as speaking as a Michigan representative. Let's level the playing field. Let's make sure China is a good partner in the world. I think only the U.S. can demand that and that we work together to make sure that the children of this world, and particularly Americans, have the opportunities that others worked for so hard that we might have them today.

Thank you very much.

[The statement follows:]

Prepared Statement of Carolyn Cheeks Kilpatrick
A U.S. Representative from the State of Michigan

Giving thanks to God, who is the power, force and director of my life, I want to thank the Members of the U.S. – China Economic and Security Review Commission for their continued hard work, objective analysis and hard questions for both China and the United States. As our world gets smaller every day, and as China emerges as one of the largest trading partners of the United States, I, along with the vast majority of the Members of Congress, seek a balanced and fair business environment on both sides of the Pacific.

I also want to commend the Commission for taking the initiative to come to my home state of Michigan last summer. Chairman of the House Energy and Commerce Committee John Dingell, Ways and Means Trade Subcommittee Chairman Sander Levin, and Senator Debbie Stabenow all added to the importance of the impact of trade on our great State and greater Nation.

The universe of consideration for today's hearing is significant. China has more people in its boundaries than any other country on the face of the earth. China's commitment to economic reform, human rights, the modernization of its manufacturing base, and democracy is largely determined by its sheer size and the fact that China has the specter of decades of state or governmental control. While China's growth and progress are to be commended, there are three areas regarding China's past and present trade practices that raise concerns not only to me, but to most Members of Congress, my constituents, and Americans in general. These areas of concern are:

- China's adherence to the obligations of the World Trade Organization, and how it affects the automotive industry;
- China's commitment to the protection of intellectual property rights and its production of counterfeit goods; and
- China's human rights policies.

Allow me to touch briefly on each of these areas.

<u>China and the U.S. Automotive Industry</u>

One of the conclusions of the Commission's hearings in Dearborn, Michigan is that in the next five to ten years, China will witness an entire new phase of economic development regarding the automotive industry. Once incapable of producing automobiles, China will have a fully mature automobile industry capable of producing a large volume of vehicles with the quality and styling sufficient to compete in all international markets. Coupled with the undervaluation of their currency, tax breaks, and subsidies, China is poised to export an unfairly priced automobile. To be more precise, it is believed that China's aim will be to seize significant shares of markets abroad rather than simply to produce vehicles for domestic trade. As the Commissioners reported, and as a Michigander concerned about not only jobs in Michigan but in the United States, this strategy has been China's practice of export driven growth; the primary target being the United States.

One in every eight jobs in the United States is somehow linked to the automotive industry. After the purchase of a home, the purchase of an automobile is the largest purchase for the overwhelming majority of America's consumers. Michigan, specifically my home city of Detroit, has been the home of the automotive industry for decades. While this role has been shifting, the decline of the domestic automotive industry, when it comes to China, has not been an entirely level playing field.

The losses of the automotive industry have been massive. In 2005, General Motors, which is headquartered in my Congressional District, lost more than $5.6 billion on its North America operations alone, with Ford losing $5.5 billion during the same period of time. GM's share of the market, which used to be 36% in 1990, had shrunk to 26% in 2005. Ford's 1990 share of the market, which was 24%, was 17% two years ago. Production for Ford and GM has dropped 26% since 1999.

In the wake of these losses, Michigan and our country has lost a significant number of jobs. Both GM and Ford announced a series of plant closings in North America, with an estimated loss of 60,000 jobs through layoffs and early retirement buy-outs. According to the Bureau of Labor Statistics, in 2005 the automotive industry lost a total of 215,000 jobs, and stated that "industry employment is headed downward and is not likely to recover for several years." This situation does not get any better for those related industries supplying automobile parts, providing insurance for automobiles, or selling vehicles wholesale or retail.

While domestic manufacturers are not entirely blameless for these losses, a significant factor has been the way in which China has done business with the Big Three. One of the Commission's conclusions at the Dearborn hearing is that "the many subsidies provided by the Chinese government to the auto industry will quickly distort the nature of the market. This will be true especially in the United States, where markets are most open. The Chinese challenge to the U.S. auto industry is a significant assault on American manufacturing, and that assault is increasing in magnitude and in pace."

American companies can compete, be innovating, and be as creative, if not more than, any country on the face of this earth. American workers will work as smart, as hard, and as efficient as any worker in the world. The automotive industry has provided good, fair paying jobs and benefits for generations of all Americans. Indeed, the auto industry was one of the first industries to provide fair wages and benefits to African Americans during an era of rampant segregation and discrimination. But this competition has to be on a level playing field, as China promised the United States when China became a member of the World Trade Organization. The Commission's findings clearly indicate that this is not the case.

In light of these facts, I strongly urge the Commission, as it does its work to equalize trade between our two countries, to aggressively ask and urge our Chinese partners and the leadership of China to address its findings from the hearing in Michigan, which include:

- What steps will China make to stop its WTO-illegal trade practices, including its governmental industrial subsidies, undervaluing of its currency, violations of intellectual property agreements, among others, to eliminate the eroding of the U.S. manufacturing base? This significant harm to our diminishing manufacturing base is jeopardizing only on the U.S. automotive industry, but of other industries as well, including the U.S. defense industry;

- What steps China will immediately take to stop China's counterfeit automobile parts to be internationally misrepresented as genuine parts, in direct violation of both China's trademark laws and China's WTO obligations; and
- What steps will China immediately take to end the requirement from domestic manufacturers of a 40 percent content requirement in American made vehicles or face higher tariffs on American auto parts? As the Commission illustrates in its conclusion, this policy increases pressure on Chinese manufacturers to use Chinese versus American made parts. It also violates promises China made, and legal obligations it assumed, when it joined the WTO.

China and Intellectual Property Rights

Another concern is China's compliance to Intellectual Property Rights and it Production of Counterfeit Goods. Violations of intellectual property are harming U.S. consumers and American manufacturers. Since the year 2000, our motor vehicle parts industry has seen a decrease of 17% or a loss of 173,800 jobs. China's discriminatory tariff practice force Chinese base auto assembly companies to use parts made in China rather than parts manufactured in the United States. This is a direct violation of promises China made as part of its accession to the United Nations. Indeed, there is evidence that workers in other countries effectively are replacing U.S. auto parts workers.

Intellectual property industries contribute to more than 50% of all U.S. exports and represent 40% of U.S. economic growth. This represents a tremendous investment of time, money and tenacity on the part of our investors and workers. The impact of Chinese violations of Intellectual Property Rights is difficult to assess. The U.S. Chamber of Commerce estimates that the global intellectual property industry loses $650 billion annually in sales due to counterfeit goods. Some analysts estimate that China is responsible for as much as 70%. U.S. copyrights loses are estimated at between $2.5 billion and $3.8 billion. Our pharmaceutical industry loses 10-15% of annual revenues due to property rights violations.

These inconsistencies are found in the subsidizing of various industries or other mechanisms to promote favored industries. These issues pose serious disadvantages to our manufacturers and work force; taken together, they present a very difficult mountain to climb to an American industry that is already immersed in obstacles These declines not only represent the loss of jobs, but also the deterioration of our communities and cities.

China and Human Rights Policies

As a Member of the House Appropriations Committee, I have served a majority of my time on that Committee on its Foreign Operations Subcommittee. I have been to China, and I fully understand and appreciate how China is seeking an increasingly active role in the world, especially in Africa, Latin America, and Southeast Asia. China's foreign relations often are tied to its desire to open new markets to Chinese imports and also to access resources, such as oil, minerals, and timber, to fuel China's continued economic growth. There are instances in which China appears to present itself as an alternative to partnership with the United States and is concerned with expanding its ability to influence global organizations and norms. Although China has heard the U.S. call for it to act as a "responsible stakeholder" in its global affairs, its continued investment in and support of the regimes in Sudan, Zimbabwe, Iran, and Burma suggests that China has not adopted this policy.

The continent of Africa now supplies approximately a third of China's oil imports. China has invested in oil exploration and production in countries across the continent, including Algeria, Angola, Nigeria, Equatorial Guinea, Ghana, and Sudan. In 2006, Chad switched its diplomatic recognition from Taiwan to the People's Republic of China; the two countries currently are engaged in oil exploration and production joint projects.

As a human rights activist and fighter, one of my personal concerns, and that of the Congressional Black Caucus of which I am the Chairperson, is ending the genocide that is in the Darfur province of Sudan. In the wake of the world's awakening to this horror, I am sure that the Commissioners are aware of the many individuals who protest China's involvement in Sudan. In particular, there are organizations that have indicated that they will use the 2008 Olympics in Beijing as an opportunity to speak out against China's continuing support of the Khartoum regime, which they argue is responsible for genocide in Darfur. I would strongly urge the Commission to explore and ask if China recognizes and appreciates the intensity of the opinion of the Congressional Black Caucus and international opinion about what is occurring there, and understand the widespread concern about China's role in enabling the conflict to persist? If that protest occurs during the Olympics in China, will China protect the protesters' right to free speech? Will China stop trade with Sudan and use its significant influence in this area to prevent further rape, death, and murder of innocent women, children, senior citizens and human beings?

I have hope that the relationship between China and the United States will benefit both countries. Fair trade between China and the United States means just that – trade that mutually benefits both parties. The story of trade with China is not all bad; China has forgiven billions of its currency in debt to some African nations. While never committing combat troops to the missions of the United Nations, China has more than 1,000 soldiers and police personnel serving in the United Nations' peacekeeping missions in Kosovo, Haiti, Lebanon, the Democratic Republic of Congo, Liberia, and the southern region of Sudan.

It is my obligation as a Member of Congress to protect the best interests of the people of the 13th Congressional District of Michigan and of America. As we continue to change course, confront crises, and continue the legacy of democracy and justice, we can have trade that benefits both partners, enriches both economically and spiritually, and do so without doing harm to one another or to others.

I look forward to the Commission's findings on this and future hearings, and look forward to working with our partners in China to level the playing field for all manufacturers and workers; ending the genocide in the Sudan; and fully respecting the intellectual property rights of all individuals and companies.

HEARING CO-CHAIR WESSEL: Thank you for your time. I know how busy your schedule is, and we look forward to working with you and your staff in the coming months as we continue our work.

MS. KILPATRICK: Thank you so much.

HEARING CO-CHAIR WESSEL: Thank you for being here. We'll now turn, if we can, to Congressman Walter Jones, who represents the 3rd District of North Carolina. He serves on the Armed Services Committee where he sits on the Subcommittee for Military Personnel, Readiness, Oversight and Investigations.

Congressman Jones also serves on the Financial Services Committee and its Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Financial Opportunities and Consumer Credit.

The Congressman is a strong supporter of American manufacturers and has consistently expressed concerns over America's trade relationship with China. We're honored to have you here for your first appearance and look forward to your testimony today and working with you in the future.

Please.

STATEMENT OF WALTER B. JONES
A U.S. REPRESENTATIVE FROM THE STATE OF NORTH CAROLINA

MR. JONES: Mr. Commissioner, thank you, and I thank all the commissioners for holding this very important hearing today.

Let me begin by saying that I strongly support fair trade on a level playing field. The problem is that the playing field with Communist China is anything but level. China engages in a multitude of predatory trade practices including rebating value-added taxes on exports, manipulating its currency, handing out loans at below-market value rates, and rampant theft of intellectual property. China also ignores its own labor laws and sullies its environment for economic gain.

Sadly, America's elected political leadership has spent the past ten years opening our borders and putting U.S. businesses and their employees in direct competition with a nation that embraces these egregious practices.

The results are painfully clear. Our trade deficit with China over the past decade is nearly $1.2 trillion, including $232 billion in 2006 alone. Trade losses with China accounted for 47 percent of the $528 billion U.S. trade deficit in manufactured goods in 2006. Lost production reflected in these massive deficits contributed significantly to the loss of 3.2 million U.S. manufacturing jobs since the year 2000! China's trade surplus with America has given it the hard currency to triple its military spending since 1994.

The Clinton and Bush administrations have repeatedly urged Congress and the American people to have patience, as they engage in seemingly endless dialogue with the Chinese about changing their trade policies. But after years of talk, China's currency is still grossly undervalued, piracy is still rampant, and massive state subsidization of Chinese enterprises is still the norm.

By now it should be clear to everyone that the Chinese have no intention of changing the policies that have brought them unprecedented economic growth. The fact that China's growth has come at the expense of America's working families is of little concern to their communist leaders.

These problems cannot be solved by dialogue alone. The United States Congress and the President must combat these practices with legislation to limit China's access to the U.S. markets unless China starts playing by the rules. Only then will China address the problems plaguing our trading relationship.

This Commission also has a valuable role to play by shining a light on China's trade practices. Your work helps the Congress and the American people understand what is at stake in this debate. I thank you for what you do and urge you to keep up the good work.

Mr. Commissioner, in closing, I want to say that I am 64 years of age. I have grown up in the best times for America. What I am seeing now is the economic failings that I think will crumble the economy of this country. It's already begun to happen.

There is one word that the books tell you, the Bible and the history books, greed can and will destroy a family, a company, and a nation. To allow the Chinese to commit the economic crimes that they have committed at the sake of the American working people is absolutely unacceptable to those of us in both parties and to all American citizens.

I hope that this Commission, and I know that you will, will please remember that a great civilization cannot stand strong without morals and an economic base. You can do nothing about the morals, but you can do something about the crumbling economic foundation of this country.

I thank you very much for allowing me to be brief in my comments today and to have this opportunity to appear before you. I ask you to please remember that greed has destroyed many a great civilization and it is eating at the economic fiber of this great nation right now. We must have fairness in trade and we must not continue to reward those who will not play by the rules. That's what this country has done to and for China and it's unacceptable.

I thank you, sir and ma'am.

[The statement follows:]

Prepared Statement of Walter B. Jones
A U.S. Representative from the State of North Carolina

Madame Chairman and Commissioners – Thank you for holding this important hearing today. Let me begin by saying that I strongly support fair trade on a level playing field. The problem is the playing field with communist China is anything but level. China engages in a multitude of predatory trade practices including rebating value-added taxes on exports, manipulating its currency, handing out loans at below-market-value rates, and rampant theft of intellectual property. China also ignores its own labor laws and sullies its environment for economic gain. Sadly, America's elected political leadership has spent the past 10 years opening our borders and putting U.S. businesses and their employees in direct competition with a nation that embraces these egregious practices.

The results are painfully clear:

- Our. trade deficit with China over the past decade is nearly $1.2 trillion, including $232 billion in 2006 alone;
- Trade losses with China accounted for 47 percent of the $528 billion U.S. trade deficit in manufactured goods in 2006;
- Lost production reflected in these massive deficits contributed significantly to the loss of 3.2 million U.S. manufacturing jobs since 2000; and,
- China's trade surplus with America has given it the hard currency to triple its military spending since 1994.

The Clinton and Bush administrations have repeatedly urged Congress and the American people to have patience as they engage in seemingly endless dialogue with the Chinese about changing their trade practices. But after years of talk, China's currency is still grossly undervalued, piracy is still rampant, and massive state subsidization of Chinese enterprise is still the norm. By now it should be clear to everyone that the Chinese have no intention of changing the policies that have brought them unprecedented economic growth, and the fact that China's growth has come at the expense of America's working families is of little concern to their communist leaders.

These problems cannot be solved by dialogue alone. The U.S. Congress and the President must combat these practices with legislation to limit China's access to the U.S. market unless China starts playing by the rules. Only then will China address the problems plaguing our trading relationship.

This Commission also has a valuable role to play. By shining a light on China's trade practices, your work helps the Congress and the American people understand what is at stake in this debate. I thank you for what you do and urge you to keep up the good work.

HEARING CO-CHAIR WESSEL: Thank you for your passionate statement and your leadership on this issue. I know you have votes pending in the House shortly so we look forward to working with you and having you before us again in the future. So thank you.

MR. JONES: Thank you very much. Thank you.

HEARING CO-CHAIR WESSEL: We will recess till 1:30.

[Whereupon, at 12:17 p.m., the hearing recessed, to reconvene at 1:33 p.m., this same day.]

A F T E R N O O N   S E S S I O N
[1:33 p.m.]

PANEL IV: DOES CHINA'S STATE-OWNED SECTOR FOLLOW TRADE RULES?

HEARING CO-CHAIR FIEDLER: Our fourth panel today has been asked to address the question of whether China's state-owned sector complies with the letter and the spirit of international trade rules and regulations.

Over the next hour and a half, we will hear from two knowledgeable Washington-based attorneys. Mr. Thomas Howell is a partner in the law firm of Dewey Ballantine where he specializes in international trade matters. His focus is on foreign industrial policies, foreign private commercial practices, and economic systems outside the United States.

His practice includes litigation on U.S. trade remedies, such as antidumping and countervailing duties, support for international negotiations, and securing market access abroad.

Mr. David Marchick is a partner in Covington and Burling. His practice focuses on complex international trade, investment, transportation, and legislative matters. I was wondering if there was something like simple international trade.

Mr. Marchick served in the State Department during the Clinton administration as Deputy Assistant Secretary for Transportation Affairs, Deputy Assistant Secretary for Trade Policy, and Principal Deputy Assistant Secretary of Commerce for Trade Development. He also held trade policy positions at the White House and the Office of U.S. Trade Representative.

He is coauthor of U.S. National Security and Foreign Direct Investment, published by the Peterson Institute for International Economics in Washington.

Gentlemen, I want to thank you for being here. We have as a practice with the Commission seven minute opening statements and plenty of time for the commissioners to ask questions afterwards.

I will start with Mr. Howell.

STATEMENT OF MR. THOMAS R. HOWELL, PARTNER, DEWEY BALLANTINE LLP, WASHINGTON, D.C.

MR. HOWELL: Thank you, members of the Commission. Thank you for the opportunity to appear here today. My panel has been asked to address the question of whether or not China's state-owned enterprises follow trade rules and that's a rather complex question.

Since China acceded to the WTO in 2001, they've undertaken a sweeping effort to bring their legal system into conformity with the WTO rules. They haven't completely done that and the U.S. government has criticized the pace at which they're attempting to conform to the WTO rules. However, there has been a major effort to bring them into conformity, and this has brought about a significant increase in trade in both directions.

With respect to the state-owned enterprises, the state ownership of an enterprise is not inconsistent with any multilateral rules. When the General Agreement on Tariffs and Trade was originally framed, the framers had a sense that governments could interfere in the markets in a variety of ways to favor certain enterprises, and there had to be some constraints put on those ways of interference. Some of these practices are now prohibited. Some of the others are subject to remedial action that is authorized under the WTO.

I'd like to talk about several of those areas in a minute. First, though, I should say that China's state-owned enterprises have been characterized as inefficient, overstaffed, poorly managed, corrupt and so on. In many cases, this is true, but there's been an attempt in the last three or four years to take a cluster of them, about 200, and turn them into a world class competitive enterprises. The ownership has been transferred from government ministries to state assets control organizations. There's been an attempt to professionalize the management, upgrade the technology, and so on.

These are national champions, so to speak. It's a traditional developmental strategy practiced by many countries around the world. They take a handful of companies in key sectors, usually state owned, build them up in traditional ways, using classic industrial policy tools like subsidization, import protection, preferential procurement and administered restraints on competition.

The first of these types of tools I'd like to talk about is subsidies, which is one of the most commonplace and important ones. Subsidies are generally not illegal or prohibited under the WTO Agreement. However, there are several categories of export subsidies and certain types of import substitution subsidies that are prohibited by the WTO.

In general, there's recognition that most kinds of subsidies are permitted, but they can cause injury to producers in other countries. In those cases, there are remedies offered under the WTO. A party can seek dispute resolution under the WTO directly or they can apply countervailing duties.

The vast majority of the subsidies the Chinese SOEs are receiving are in this latter category. They are what we commonly call domestic subsidies. The most important category by far is directed lending by government banks. Banks will make loans on below-market basis to companies that are favored by the state. The national champions I referred to before are obviously very high on the list to receive these types of loans.

They'll receive preferential financing and a lot of that debt is subsequently written off, converted to equity, or dealt with in another way so that the loans are not repaid. That creates a huge competitive advantage and distorts, and will further distort, competition in the world market if the practice isn't offset.

To be clear, that kind of assistance is not illegal, but it is actionable I think there's an important recent step that the Commerce Department took in holding that our countervailing duty law does apply to China and specifically to that kind of subsidy. That was an important step forward, and I think that the CVD law will be an important part of any response to this kind of aid in the future.

Administered restraints on competition are also a common industrial policy tool. We saw these used many times on many occasions in Japan, the European Union, and other countries as well to diminish the competitive pressures on producers. Typically, the government directs the industry to get together on prices, to limit their output, to keep prices stable, and essentially to limit competition at least in the domestic market.

The consequences of this over time, as we've seen in Europe and Japan, have been dumping in export markets, overcreation of overcapacity. China has headed down the same road. They are cartels in China's heavy industries that have been set up since the mid-'90s. They involve many of the national champion companies and the SOEs that are very similar to the old production restraint cartels we saw in Japan and Europe.

It's leading to overcapacity just like it did in those countries and it's leading to dumping. In the case of WTO policy, there are really no rules on competition policy, probably won't be for the foreseeable future, because the contracting parties cannot get together on that subject.

The antidumping law will remain the principal response to this kind of foreign industrial policy measure.

Finally, I’d like to discuss preferential procurement, which is also a very common promotional tool used in Europe, Japan, Korea, and other countries, and it is being employed in China as well. The practice has been curtailed elsewhere because of WTO rules that have set up the government procurement agreement. China did not accede to that agreement when it became a member of the WTO. They're actually implementing a number of new procurement policies that favor domestic industries and are designed to promote those industries through procurement.

However, there was a commitment made by China when it joined the WTO to base procurement decisions of the SOEs solely on commercial considerations. They gave those assurances to the WTO Working Party on their accession.

They also made a commitment that the government would not try to influence purchasing decisions by the SOEs. If the SOEs were to start favoring domestic products, that would be a WTO issue.

The issue is different, though, in that the government ministries in China are a huge market for products, and they are legally free to practice preferential procurement. Although one could argue that the implementation of these new measures that are discriminatory is inconsistent with the spirit of their commitment to move towards membership in the GPA.

My conclusion is that the SOEs represent a potential problem for U.S. industries and international trade. There may be some things that could be challenged in the WTO, but by and large, it will be up to the United States to use the remedies that it has, which are antidumping, countervail, safeguards, are the primary ones.

I believe that the problem in the long run will be self-correcting. China will conclude that use of SOEs as a promotional developmental tool is not the best way to achieve its ends and that the private sector can do a better job. However, it's going to be a rocky road between here and there.

Thank you.

[The statement follows:]

Prepared statement of Mr. Thomas R. Howell, Partner, Dewey Ballantine LLP, Washington, D.C.

Members of the Commission and Co-Chairs, my name is Thomas Howell. I am a partner in the International Trade Group of the Washington DC offices of Dewey Ballantine LLP, an international law firm. I have been working on matters involving China since 1979. I appreciate this opportunity to appear before you today.

My panel has been asked to address the question of whether China's state-owned sector follows trade rules. Since acceding to the WTO China has undertaken a sweeping effort to bring its laws and measures into conformity with WTO rules. While this effort has brought about a significant liberalization of trade and investment policies, the U.S. government continues to express concerns about the pace of China's WTO implementation. With respect to China's state-owned enterprises (SOEs), state ownership of a commercial enterprise, standing alone, is not inconsistent with WTO rules. However certain government policies and practices commonly associated with China's SOEs can cause market distortions and injury to private enterprises and in some case may be inconsistent with WTO rules. I would like to devote my presentation to three of the most important categories of such measures which are used to support with China's SOEs which for the most part are not inconsistent with WTO rules, but are nevertheless potentially problematic for U.S. industries -- subsidies, government-sanctioned restraints on competition, and preferential government procurement.

China's State-Owned Enterprises

When the Communist Party assumed power in China in 1949 all large producing entities became governmental organizations, the so-called state-owned enterprises or SOEs. Since 1978, when China's leadership committed the country to a course of long run economic reform, restrictions on the formation of private enterprises have been relaxed, some SOEs have been privatized, and foreign enterprises have been encouraged to form joint ventures with Chinese firms and to establish stand-alone local enterprises. In many parts of the economy a vibrant private sector has emerged. SOEs continue to dominate a number of sectors, including metals, mining, banking and energy. The conventional wisdom is that these SOEs are inefficient, overstaffed and poorly managed, and technologically backward, and in many cases the conventional wisdom is true.

However in recent years the Chinese government has been engaged in a comprehensive effort to reform the SOEs and to groom a number of them as "national champions" capable of competing at the world level in terms of scale, managerial competence, and technology. In 2003, the government created the State-Owned Assets Supervision and Administration of the Sate Council (SASAC), an entity charged with owning and supervising designated SOEs. Ownership of 196 SOEs has been transferred from government ministries to SASAC, and at the regional level branch SASACs have assumed control of some SOEs from local governments. SASAC has undertaken to rationalize management of the SOEs, reduce corruption, and protect the economic decisionmaking of the SOEs from interference by central and local governments. Some of these SASAC-held SOEs, such as Shanghai's Baosteel Group, have emerged as world-class competitors with competent managers, advanced technology and production processes, and sophisticated products.

These reforms are sometimes seen as transitional steps on the way to eventual SOE privatization. While this is partially true, China's leadership clearly intends that certain key industrial sectors will be more or less permanently dominated by SOEs as a matter of state policy. In December 2006 SASAC issued a notice stating that the "state-owned part of the economy shall have absolute control over important industries and key fields that are the vital arteries of national security and the national economy, "including armaments, power generation and distribution, oil and petrochemicals, telecommunications, coal, aviation and shipping." SASAC indicated that in these sectors "state-owned assets should expand in volume and be optimized in structure, and some key enterprises should grow into leading world businesses." (*Guo Ban Fa* No. 97, December 5, 2006). Similar statements by other government organizations have identified additional sectors to be retained under state control, such as the steel industry.

The WTO agreements, including the General Agreement on Tariffs and Trade (GATT) contain many rules premised on the notion that reducing government interference in the operations of private enterprises is beneficial and conducive to the world's economic welfare. But there is no prohibition, per se, on government ownership of an enterprise. Rather, the WTO system establishes constraints on the common mechanisms governments can use to promote individual enterprises whether publicly or privately owned -- import protection, subsidies, discriminatory taxes and domestic regulations, preferential government procurement, and so on. The longtime members of the WTO have learned to operate within these parameters and many of them have demonstrated that it is possible to channel massive state support to individual enterprises without running clearly afoul of GATT/WTO rules. Since the inception of the GATT "National champions," usually government-owned, have been promoted in Britain, France, Italy, Spain, Brazil, Mexico, Korea, and many other countries. There are many parallels between China's current promotion of key SOEs and those earlier efforts.

The challenge U.S. policymakers and U.S. industries face from China's SOEs is similar to that which was presented by SOEs based in Europe, Asia and Latin America. "National champion" SOEs benefit from an array of government measures intended to confer competitive advantages on individual enterprises. For the most part, while we may not approve of these promotional policies, they are not prohibited outright by WTO rules. Instead the WTO system provides institutional mechanisms for members to take remedial action when certain kinds of government promotional policies or industry trade practices cause economic injury to the industries of another member. This includes the ability to invoke WTO Dispute Resolution Procedures or to take action under national countervailing duty, antidumping and safeguards legislation. Although Chinese measures have already been subject to several WTO challenges, I believe that over the long run the U.S. trade remedies will remain the principal form of recourse available to U.S. industries confronting market distorting policies benefiting China's SOEs.

Subsidies

One of the most problematic aspects of China's SOE policies relates to the various forms of financial support SOEs receive from the government. China's equity and bond markets are not well developed and most SOEs must rely on government-owned banks for financing. The government controls interest rates at sub-market levels, creating an excess demand for credit, and the banks typically channel loans to enterprises designated by the government rather than to areas where the highest returns can be achieved. (A similar practice was at one time found in Japan and Korea.) Historically many of these loans have become nonperforming and have been written off or converted to "equity" without increasing the governments' proportion of ownership. Such politicized lending has characterized the operations of not only the country's three "policy banks" but its four main so-called "commercial banks," which, despite their name, continue to direct their loans toward the SOEs.

From the perspective of China's trading partners, private enterprises must compete against Chinese SOEs that may be considerably less efficient and productive, but which enjoy massive government financial support. This dynamic occurred in the European Community in the 1970s and 1980s and the result, both inside and outside of Europe, was that massive overcapacity was created and competition by subsidized SOEs drove more efficient private firms into financial distress and in some cases, out of the market altogether. As the presence of China's SOEs in international markets grows, this phenomenon may recur.

The WTO Agreement on Subsidies and Countervailing Measures ("SCM Agreement") prohibits subsidies which are contingent on export or which are contingent on the use of domestic or imported goods. But the vast preponderance of government financial assistance to China's SOEs, however, does not fit in either category. Most of these subsidies are so-called "domestic subsidies" which do not violate WTO rules but which are actionable under some circumstances when they cause economic injury to producers in another member country. WTO Dispute Resolution procedures can be invoked when subsidies cause "adverse affects" or "serious prejudice" to the interests of another member, but for whatever reason this remedy has not proven an effective discipline on subsidies.

The most common remedial measure with respect to injurious subsidies has been the application of countervailing duties by member governments, which is authorized by Part V of the SCM Agreement. To be clear, a subsidy which is subject to countervailing duties is not "illegal" or in violation of WTO rules. Most countervailed subsidies are domestic measures permitted under WTO rules which are found to have caused "material injury" to producers in another country. Under those circumstances, the WTO authorizes the country whose industry has experienced injury to apply a duty calculated in a manner which is intended to offset the effect of the subsidy and, in effect, to level the competitive playing field. In a reversal of policy, the U.S. government recently ruled that countervailing duties can be applied to subsidized imports from China, and the countervailing duties currently represent the most viable existing response when Chinese subsidies injure U.S. industries.

Administered restraints on competition

Competition policy has commonly been used as an industrial policy tool in industrialized countries. In the 1960s Japan used its Antimonopoly Law as a defensive weapon to protect domestic industries from "mammoth foreign capital." In the 1970s and 1980s in the European Community and Japan, cartels were commonly sanctioned by government authorities to enable depressed industries to stabilize prices and curb what was sometimes called "excessive competition." By reducing market pressure on domestic producers, cartels prevent competitive shakeouts from occurring and lead to excessive capacity and dumping in export markets.

Since the mid-1990s China has utilized cartels in SOE-dominated industrial sectors to limit "disorderly competition" (*exing jingzhang*) and to help domestic producers stabilize and in some cases increase prices. Typically these arrangements involve the establishment of collective restraints on output for domestic sale, but with no restraints on production for export. Compliance is monitored by industry trade associations and government officials. The government sometimes threatens to cut off bank loans to enterprises that do not comply with agreed output restraints or that engage in unauthorized discounting. Historically similar cartel-based output restraints were utilized in Japan, Europe, South Africa and other countries, and have almost invariably led to dumping in international markets during recessionary periods. This is a likely consequence of the application of similar policies in China.

China is currently in the process of drafting an Antimonopoly Law which will prohibit cartel-type activities like price fixing and collective restraints on output and sales (Article 7). However, Article 10 of the draft law provides for exemptions from these prohibitions "during the period of economic depression, to moderate serious decreases in sales volumes or distinct production surpluses." In effect this is a provision for legalizing anti-recession cartels, and, if the European and Japanese precedents for such policies are followed, the exemption will find widespread application in SOE-dominated heavy industries suffering from overcapacity.

The WTO has no rules governing competition policy, reflecting the dissensus that has prevailed on this issue in the multilateral community since the inception of the GATT. China will thus enjoy broad leeway in using cartels to protect domestic industries from competitive pressure without running afoul of any WTO rules. The principal policy tool available to U.S. industries affected by dumping is not WTO dispute settlement but application of duties pursuant to the U.S. Antidumping Law.

Dumping, like most forms of subsidization, is not "illegal" under WTO rules, although Article VI of the GATT provides that dumping "is to be condemned" if it cause or threatens material injury to an industry of another member or materially retards the establishment of a domestic industry. In such cases GATT Article VI and the WTO Agreement on Implementation of Article VI of the GATT authorize members to impose duties calculated to offset the margin of dumping.

Preferential procurement

Preferential government procurement policies are a common industrial policy tool and at one time were common in Europe, Asia, and the United States. The practice has been sharply curtailed, however, by the adoption of multilateral rules, currently embodied in the WTO Government Procurement Agreement

(GPA) committing GATT/WTO members to practice nondiscriminatory procurement with respect to designated governmental entities. When China joined the WTO, it did not accede to the GPA although it accepted observer status with a commitment to accession at an unspecified future date. As a strictly legal matter, Chinese government ministries can take the position that they have no obligation to refrain from favoring domestic enterprises in their procurement decisions. China enacted a *Government Procurement* Law in 2003, Article 10 of which provides that "the government shall procure domestic goods, construction and services," except when the needed items are not available in China, cannot be acquired on reasonable commercial terms, are for use abroad, or are subject to the provisions of other laws.

Moreover, recent actions suggest that the government intends to make expanded, orchestrated use of preferential procurement as a tool to promote the development of indigenous industries. The *Long Range Science and Technology Plan to 2010*, released in 2006, provides that "Rules governing government procurement should be adopted so that the government will give priority to purchasing high-tech equipment and products and products that domestic manufacturers own their independent IPR." In December 2006 three Chinese ministries jointly released the *Provisional Measures for Accreditation Measures of National Indigenous Innovation Products*. The measures establish an administrative accreditation process so that "domestic innovative products" could be certified and that products so certified "shall be given priority in procurement projects for government and in key national projects that will spend treasury funds." The protectionist intent underlying these recent measures is manifest; the *Long Term S & T Plan* speaks of the need to "stop unscrupulous and redundant imports," and the Accreditation Measures stipulate that consideration be given as to whether the applicants' products can be substituted for imports.

Despite China's nonmember status with respect to the GPA, it does not follow that China is completely free to use preferential procurement as a tool of industrial policy. When it joined the WTO, China gave assurances with respect to the SOEs that these enterprises would "make purchases and sales based solely on commercial considerations, e.g. price, quality, marketability and availability, and that the enterprises of other WTO members would have an adequate opportunity to compete for sales to and purchases from these enterprises on non-discriminatory terms and conditions." (Working Party Report WT/ACC/CHN/49). The government of China also gave assurances that it "would not influence, directly or indirectly, commercial decisions on the part of state-owned or state-invested enterprises, including on the quantity, value or country of origin of any goods purchased or sold, except in a manner consistent with the WTO agreement." On the basis of these commitments, it would appear that any attempt to extend the procurement preferences policies outlined in the *Long Term S & T Plan* and the *Accreditation Measures* to purchasing practices of the SOEs would be inconsistent with China's WTO obligations.

However China's central and sub-national government entities are not subject to a WTO commitment of nondiscrimination in procurement (apart from an assurance that one foreign supplier would not be treated more favorably than another in procurements open to foreign bidders). Because of the pervasive role of the government in the Chinese economy, these government organizations represent a vast market that is substantially walled off to foreign entry, with a major class of beneficiaries being the SOEs themselves. It can be argued that given China's accession to join the GPA "as soon as possible," the implementation of sweeping new preferential procurement measures that cut against the principles of the GPA is at odds with the spirit, if not the letter of this commitment. The reality, however, is that a successful legal challenge to China's procurement preferences in the WTO is unlikely. Any comprehensive effort to level the competitive playing field with respect to the SOEs will require China's full accession to the GPA and the application of WTO disciplines to China's public procurement policies and practices.

Conclusion

The WTO system establishes a variety of interface mechanisms to address the practical reality that national economic systems differ, with an eye toward mitigating conflicts as these systems came into closer interrelationships with each other. China's SOEs represent a major systemic difference between the economies of the U.S. and China, both of which are now WTO members and engaged in extensive and wide-ranging trade and investment relationships. In the near term it will be necessary, on occasion, to use WTO-consistent policy measures to offset injury that can occur to U.S. producers. This will require periodic resort to U.S. antidumping and countervailing duty remedies and, possibly, negotiation of new multilateral rules and enactment of legislation or regulatory changes to strengthen those laws. It will require bilateral negotiations and agreements with China to minimize friction. In some cases it may require resort to safeguards measures authorized under the WTO Agreement on Safeguards and the provisions of China's protocol of accession to the WTO. It will require bringing China into the WTO Government Procurement Agreement.

In the longer term the challenges posed to the world trading system by China's SOEs may prove to be self-correcting. Newly-industrializing countries like Brazil, Mexico, Korea and Taiwan have used "national champion" SOEs as a developmental tool, but have scaled back or abandoned government ownership of enterprises as their economies have matured, generally concluding that faster and more balanced economic growth can be fostered by private enterprise.

China may reach similar conclusions, and a lively debate has been under way about the future of the SOEs since the early 1990s. Chinese policymakers recognize that the SOE sector taken as a whole is a drag on the economy and a source of potential friction with trading partners. The banking system channels a disproportionate share of loans (roughly three quarters of the commercial banks' loans) to the SOE sector despite the fact that the SOEs' productivity is approximately half that of the private sector. The result has been the creation of excess capacity in sectors like steel and the diversion of resources into comparatively unproductive enterprises and activities. The drain on the banks represented by nonperforming loans has required periodic bailouts of the banks by the government. Although some SOEs have emerged as powerful international competitors, for the most part this has not occurred in technology-intensive sectors. China may well follow the model of other industrialized economies and seek to privatize or shut down most of its SOEs.

HEARING CO-CHAIR FIEDLER: Thank you. Mr. Marchick.

STATEMENT OF MR. DAVID MARCHICK, SENIOR ECONOMIST, ROUBINI GLOBAL ECONOMICS, NEW YORK, NY

MR. MARCHICK: Thank you very much. Thanks for the opportunity to be here. I fear that the focus of my presentation is maybe geared more towards the next panel than this, but I will give you my thoughts nonetheless. With your permission, I'd like to talk about three issues.

First, I'll discuss developments with respect to outward investment by China. Second, what U.S. policy might be towards these investments? Third, how CFIUS might analyze future investments from China because there are some unique aspects associated with Chinese investment that differentiates it from other significant countries?

Then if I have time, I'll address some concerns about closing markets, both here and in China.

First, with respect to developments of outward investment from China: in my view, the increased focus on outward investment from China is really a natural evolution of Chinese economic development. As you well know, China started by opening markets in certain zones to trade and investment back in the late '70s, has gradually liberalized since then and now it's one of the largest recipients of inward investment. In 2001, China actually received more inward investment from the United States than anywhere else. That may have been an aberration but still quite phenomenal.

While China has officially adopted a go-out policy or a policy of encouraging SOEs and other companies to invest abroad, China's outward investment frankly remains very, very small; well less than one percent of global FDI. By the end of 2005, the total outward stock of Chinese investment was less than $30 billion.

There was about $16 billion in outward investment in 2006. There's been significant growth over the last two or three years, but it's still very, very small in the larger picture. The total cumulative outward investment from China through 2006 was less than or just approximately the same as the amount of investment they received inward in the same year. The outward total stock equals essentially what they receive in one year.

There have been more inward investments in the United States announced just in May than there were outward investments to China over the last three years. Again, it's still very, very small. That being said, I think that you could expect significant growth levels over the next few years, both because of Chinese government policy and because of the natural evolution of their economy.

If you look back at Korea and Japan in the '80s and '90s, they had very rapid rates of growth in outward investment. In the '90s, for example, Korea and Japan had about 28 or 29 percent growth on an annual basis over a ten year period in outward investment and cumulatively that entails a significant amount of investment.

One leading investment bank suggests that China could be in the top four outward investors in the next five years. That would be just behind the U.S., the UK, and Japan I think is the third country.

There's been a lot of discussion over the creation of the investment fund in China to set aside certain reserves. In my view, this should be viewed in a positive light for a number of reasons. First, it's not really extraordinary in many ways because lots of other countries have similar funds ranging form Norway to Azerbaijan to Canada to Korea, Kuwait and even some of our states like Alaska and Wyoming have funds that they've invested in surplus.

There are two key policy issues I think should be addressed by this Commission, Congress and the executive branch. First and most importantly is whether or no those outward investments by this fund are going to be made for commercial and financial reasons, meaning enhancing return on their resources? Or are they going to be made for industrial policy, state policy or foreign policy objectives? Moreover, will there be national security issues associated with those investments in the United States or elsewhere?

A second issue is how should the U.S. react to what we can only expect to be growing Chinese investment in the United States? In my view, with a very narrow set of exceptions, where there are national security risks, we should welcome Chinese FDI. It will help strengthen our ties. It will align their interests with U.S. economic interests. It is better in my view for China to invest in fixed investments than liquid investments in the United States.

It will help them become a responsible stakeholder. It will expand the rule of law and expose business norms and practices in the United States to Chinese companies.

Now, what about those narrow set of transactions that do raise national security issues, how will CFIUS deal with them? In my experience, CFIUS already heavily scrutinizes Chinese investments in the United States. If either the House CFIUS Reform bill or the Senate CFIUS Reform bill become law, then there will be even more scrutiny of Chinese investments.

There are a few unique issues associated with Chinese investments in the United States that are assessed by CFIUS on the issue of state ownership. First, virtually, more than any other trading partner, there is obviously very heavy level of state ownership and state direction of Chinese enterprises. Of our top ten trading partners, China is really the only one that is not considered a traditional NATO partner or other ally of the United States.

There is great concern within the executive branch and the CFIUS on export control issues, both in terms of compliance and also in terms of what additional technology transfers could mean for the strengthening of China's military. I think you just need to look at the past few Pentagon reports and you can see their views on that.

The third issue is intelligence collection. There have been public FBI and DOJ and CIA statements expressing concerns about active Chinese intelligence collection including through the use of businesses and students in the United States. That's an issue that in my experience CFIUS really takes out the tiniest of microscopes and scrutinizes China.

The last issue is government subsidies. CFIUS is very disciplined in not injecting economic security issues or economic impact issues in their analysis. However, government subsidies can be a significant indicator of the level of government control or the level of government involvement in a transaction which has an impact on the national security analysis.

Overall, we should welcome Chinese investment. There are a narrow set of investments that could raise national security issues. For those narrow set of investments, the CFIUS review process is a very robust one and will adequately address those.

They can mitigate those concerns or if necessary block a transaction, but for all other investments that don't raise national security issues, we should welcome Chinese investment. Thank you very much.

[The statement follows:][3]

Panel IV: Discussion, Questions and Answers

HEARING CO-CHAIR FIEDLER: Thank you. The first question goes to Commissioner Wortzel.

COMMISSIONER WORTZEL: I actually have a question for each of you and we get five minutes so split the time.

Mr. Howell, I'd like to start with you. In the concluding section of your written testimony, you say that newly industrialized countries like Brazil, Mexico, Korea and Taiwan used national champion SOEs as a development tool and then scaled back.

Certainly in Taiwan, some of those companies were not only national champions, but they were also ruling political party champions. As such, what do you see as the likelihood that the Chinese Communist Party is going to let this happen when it also means losing Party control and income when it maintains a strong military control?

MR. HOWELL: That's a good question. For one thing, SASAC came out with a statement that I've cited in here saying they don't intend to let the state-owned enterprises relinquish their grip on key sectors like mining and transportation. They're going to be always dominated by the state.

Also, in many of those enterprises, the CEO and the Chief Operating Officer are picked by the Party. In many cases, they actually are senior Party officials, and given that I think the grip will remain very strong.

COMMISSIONER WORTZEL: That reference to SASAC brings a nice segue for my question for Mr. Marchick. Let me pose you a hypothetical question here. SASAC controls 159 Chinese corporations, or around that number. I got the list the other day from one of our staffers.

Among those companies controlled by SASAC are the Xinxing Company, which is the trading arm established by the General Logistics

[3] Click here to read the prepared statement of Mr. David M. Marchick

Department of the People's Liberation Army, Xinshidai Corporation, which is the trading arm established by the Commission of Science, Technology and Industry for National Defense of China; and Polytechnologies, our favorite exporter of missile technology.

That's just three of the 159. I actually picked up about 20 traditional military companies that are part of the defense industry that pose serious threats for the U.S. SASAC controls 159.

They know the United States would probably object to Xinshidai, Xinxing or Polytechnologies buying a U.S. company and controlling it. Why can't they just pick and choose among the 159 and hide their intelligence collection and technology acquisition around it? I'm just not sure this investment is a great thing.

MR. MARCHICK: Actually, it's a very good thing. CFIUS, in my experience, looks at two issues with respect to transfer of technology. One aspect is whether or not there are there key technologies that the U.S. needs? The second looks at are they key technologies that we don't want another country to have?

I think with respect to investments from China, the latter issue is perhaps much more important than it is with investment from say the UK, Canada, Australia, other allies.

My experience has also shown me that CFIUS scrutinizes with the tiniest of combs any relationship between Chinese companies and the military industrial complex. They will want to look at all the ties that exist or potentially could exist and mitigate against any threat that a transaction could create.

Again, I think there are a narrow set of companies that I think will be highly problematic for them to invest in the United States in almost any sector. Outside of those, I think the key issue is going to be how sensitive is the company that they're buying. If they're buying a sock company in the United States, there's no issue; but if they're buying a company that has sensitive technology that either the DoD needs or the DoD doesn't want China to have, then I think the investment will have some difficult times.

COMMISSIONER WORTZEL: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Thank you. Thank you both for being here. I have two separate areas of concern. Mr. Howell, maybe you can help on the first. The recent decision by the Department of Commerce as it relates to CVDs against China, does that go far enough? I understand there were some issues regarding benchmarking as it relates to loans and those kind of issues. Do you think congressional action is necessary in light of what Commerce has done?

MR. HOWELL: That's also a very good question. I'd be in a better position to answer it after the final determination, but I think that

Commerce has gone further than they have gone in the past. The issues of preferential lending and loan benchmarks have come up in other countries. I remember Korea was a hugely contested issue for ten years, and they never really got what I felt was an appropriate benchmark.

They had a benchmark that was too low and the subsidies were not adequately offset. They are now looking for surrogate benchmarks in other countries in this case. That's a good thing. The question is whether that will be upheld if it's appealed to the CIT et cetera.

I think legislation certainly could clarify that question, which is a critical question in dealing with China because of the sheer volume of loans.

HEARING CO-CHAIR WESSEL: That leads to the other question as well, which is the foreign currency reserves, and I think the figure used this morning is 1.2 trillion of reserves. That may rise by another 500 billion this year.

In the recent past, we saw the CNOOC transaction where there were a large number of members of Congress who raised questions about the acquisition of what they viewed as a strategic resource. Not only that, but because of the capital that was infused or available from the state, they asked how that could have a subsidy value in the transaction.

It's hard to see with these 159 companies, many of which are on this go-out strategy, that there won't be some kind of subsidy value involved in many of those transactions, whether it's a soft or a hard procurement. Maybe we've put ourselves in this predicament as well from causes of consumption. CFIUS needs to be looking not just at the basic security issues, but the economic security issues of whether the subsidy value is giving China a preferential opportunity in terms of procurement. I'd appreciate it if you can both comment on that.

MR. MARCHICK: I think the issue of economic subsidies through either state support or preferential loans from state-owned banks in China or in any other country is a very important policy issue that the United States needs to grapple with. I think that it's important to distinguish between the national security issues related to subsidization and the economic issues related to subsidization.

From a national security perspective, subsidies, whether direct subsidies or preferential loans, creates another layer of cover for Chinese investments. It's a significant indication of state control over an asset and therefore under CFIUS, it should have higher scrutiny as a state-owned entity.

From an economic perspective, I think they are also very important issues. U.S. companies don't have access to subsidized financing and that could put them at a competitive disadvantage for acquisitions or for investments.

My view is that economic issues should not be part of the national security analysis by CFIUS. In part because it is a very slippery slope and we don't want other countries to block our investments based on economic concerns.

I'll give you one example. About a year and a half ago, Pepsi was rumored to be looking at buying Dannon, the yogurt and water company. The French president said that yogurt is a strategic asset, and the transaction went away. That's just plain silly.

U.S. jobs and U.S. economic growth depend on outward investment. We don't want other countries to start to scrutinize our investments based on economic issues.

HEARING CO-CHAIR WESSEL: Mr. Howell.

MR. HOWELL: I think that in general we are well served by encouraging inward investment. If it's close call, I would probably come down on the side of allowing the investment. I think there is still a concern raised by large subsidies as an indicator that decisions are not being made on a market basis. The concern furthers the notion that the Chinese might, in acquiring a company, operate that company in a way that would not make sense in a market economy where they were trying to maximize their investment.

I think that's a concern. We don't have any policy tool to address that concern now. I don't think it's necessarily a national security concern, but it would be a concern.

HEARING CO-CHAIR WESSEL: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Houston.

HEARING CO-CHAIR HOUSTON: Thank you very much. I have a question about the role of non-cash asset transfer in China, SOEs on the ground there in regards to trading non-movable assets like buildings, railroad tracks, roads, mining equipment, et cetera.

How great a role do those sorts of non-cash assets play in SOEs in regards to their success within China? How easy is it to track that these are taking place? Also, do those break trade regulations by providing those kinds of assets to the SOEs?

MR. HOWELL: A typical situation might be where an SOE is spun off from a government ministry and its assets or its shares are acquired by a SASAC. It also receives the assets it had before as a state entity. Typically, that is not actionable under the WTO and it's also not countervailable under U.S. law. There's nothing we could invoke against a practice like that.

Is it an advantage? Sure, it is. One way that companies that are well advised in other countries favor their industries without running afoul of the countervailing duty laws or the WTO is to build around the company rather than give the company assets. Not only does this entail building around it, but it also includes giving it infrastructure, harbors, rail transportation, and that sort of thing; none of which is actionable. And tremendous benefit is conferred in that sense.

MR. MARCHICK: I agree with Mr. Howell. I'll just add one positive development in terms of non-cash transfers is that Chinese companies. As they are listed on public stock exchanges, particularly the Hong Kong Stock Exchange, which I think is the largest location for listings, they subjects Chinese state-owned entities to public scrutiny and shareholder scrutiny. I think earlier this year or late last year, there was a case where there were some non-cash transfers between companies and the shareholders basically revolted and voted it down. I think that's quite a positive development that they now have increased transparency and increased shareholder scrutiny, which will put pressure on Chinese state-owned entities to abide by normal commercial norms.

HEARING CO-CHAIR HOUSTON: Okay. Great. Thank you.

HEARING CO-CHAIR FIEDLER: I have a couple of questions. Trade has always struck the average American as complicated and defying common sense. I'd like to ask a common sense question. Oil and petrochemicals are national champion, absolute control industry decisions. That means to me that we can't buy that. How do you explain to a person they can buy us but we can't buy them?

Is that right? Is that progress? Is it sensible? Since you're both lawyers, I'll ask is it legal for us to say you can't buy us if we can't buy you?

MR. HOWELL: Yes, in the sense of is it legal, I think it is in the sense that we haven't negotiated any kind of arrangement of reciprocity in terms of, “If we can't invest in your oil industry, you can't invest in ours.” There isn't a set of rules dealing with that.

We have made some of our own sectors off limits to foreign investment like air transportation and some kinds of mining. We've said these should not be under foreign control. That's been a decision by the Congress over time and I think that's a legitimate act. Different countries define what should be a protected industry in that sense against foreign control in different ways.

The Chinese have got a whole bunch of industries they wish to keep protected. They have come out with a list just recently of industries that they will not allow any foreign majority control involved. It's a much broader list than we have.

HEARING CO-CHAIR FIEDLER: A broader list than the champions and heavyweights?

MR. HOWELL: It's a pretty broad list. There are about 15 sectors. There's heavy equipment and there's all kinds of things. There are also some individual ministries that have said they're not going to ever allow foreign control like in the steel industry. They add that this is going to always be under control of domestic companies, and they can do that legally. We can do that too just as legally. They've just been much more inclusive in what they've decided to protect.

HEARING CO-CHAIR FIEDLER: So we can do that as long as it is not country specific?

MR. HOWELL: Well, I don't think we would do it country specific. That's just not the American way to do that.

HEARING CO-CHAIR FIEDLER: Well, if the French allow us to buy into their steel industry, and we allow them to buy into ours, but the Chinese don't allow us to buy their steel industry. Why should we allow them to buy ours? Is that legal? That was the heart of my question.

MR. MARCHICK: I think it's legal. We have bilateral investment treaties, but there's not a multilateral investment framework like there is in trade. My view is that with respect to investment, trade has worked more based on a reciprocity basis in many respects--

HEARING CO-CHAIR FIEDLER: Than investment.

MR. MARCHICK: --than investment. I think that there are reasons that could explain that to the average American. It's not always easy, but I think investment coming in the country helps us, you know, unless there's a national security issue. It's more jobs, more opportunity, and new plants and equipment.

To quote Barney Frank, in a hearing where I testified a couple weeks ago, he said that folks were alarmed in the '80s about Japan buying Pebble Beach and Rockefeller Center. They later sold at a huge loss. Barney Frank called that a huge transfer of national wealth. He said we'll take their money.

I think we should welcome investment unless there are national security issues at stake. We should also work like crazy to get China and other countries to open up their borders to U.S. investment.

HEARING CO-CHAIR FIEDLER: Which, with indulgence, gets to my second question, which is about your testimony on the distinction between national security and what you called economic implications. I'm not going to presume anything, but let me just preface it by noting that during the Clinton administration, the MFN fight, the WTO fight and post Cold War we heard a great deal about economic security.

Arguably, the Chinese in deciding what sectors not to allow control by foreigners of have decided that their economic security includes oil, coal and construction, a bunch of other stuff.

Going back to oil again, I think the average American could understand that oil is an economic national security question; right?

MR. MARCHICK: Agreed.

HEARING CO-CHAIR FIEDLER: So there's no question that we can prevent somebody from buying our own oil companies.

MR. MARCHICK: Right.

HEARING CO-CHAIR FIEDLER: Now, the Chinese have decided that construction or iron and steel--

MR. MARCHICK: Right.

HEARING CO-CHAIR FIEDLER: We have a lot of companies, but we are seeing those numbers diminish. As such, it's not a purely economic decision here. It's a security decision. We say that our economic security is defined by the number of jobs that are created in the industry that is at stake. Therefore, we shouldn't let the Chinese buy U.S. steel, Bethlehem Steel or whatever. Is that fair? Is that economic security, national security, pure economics or what? Or am I being protectionist?

MR. MARCHICK: No, I don't think you're being protectionist. I think it's a very hard, fine line, and national security has never been defined under Exon-Florio. When you look at the existing definition of critical infrastructure in the Senate bill on CFIUS reform, there is the concept of economic security. In the Patriot Act, they're the same thing.

Certain assets are so vital to our economic and national security that they need to be protected. The question is, “What is the impact of foreign investment on those investments, and is there a delta in risk between being U.S. owned or foreign owned?” In some assets, there is a delta. In the telecommunication sector, for example, the U.S. has a very strong interest in making sure that they can conduct wire taps or investigations without alerting foreign persons and foreign governments.

There is heavy scrutiny of foreign investment in the telecom industry. I think the Chinese are making a mistake by blocking the coal industry off. I can understand the political pressures to do so, but I think that history will judge it negatively. It's not in the Chinese’s interests and it's not in our interest.

HEARING CO-CHAIR FIEDLER: Thank you very much. Commissioner Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you and I'm sorry that I wasn't here, gentlemen. I had a speaking commitment that I thought I had agreed to on a different day that turned out to be today. I am sorry that I missed your testimony.

I want to follow up with Mr. Marchick on this. Obviously we're grappling a lot with this economic security versus national security distinction. Where is the line? We would probably disagree among ourselves. Some of us believe that we need a strong economy in order to be strong militarily and so that they are integrally linked.

Putting that aside, one of the things that we started looking at last year and are going to continue with this year, are defense industrial base kinds of questions. Some of that really came up in the context of when we were up in Dearborn, Michigan. I've been thinking about things like tool and die manufacturers, which on their face would probably not necessarily be perceived as being crucial to national security. However if we no longer have the ability to even manufacture triggers for Howitzers, that is a potential national security issue for us; particularly if the only places that are manufacturing those things are countries with which hopefully we'll never get into a war, but could, or countries that might choose to not allow us to have access to material for defense equipment.

MR. MARCHICK: Right.

CHAIRMAN BARTHOLOMEW: How do you look at that? Where can we draw some kinds of lines like that on those kinds of questions?

MR. MARCHICK: First of all, I don't think there is anything that you said that I would disagree with. I think it would be hard for people to disagree with what you just said. You said that a strong economy is critical to our national security, and that put capability in certain manufacturing technologies is also critical to our national security.

It's undeniable. The question is, does it matter whether a tool and die manufacturing company is owned by Americans or by Canadians or by Brits or by Chinese? In some cases, it does. In some cases, it doesn't, but it's a case-by-case basis. The U.S. has a very strong interest in maintaining our manufacturing base.

It so happens that the foreign investors invest disproportionately in the manufacturing base. Roughly five percent of the U.S. workers are employed by U.S. subsidiaries or foreign entities. However, 20 percent of manufacturing is foreign owned. Foreign companies invest heavily. I think that's a positive, again with the few exceptions for national security reasons. We should welcome that investment because in many cases foreign investment is helping to keep our manufacturing base vibrant and alive.

CHAIRMAN BARTHOLOMEW: Mr. Howell.

MR. HOWELL: I might speak to that as well with a historical case. When Britain fought Napoleon it was the workshop of the world. They had a big fleet and they also supplied not only their own army but all of their allies' armies with arms. A century later, after they implemented free trade at mid-century, there were a lot of these same kinds of debates. Do we need these kinds of industries in this country anymore? Our steel industry is eroding, a lot of our toy making is eroding, and our sugar industry is eroding; the basic consensus was to let them go. The consensus went on to say, "If there's another war, we'll win it because our military is so skillful. We've got a small professional army and a good professional navy, and that will fine." They got into World War I, and it was a war of attrition where basically it was a matter of mass armies being armed with steel and other kinds of armaments.

They could not wage that war from their own resources, and they almost lost the war. They actually were near the ends of their supplies and had the Americans and others not been able to supply some of their needs, they would have been defeated. They couldn't make shell steel nor make fuses for detonators. There was just a whole range of things. They couldn't make aircraft motors. They invented tanks but couldn't make enough of them until the last year of the war.

I think the answer is do you need something; do you need an industrial base to remain strong defensively? Of course you do. The question is what should that consist of, and I think Mr. Marchick's point is a slightly different one. If a foreign company buys an American company, as has happened with the Japanese company buying a ball-bearing company up in New England some years back, and dismantles that company and moves everything to Japan or wherever, then that is a problem. If it remains here in this country and it's available to us in emergency, that's a much closer question, I think, so--

CHAIRMAN BARTHOLOMEW: Can I just ask a clarifying question? You raise a point which I was going to ask which is when we talk about foreign governments investing in the United States, do we differentiate between investing in the United States in a way that maintains the facilities in the United States and investing in the United States, buying a steel mill or a manufacturing facility or something like that, dismantling it, and taking it back?

MR. MARCHICK: We absolutely do and we should. The Defense Department, in some of the cases I've been involved in, has required commitments to maintain certain manufacturing and certain technologies in the United States. They are very focused on the defense supply base, and the critical issue is whether or not they are able to procure certain products and services in the United States? That's critical for national security.

CHAIRMAN BARTHOLOMEW: Are there any repercussions if they don't stick with their commitment? I'm thinking of Magnequench now.

MR. MARCHICK: Sure. They have a variety of tools under law and they also have the Defense Production Act under which they can essentially take over assets.

As another historical example, if you look back at World War I, the high tech industry at the time was the chemical industry. It just so happened that Germany was the leading chemical manufacturer in the world. They had about 30 percent of the U.S. chemical industry. Before we went to war with Germany, the U.S. took it over, and that technology was critical in our ability to win World War I.

The question is whether or not there a national security nexus to the technology, manufacturing, or product? If so, does foreign investment raise national security issues? If yes, how can the government ensure that its concerns are addressed. There are a variety of tools to do that. If not, they block the investment.

CHAIRMAN BARTHOLOMEW: Thank you.

HEARING CO-CHAIR FIEDLER: Thank you. Commissioner Shea.

COMMISSIONER SHEA: Thank you both for being here today. As two lawyers, I was hoping you could sort of help me out with what a legal framework looks like with respect to the disclosure requirements for state-owned industries overseas seeking to invest in U.S. companies. If you can explain what sorts of information, disclosure information, the U.S. government seeks when reviewing a proposed acquisition by a state-owned company of an overseas U.S. entity? What sorts of information is required to be disclosed?

MR. MARCHICK: Sure. There are two distinct legal frameworks. One is the CFIUS framework under Exon-Florio.

COMMISSIONER SHEA: Right.

MR. MARCHICK: The other is under SEC or public listing rules. The CFIUS agencies require complete disclosure of the full chain of ownership all the way up to who makes decisions or who has control. In state-owned enterprises, that can be a very complicated chain of ownership. We've been through exercises, as a lawyer with CFIUS, where you literally spend days and days explaining the boxes, who the people are, and who ultimately owns and controls the asset.

With CFIUS under the Exon-Florio regulations, there's an extremely broad definition of control, which is the ability to influence or direct a decision, whether exercised or not. Even if the state entity has never exercised a particular decision, if they have the ability to, then that triggers state control.

COMMISSIONER SHEA: So, theoretically, going to Commissioner Wortzel's question, if an entity, one of the 159 companies owned by SASAC sought to purchase a company in the United States, then the entire ownership of SASAC would have--

MR. MARCHICK: They would look all the way--

COMMISSIONER SHEA: Everything about SASAC would have to be disclosed in the application for the purchase?

MR. MARCHICK: They would need disclosure that SASAC is the ultimate owner and the decision-makers throughout the chain from SASAC all the way down.

COMMISSIONER SHEA: What information about SASAC would have to be disclosed?

MR. MARCHICK: I haven't had a case where SASAC has been the ultimate beneficial owner so I don't know. However, I assume that the governments and the various agencies that provide information to CFIUS have a lot of information on SASAC already.

I'm not a securities lawyer, but they're also significant disclosure requirements about controlling interests under SEC and New York Stock Exchange rules.

MR. HOWELL: I've been through some CFIUS reviews. The CFIUS also reaches out beyond the foreign acquiring company to U.S. industries and asks for people to inform it about any concerns they may have. This can be a very informal thing, but they're encouraging people that have concerns to bring them in.

You can never be completely sure you've gotten the whole story in a situation like this even with a very thorough investigation. However, they do make an effort to find out as much as they can about an acquiring entity.

COMMISSIONER SHEA: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Wortzel for a second round.

COMMISSIONER WORTZEL: I wanted to try and pose a more philosophical sort of question on the extent to which either of you believe that certain parts of our critical infrastructure or of our natural resources are really elements of economic security? When we had to deal on this Commission with the Unocal question, we began to address it and then we found that it was not until the latter part of the Clinton administration that the national security documentation in the United States began to even discuss economic security as an element of national security.

How far can we go with that? A power grid, a highway system, a port?

MR. MARCHICK: My personal view is that there are certain systems or assets that are so critical and vital that, going back to the Patriot Act definition, their destruction or the inhibiting of the function of those assets would have a terrible debilitating impact on the functioning of the U.S.

Think about telecommunications networks or when the energy grid went out in New York and the other northern states. If that happened during a national emergency, it would have been a disaster. Certain energy assets should not be placed under foreign control. The question is what are those assets? How do you define that set of assets and what do you do about it? With respect to the first question, the Homeland Security Department has come out with various lists of critical infrastructure. The problem is it keeps changing and it's not very precise.

There have been four different reports from the government in the last four years, each of which has defined it in slightly different terms. Each of those reports has different sectors and then there's also a list of so-called key assets which was compiled with input from various state and local governments. That has some 70 or 80,000 assets on it going to some popcorn factories and state fairs which seems a little unusual.

In my view, the government has a very strong interest in having a precise definition and focus on what assets need to be protected for our national interest. Then the question is what do you do about that? In my view you start by developing a baseline of security measures that need to be in place on a sector-by-sector basis, regardless of foreign ownership. Then if there are particular concerns about foreign ownership of particular assets, you address those concerns with respect to that particular asset. If there are certain assets that are so important that they shouldn't be foreign owned, then the U.S. has the power to block them.

HEARING CO-CHAIR HOUSTON: There's a related question about certain kinds of manufacturing processes, skills, research and development capability. Arguably, we're better off with those things located here with graduates from our universities finding jobs in those activities here rather than migrating abroad. You're probably familiar with the migration of much of the semiconductor industry to Asia. What happens is the manufacturing goes first and then the design goes and now a lot of the top people are going there. What's left here when an electrical engineer graduates with a Ph.D.? Where do they go? Increasingly, it's not here; it's elsewhere. That's a security issue when those kinds of skills and processes are part of our defense base.

HEARING CO-CHAIR FIEDLER: Commissioner Wessel is next in the second round.

HEARING CO-CHAIR WESSEL: Let me understand, if I could, a little more regarding the transaction of Magnequench that one of our former commissioners raised time and time again. I believe Commissioner Bartholomew raised it in part earlier.

Mr. Marchick, you indicated that there are certain transactions that if the entity changes its plans later on, they can be reversed. I thought the standard in the current law is unless they lie on their filing, that there is little ability to unwind these transactions.

The first transaction that had a very broad evergreen provision was the Alcatel-Lucent merger last year. In Magnequench, a commitment was made to the local communities that they would continue to operate here in the U.S. The facility is now shuttered and the production equipment has all been moved to China. I don't believe that the new CFIUS legislation that's currently undergoing review has certain automatic evergreen provisions that are being triggered.

How do we know when you have a state entity with so much state capital going into these transactions what their long-term plans are and what do we do about it? Blackstone, as an example, probably has a good portion of their go-out strategy dictated under some state direction.

MR. MARCHICK: That's a good question. I don't know anything about the Magnequench issue, so I'll just talk in general. Rather, I've read a lot about the Magnequench issue, but I don't know the details.

The first issue is in a number of CFIUS transactions where there are security concerns; CFIUS requires commitments by the parties involved in the acquisition. If maintaining certain assets and operations in the United States is one of those things, then CFIUS has required that.

I've seen deals where they've required commitment to maintain production of certain products in the United States that are of critical concern.

If those types of commitments are made, then there are various enforcement mechanisms that CFIUS has at its disposal including going to court with various criminal statutes.

In the past where either the National Security concern was so great or there were concerns about the reliability of the commitments, CFIUS has imposed the so-called "evergreen provision" which allows CFIUS to reopen a transaction, particularly unwind it at anytime with no statute of limitations for material noncompliance.

In both the House and the Senate bill, there is an evergreen provision which allows CFIUS to reopen a transaction if there were material misstatements of fact, material omissions, or material noncompliance with an agreement. The last part holds true so long as certain procedural mechanisms are met such as it has to be intentional noncompliance and other remedies can't be available.

Opening up a transaction after it's been closed is the nuclear bomb of investment policy. It should be rare, but it's a tool that CFIUS has had and CFIUS has used.

Personally, I'm very concerned about the use of the evergreen provision. I've advocated against it, both within CFIUS and in testimony to Congress, but CFIUS does use it. It's a very powerful tool, and they use it.

HEARING CO-CHAIR WESSEL: What kind of post-transaction review is there? Is it triggered by users or by industry? Is there any kind of post-transaction review?

MR. MARCHICK: For CFIUS there are regular review. I think since September 11, and particularly since DPW has intensified their monitoring compliance, they've increased compliance inspections.

There are annual reports, there are third-party audits, and there are other various mechanisms put in place to ensure compliance. Then when the evergreen provision is triggered or if the Senate or House bill becomes law, then any agency can initiate a review, an evergreen provision or propose an evergreen review based on any facts they have. These can be either facts they develop themselves or facts that have come in through third parties.

HEARING CO-CHAIR WESSEL: I'm sorry; This will be my final question. My understanding is that the Senate bill includes for the first time the designation of the Secretary of Labor or at least the draft bill did. It seems to me that they're moving more towards an economic security and job security approach. What are your views on broadening it in that way?

MR. MARCHICK: In the Senate bill, there are two provisions related to labor. One is that the Department of Labor is an ex officio member, and second is that CFIUS has to put out regulations that describe the type of circumstances where the Secretary of Labor should be consulted or the Labor Department should be consulted on impact of mitigation agreements.

There have been some controversies about various mitigation agreements where organized labor has expressed concerns about the use of mitigation agreements. My view is that mitigation agreements should be used only for national security purpose and not for any policy with respect to organized labor.

HEARING CO-CHAIR WESSEL: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you. Thanks again, gentlemen. I notice that the title of this panel is "Does China State-Owned Sector Follow Trade Rules?" However, I'd like to take advantage of the opportunity to pick your brain on just another aspect of this defense, national security-economic security nexus.

Some of what we've been talking about is the preservation of certain assets from foreign ownership or who among foreigners owns some of these assets. What about the ability of these certain assets to compete? We have been talking about a very specific kind of investment, but what do we do about the need to maintain health in some of these sectors that are essential for us in light of competition. In a lot of these cases, is competition is being fueled by state investment in other places?

It's a bigger picture question, but I just wondered if you have any thoughts on that? How do we address that? What do we do to keep these industries vibrant, especially when they're competing against companies that have the benefit of China's deep pockets, for example?

MR. HOWELL: I'll say that that problem doesn't originate with China. We faced that same problem in the '70s and '80s vis-à-vis the

European steel industry where you had something around $50 billion that they put into their steel producers and they were exporting what they call social tons, which were very cheap tons of steel that were designed to keep employment up in Europe. It displaced a lot of our industry.

The question is how do you respond to that? Now, our response in that case was border measures of various kinds. We basically put duties and countervailing duties and antidumping duties on the steel. There were voluntary restraint arrangements. There is whole panoply of border measures.

The harder question was partially successful. I think we still have a steel industry here. There was a lot of dislocation, but it was much less than it would have been without those border measures. The harder question is what happens when you've got a global industry where you can't just put restrictions at the U.S. border because most of your markets may be overseas.

An example is an airplane manufacturer or a semiconductor manufacturer. There I think we have responded in the past to problems like that with domestic measures of various kinds. SEMATECH was a government-funded research consortium in semiconductors. The government has gone out and essentially sponsored domestic programs of various kinds to enable us to compete against companies in other countries who were getting government help.

That's been successful. We tend to do it as a reaction to when somebody else does it first. We then come in, the government does something, and once the problem is mitigated, our government gets out again. A lot of those measures have originated in the Congress. They've been improvised really in response to a specific problem or threat, but they work, and it is an option. As we face this problem vis-à-vis China, we ought to look at what kinds of measures we can take here, both border measures where that's appropriate or domestic support measures of various kinds to our industries in order to offset some of these advantages that are being given in any other countries.

CHAIRMAN BARTHOLOMEW: Mr. Marchick.

MR. MARCHICK: I agree. I think that the issue is the aggressive use of our trade laws. The real pressure comes from subsidized or unfair trade practices abroad competing with U.S. products that don't have the benefit of subsidies as opposed to foreign investment. Whereas, if a foreign company wants to invest in building a steel mill in the United States, I think that's terrific and we should welcome that. I don't think I have much more to say than Mr. Howell.

CHAIRMAN BARTHOLOMEW: Thanks.

HEARING CO-CHAIR FIEDLER: Let me ask you a couple of questions. Mr. Marchick, in your testimony on outward FDI, you began it by saying it wasn't much and include a lot of numbers about how small it was. However, they got a lot of money and the nonprofitable SOEs are now profitable to the tune of 688 billion yuan, —translate to about $70, or $80 billion.

There's a lot of capital and everything is growing exponentially. A decade ago, we didn't think their military would grow very fast and pretty soon they're shooting satellites out of the sky dead on.

So as to the ownership question, given their foreign ownership and their investment policies, why would we expect them to make only economic decisions in their outward FDI if they make non economic decisions in the creation of certain industries putting them under absolute control? Why shouldn't that be a major concern to the Congress and the American people?

MR. MARCHICK: I guess my view is that if they make bad economic decisions to invest a lot of money in the United States to create jobs, that's their mistake.

HEARING CO-CHAIR FIEDLER: If they want to buy a golf course, I agree with you. We'll take their money.

MR. MARCHICK: The question is if a state-owned entity buys into a particularly sensitive asset in the United States, then that should and will be scrutinized.

HEARING CO-CHAIR FIEDLER: Well, let's say, I'm not actually just concerned with the United States, but all over the world.

MR. MARCHICK: Right.

HEARING CO-CHAIR FIEDLER: What incentives would a European company, which is now a Chinese company in Europe; have to base their decision making on non economic reasons? The economic national security complications get global here; right?

MR. MARCHICK: Right.

HEARING CO-CHAIR FIEDLER: That's especially the case in oil. We're going to be looking into FDI much more. Since we're early on in it as a Commission, we plan on commissioning research on it. I would hope that we could talk to you about that as we go down in the future.

I have a question for you on materiality. How familiar are you with the companies that are listed on the New York Stock Exchange as ADRs that are Chinese? Have you sort of looked at their disclosure? Has anybody, have either of you looked at their disclosure?

MR. HOWELL: Actually they are Taiwanese companies that are based in China that have been publicly listed. The one I can think of is SMIC, the semiconductor manufacturer in Shanghai. There is disclosure, but I don't think you get the whole picture because there are a lot of subsidiaries. These subsidiaries have an operation in Beijing that I think is separate and they've got other ones in Chengdu and elsewhere that are not part of the same corporate structure.

HEARING CO-CHAIR FIEDLER: Are you familiar at all with the companies that are listed on the New York Stock Exchange? Have you looked at their--

MR. MARCHICK: I haven't. I'm familiar that there is a growing number. Chinese companies tend to list more in Hong Kong than in New York, but I haven't scrutinized those companies or looked at them.

HEARING CO-CHAIR FIEDLER: The reason why I'm asking the question is to lean how they actually disclose subsidies or even if they do? There are many state-controlled companies that are listed on the U.S. stock exchanges and I'm not certain that they fully disclose the subsidies that we're asking about today in these hearings. Generally speaking, you mentioned that there were two regulatory things. I guess there was the SEC and something else.

However, let's concern ourselves with the SEC here for a moment. Commissioner Shea was asking the disclosure question. In the United States, under securities laws, as I understand them, we don't legislate specific disclosures. We have a concept called materiality. Do you think that materiality in the auto industry in the United States is the same as a materiality as expressed in disclosure in China?

MR. HOWELL: My guess is that there is probably some cultural differences at least, but I think there should be the same standard if you're talking about what's disclosed to U.S. investors. There ought to be the same standard.

HEARING CO-CHAIR FIEDLER: Let's take a coal company like Huaneng Power that isn't disclosed. It is sold in the United States as an ADR. I believe Li Peng's children each have a power company that's public. Now, there's disclosure in those ADRs that those companies' executives are related to powerful figures in China at a time. Although, there was a time when you couldn't go public in the United States without state council approval and the parent was on the state council.

That's a difference. George Bush's brother Neil, if he were on a publicly traded company, wouldn't have to disclose that his brother is the President of the United States because his brother, the President of the United States, wasn't determining whether or not they had initial public offering. That's not cultural. That's political. It's economic.

The richest people in the country are allegedly minor princes. Does that matter to us in disclosure to know their connections? We heard testimony this morning that there were three requirements of success in China. One was the political network, one's a personal network, and one's a familial network.

I'm trying to get at why we don't sort of reflect this reality of China in our disclosure in the United States? Those are not material things so how do we factor that into our considerations?

MR. HOWELL: While I'm not sure if it's a cultural difference, I think you are describing a systemic difference in the sense that China operates differently. There are these well-connected lines of relationships and so on that are linked to the government, the Party, big industrialists and so on in a way that's probably different than we see here. That is a difference, and I don't really--

HEARING CO-CHAIR FIEDLER: Is it a disclosable difference is my only question?

MR. HOWELL: I don't have enough knowledge about the disclosure requirements to be able to answer that.

MR. MARCHICK: I don't know. I'm not a--

HEARING CO-CHAIR FIEDLER: Common-sensically?

MR. MARCHICK: Common sense? I think that anything that affects investors' money and the confidence with which they should invest in certain stocks is material.

HEARING CO-CHAIR FIEDLER: Definition of materiality.

MR. HOWELL: One thing, going back to your question about subsidies, is that I am familiar with one Chinese company that we've been looking at that is privately owned in China. What they said in their IPO documents, was that we're getting subsidies and investors ought to like that. They go on to add ,"We're also mentioned in the State Five-Year Plan, and you ought to like that, too, because it means we're going to get better financing from government banks than we would otherwise." What's more, they disclosed it. It's obviously because they think that investors will be happy to hear that.

HEARING CO-CHAIR FIEDLER: Or they'll think that they're well connected. Do we have any other questions from the commissioners? Do you have any other comments you'd like to make before you leave?

MR. MARCHICK: This has been enlightening.

HEARING CO-CHAIR FIEDLER: Thank you very much for your testimony today, gentlemen.

MR. HOWELL: Thank you.

HEARING CO-CHAIR FIEDLER: We'll take a break now and resume the hearing with the panel on foreign direct investment.

[Whereupon, a short break was taken.]

PANEL V: CHINA'S FOREIGN DIRECT INVESTMENTS ABROAD

HEARING CO-CHAIR HOUSTON: We are ready for our fifth panel of the day on China's Foreign Direct Investment Abroad. Our last panel today will examine the increasing flow of outbound foreign investment from China.

We are very fortunate today to have two panelists with us who have a broad range of expertise in this critical area of growing importance.

Dr. Brad Setser is a Senior Economist at Roubini Global Economics and a Research Associate at the Global Economic Governance Program at University College in Oxford, England.

He served at the U.S. Treasury Department from 1997 to 2001 where he worked extensively on the reform of international financial architecture, sovereign debt restructurings and U.S. policy toward the IMF.

He has a Master's Degree and Doctorate in International Relations from Oxford, a Master's in Economics from Sciences-PO in Paris, as well as a B.A. in Government from Harvard University.

Mr. Daniel Rosen, who will be with us just shortly, is an economist specializing in China's commercial development. He is the Principal of China Strategic Advisory, a New York consulting firm. He is an Adjunct Professor at Columbia University and a Visiting Fellow at the Peterson Institute for International Economics.

From 2000 to 2001, he was Senior Advisor for International Economic Policy at the National Economic Council where he helped in China's accession to the World Trade Organization. Dr. Setser, as you're there by yourself, I think we'll start with you.

STATEMENT OF DR. BRAD SETSER, SENIOR ECONOMIST, ROUBINI GLOBAL ECONOMICS AND RESEARCH ASSOCIATE, GLOBAL ECONOMIC GOVERNANCE PROGRAMME, UNIVERSITY COLLEGE, OXFORD, ENGLAND

DR. SETSER: That seems reasonable. While the hearing is formally centered on foreign direct investment, my testimony is going to focus on my own personal area of expertise which is much more on China's portfolio investment, which entails its purchases of U.S. debt securities and its purchases of equity securities with a likely increase of its purchases of equity securities.

I'll touch briefly on foreign direct investment, but that won't be the primary focus of my testimony.

I want to thank the Commission for inviting me to discuss China's foreign assets and the management of China's foreign assets. As I think is very well known, at the end of 2006, China had roughly $1.1 trillion in formal foreign exchange reserves. It also had transferred a rough additional $150 billion to various entities that have an ownership stake in the Chinese banking system through various swap arrangements to the Chinese banking system itself.

Consequently, my personal estimate is that China ended 2006 with about $1.2 trillion in the bank. Moreover, roughly 70 percent of that is invested in U.S. securities of various kinds. That is my own personal estimate. China, of course, doesn't disclose the portfolio composition of its reserves.

While the size of China's reserves is extraordinarily impressive, it's the pace of growth in those reserves that really matters to the global economy and to the United States' ability to finance its very large external deficit at low cost.

The pace of reserve growth slowed briefly in the first part of 2006 but then started to accelerate late in 2006 and particularly in the first quarter of 2007. I think China is on track to add at least $400 billion to its foreign assets a year. While the creation of a new investment fund, which has been much in the news, may slow the pace of formal reserve growth, the overall pace of China's foreign asset growth is unlikely to slow dramatically or significantly in the foreseeable future.

China's government therefore is now the largest single actor in the foreign exchange market, the largest single buyer of U.S. Treasury and agency bonds, and the largest potential source of demand for almost any kind of dollar denominated financial assets. The way China allocates its portfolio is of immense interest to many in the financial markets as well as to this Commission.

I wanted to emphasize five points that I explore in much more detail in my testimony. First, the U.S. current account deficit implies rising foreign ownership of U.S. financial assets. That's basically what it means to run a current account deficit. The U.S. current account deficit is currently $850 billion, a little bit more last year. While there's a range of opinions about its likely evolution, I don't think it's likely to fall significantly in the near future.

China's current account surplus was around $250 billion last year, and it is set to rise, according to recent estimates, between $350 and $400 billion this year. If you do the math, at a global level, it would be very hard for China not to play a significant role in the financing of the U.S. external deficit when China is running an external surplus of such magnitude.

My personal view is that both the U.S. deficit and China's surplus are too large and that a gradual process of adjustment to reduce the United States' need for financing and reduce China's need to finance the U.S. would be in the interest of both the United States and China. However, I think an overly sharp adjustment would not be in anyone's interest. That implies the U.S. will be running deficits for some time, and that China will be financing the U.S. for some time.

The second point I wanted to emphasize is that the increase in China's foreign assets will likely come through an increase in the assets of the government of China. Now it is not necessarily the case that countries running current account surpluses will see their reserves grow or see the foreign assets of their governments increase.

Japan has a large current account surplus that is offset by large private outflows of capital from Japan. The same is true of Switzerland. The same is true of Germany. However, in China's case, a large current account surplus, which is an excess of domestic savings over domestic investment, coincides with large net private inflows into China from abroad.

The $350 to $400 billion current account surplus will be augmented by a net inflow of funds, by my estimates, of around $100 billion. Hence, you will see $450 to $500 billion in annual growth in the foreign assets of the Chinese government. In effect, private money is coming in. The trade surplus is large and the dollars end up in the hands of the government of China. That is also unlikely to change in the near future. The undeniable reality is that for the foreseeable future the U.S. will rely to some extent on China's government to finance its external deficit.

The third point I wanted to briefly touch upon is that China's net international investment position is in many ways the mirror image of the net international investment position of the United States. By that I mean that the U.S. has more external liabilities than it has assets. China has more external assets than it has liabilities. The U.S. actually has $3 trillion more in equity investment abroad than there is foreign equity investment in the United States; but that is offset by the fact that the U.S.' net debt position is negative $5 trillion.

China, by contrast, has more equity investment inside China than there is Chinese equity investment outside of China. China's net equity position is at least a negative .6 trillion dollars. However, China has a positive credit position because its foreign lending exceeds its foreign borrowing by about $1.2 trillion.

The mirror imaging continues if you look at the situation in more detail. The U.S. government is a net external borrower given the large holdings of Treasuries abroad. China's government is a large net external creditor given its holdings of U.S. and European government debt. While the majority of the United States' external assets, because the U.S. has both external assets and external liabilities, are in the form of equity. U.S. net equity positions after a very strong 2006 are close to $9 trillion.

China's total equity holdings, or rather its gross equity holdings, are around $100 billion. There is an enormous discrepancy between the United States' external investments, equity investments, and China's external equity investments. The State Foreign Exchange Investment Company which we can discuss in much greater detail during the question and answer is part of a natural process of diversifying China's external portfolio.

Right now that portfolio, judging from the data that is reported in the U.S. Treasury Portfolio Survey, is overwhelmingly in debt, meaning around 99 percent. Over time China is likely to seek to hold a higher fraction of equities in its portfolio.

That increase in equities in its portfolio does not necessarily imply any reduction in Chinese foreign direct investment abroad, given the overwhelming size of China's current account surplus.

I see that my time has expired, but I wanted to emphasize that in 2006, the net outflow of foreign direct investment from China was around $17 or $18 billion, and the net inflow of equity investment into China was about $80 billion. I think it is quite clear that it is the policy of China's government to remedy that imbalance and to try to increase both its holdings of equities and to increase Chinese direct investment abroad to offset the large equity inflows into China as well as to diversify the portfolio composition of China's vast securities holdings.

Thank you.

[The statement follows:][4]

HEARING CO-CHAIR HOUSTON: Thank you very much, Dr. Setser. Mr. Rosen, you were introduced in absentia so your reputation precedes you here today. Feel free to start on your seven minute presentation.

STATEMENT OF MR. DANIEL H. ROSEN, PRINCIPAL, CHINA STRATEGIC ADVISORY AND VISITING FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, NEW YORK, NY

MR. ROSEN: Thank you very much. I apologize for being late. I was with a House U.S.-China working group just before coming here. So good afternoon and thanks very much for asking me to spend some time with you here today. You know my background with the IIE and in other roles.

I'm going to offer brief comments to you in response to the four specific questions you laid out for these hearings. In the context of that, I'll draw on a few observations specific to China's energy sector interests that reflect the work that a colleague and I recently published from IIE on that subject.

The Commission's first question concerns the motives and objectives of the new agency being set up in China right now to help manage foreign exchange reserves of the country, which has been referred to by various names. I'll refer to it as the China Foreign

[4] Click here to read the prepared statement of Dr. Brad Setser

Exchange Investment Corporation. It looks to have about $200 billion worth of China's foreign exchange to worry about.

I've asked a number of well-placed Chinese thinkers and foreign thinkers in China close to the situation what they thought about the likely behavior of the organization once it’s up and running. My current impression is that the guiding principle there will be neither of those posited in your question. They will seek neither maximizing returns nor furthering industrial policy goals, but rather value preservation.

The portfolio managers and fund managers likely to work at CFEIC are not likely to be enticed to try to maximize the return of the fund. Rather, they are going to be judged for future career purposes based on their conservative protectionist stance toward the money under their management.

At least, that's been the tendency at PBOC, at SAFE and Huijin, Central Huijin Company, which all came before them. It is likely to continue to be the case. Even with that very timid investment philosophy, PBOC saw $30 billion net gain on their portfolio in 2006, according to our friend Stephen Green at Standard Chartered who did a pretty good job of trying to figure that out.

However, being overweight on U.S. government and agency securities in particular is a risk unto itself. Returns are low, risks to the dollar are rising, and the political tensions associated with having such a T-bill heavy portfolio are unhealthy for the bilateral relationship, as we all know.

Therefore, I would imagine that the conservative thing to do if you were a portfolio manager at CFEIC would be to diversify from Treasuries. Though that doesn't necessarily mean they would diversify out of dollars all together. Up in New York, everybody is running around pitching the PBOC rep for North America on their structured product such as ABS, mortgage-backed security, and other dollar alternatives to U.S. government and agency treasuries.

As for the industrial policy motive, I think that the purpose of CFEIC in regards to industrial policy is limited the extent to which China really has such a policy. Despite the soaring rhetoric in the Five Year Plans, those industrial policy goals are about as reliable as a guide to where the economy is going during the campaign platforms in a typical U.S. election cycle.

China's state firms that are going abroad are mostly flush with cash and are not dependent on a CFEIC to help them undertake the overseas operations. I think outward investments that are supported by government are going to be done on an ad hoc basis.

To wrap up that topic, I would say that there are policy entities in China other than this foreign exchange management entity that are better suited to support the outward FDI intentions of Chinese firms. In sum, there will be a mixture of motives for CFEIC. In some cases, it will appear to be supporting industrial policy goals. In general I don't think that will be the primary motive.

The second question you raised relates to the motive of China's state-owned enterprises in acquiring stakes in U.S. firms and whether there will be an increase in such interest in the future?

I think there will be a great increase in the interest of Chinese state and private firms to make acquisitions in the United States for the same reasons that there's been a great surge of interest among U.S. firms to make acquisitions in China.

As our economic relationship deepens and integrates, there's more reason to have a business platform that moves downstream toward customers and be a more effective business in one another's markets. I think we'll see more and more of that.

In the case of China, there's a special urgency to buy it rather than build it from the ground up. No Chinese firm on its own turf knows what it means to operate in a regulation intensive, highly litigious marketplace. None of them know how to do it. All of them trip up terribly the moment they step into the U.S. market but continue to attempt this method regardless. It is much more effective to buy a going concern, take a stake in that which can help them accelerate their ability to start their own companies.

The other method to attaining a business platform is having a proven reserve of some kind of resource. There China's appetite is equally boundless, but I think their experience in the Unocal case will temper their readiness to step in and make acquisitions in the United States for some time to come.

The signature Chinese overtures to make acquisitions in the U.S. I think are better understood through a commercial motive at the end of the day than any other kind of motive. I think that even applies to the Blackstone IPO bloc purchase that we heard announced this week.

In the case of oil markets overseas, my colleague and I have demonstrated that even CNPC, China Petroleum, operations in Sudan were more likely to sell that oil out to Japan and South Korea rather than bring it back to China. It depends on where the best price was that they could get for the oil. There's a big disconnect between the sense that these are entirely government informed overseas overtures and the actual behavior we see by these Chinese firms.

Thirdly, the Commission asked whether a heightened effort by Chinese companies to invest in the United States would be a legitimate reason for concern in regards to the risks of technology transfer. I'm not inclined to think so. The vast majority of Chinese firms that offer to purchase firms in the United States will not raise security concerns.

There will be hunting for the business platforms I described in my previous point. Those do raise those concerns, but we have robust processes in place to deal with those consequences. Those processes are, of course, CFIUS and export controls which cover all U.S.-domiciled firms, even if their ultimate owners are Chinese.

Finally, I think our innovative capacity reflects in our capital markets and our institutions and not just a finite stock of technologies here that we're going to run out of at some point. If we focus on that innovative capacity rather than preventing other people from bidding on that innovative capacity, I think we maximize our interests.

My time is almost up, but for 20 seconds, I will address your fourth question concerning the composition of U.S. dollar denominated assets in the Chinese foreign exchange portfolio. Dr. Setser is eminently more capable and has already covered in much greater detail than I could hope to econometrically fish out. However, I do have some opinions on the vulnerability arising from that very large stock of U.S. dollar assets.

I think it tends to be exaggerated because while China's holdings are large, the market for U.S. Treasuries and other dollar assets is much larger. Secondly, the immediate cost to China from trying to sell down that position would be huge. Thirdly, the longer-term consequences for China arising from any effort to use that as a tool would be absolutely gargantuan. Opinions and attitudes would change forever in the United States if China were to try to play that card. I think they're aware that those consequences would be untenable.

Let me stop there. We will have plenty of time for discussion, I hope. Thank you.

[The statement follows:]

Prepared Statement of Mr. Daniel H. Rosen, Principal, China Strategic Advisory and Visiting Fellow, Peterson Institute for International Economics, New York, NY

Good afternoon and thank you for inviting me to share views with the Commission on the extent of the Chinese government's control over its economy. I come to you as a member of the Peterson Institute for International Economics staff since 1993 including my time as an active Visiting Fellow, and as the principal of a private sector advisory practice helping US policymakers and business-decisionmakers understand the workings of the Chinese marketplace.

I will offer brief comments in response to the formal questions provided in advance of today's hearings, and provide a few observations about China's energy sector in particular as it relates to this topic in the course of answering those questions, since this is the subject of extensive work I have recently undertaken.

1. The Commission's **first question** concerns the motives and objectives of new agency authorities are

setting up in Beijing to help manage the nation's foreign exchange reserves. The agency, referred to in English as the State or China Foreign Exchange Investment Corporation (CFEIC), is not yet fully operational, but is expected to be charged to administer up to $200 billion in for-ex when up and running.

I have asked a number of well placed Chinese contacts and foreign contacts close to the thinking around this agency about its likely behavior. My current impression is that the guiding principle of CFEIC will be neither of those posited in your question -- maximizing returns or furthering industrial policy goals -- but rather value preservation. The investment managers at CFEIC, as those at SAFE, PBOC and Huijin before them, are not incentivized to maximize returns on these assets. They are incentivized not to loose money (as is the case with most government asset managers). With its timidly conservative investment strategy last year the PBOC made well over $30 billion, according to Stephen Green of Standard Chartered Bank. Higher return means higher risk, and without a payoff for taking risk, there is little reason to do so.

However being overweight on US Treasury bonds is a risk itself. Returns are low, risks to the dollar are rising, and the political tensions generated between the US and China as a result of heavy T-bill holdings are unhealthy. Therefore the conservative thing for official for-ex managers to do in China is diversify from Treasuries to some extent, though not necessarily from US dollars. Profit maximizing is out of the question, but value preservation begs for better diversification.

As for the industrial policy motive, the purpose of CFEIC could be industrial policy only to the extent that China has one. Notwithstanding their soaring rhetoric, the Five Year Plan documents are about as good an indication of national economic priorities as the campaign platforms put forth during elections in the United States. There is a great deal of debates about the outward investment behavior of China's state firms today. Many are flush with cash. In many industries government prefers to see investments made at home rather than abroad. Supports for outward investment are being made on an ad hoc basis rather than systematically. I expect CFEIC to make investments alongside SOEs abroad when it sees a secure opportunity to lock in a return, but not to do so when the risk-return calculus does not support it. There are other policy entities available for supporting outward FDI are a non-commercial basis when needed, just as there are in the United States. China Ex-Im Bank is one of them.

In the case of China's national oil companies in particular, the government support offered to CNOOC in the context of Unocal was exceptional. The transaction would represent more than half the total market capitalization of CNOOC. In the case of CNPC and Sinopec investments around the world, the transactions are well within these firms' ability to finance. Meanwhile, due to a combination of moderate interest rates and low dividend payment terms, the hurdle rate of return these firms require is lower than IOC competitors. Therefore, they generally do not need direct subsidies to justify overseas forays. Host countries, meanwhile, often negotiate concessionary lending or grants to finance infrastructure around these energy deals that they could well manage themselves if they had to. That financing is not going to be provided through CFEIC however, except in rare cases where it represents an attractive investment.

In sum, there will be a mixture of motives for the CFEIC, but the commanding principle is likely to be value preservation. While political pressures can deflect the core missions of Chinese agencies, the disposition of China's state natural resource firms – the foremost outward investors at present – is not likely to incline them to subsidized support through the CFEIC channel. Where they do need for-ex financing for their overseas activities, they may work through CFEIC on a largely market-basis.

2. The **second question** poised by the Commission is the motive of Chinese state enterprises in acquiring stakes in US firms, and whether there will be increased such interest in the future.

Certainly I expect there to be a dramatic increase in offers from Chinese firms to purchase stakes in US firms in the future. In large part this is for the same reason there has been and will be a dramatic increase in US purchases of stakes in Chinese firms, including in strategic Chinese industries such as finance and mining machinery: our economies are becoming more integrated and in the process there are only two options for establishing a business platform from which to sell to a new market: build it or buy it. In the case of China there is a special urgency to buy it. Outside manufacturing, China has poor skills, talent and experience. Operating margins in manufacturing are at risk, relative to margins in distribution, retail, and higher-end services such as financial and design. In order to become more competitive in other markets, instead of just exporting cheap manufactures, China's firms absolutely must expand their businesses downstream from the factory. And yet, they have little experience operating in a heavily regulated, customer-oriented marketplace such as the US. To build retail operations from scratch will require decades; acquisition is the logical and quicker alternative. Typically, the business capabilities global Chinese companies attempt to acquire in this regard will be mundane.

In other industries what is finite is not skills and experience, but proven reserves of resources. China's national energy companies have little enthusiasm to go to Sudan, Iran and other states of concern in order to find exploitable energy and commodities if they can find alternatives in the rest of the world. Therefore, to the extent the US welcomes such investments, there will continue to be Chinese interest in investing in US resources for the foreseeable future. However, there is now a deep distrust of US intention toward investments in natural resources in the United States, and fear of embarrassment again as occurred with Unocal, and this will likely depress the number of investment overtures in this sector.

The signature Chinese overtures to invest in US businesses to date demonstrate a commercial motive. CNOOC's bid for Unocal made sense given their oil and gas portfolio; Lenovo's purchase of IBM PC reflected the logic of acquisition rather than organic build-out described above. I interpret the planned PBOC investment in Blackstone Group's IPO unveiled this week to be another case of business logic. China will make these investments when they represent something Chinese firms could not do well themselves, cannot do quickly enough without making an acquisition, and cannot do without.

In the case of oil markets, in recent research my colleague and I have demonstrated that while state oil company CNPC is actively shipping oil out of Sudan, that oil can wind up in Japan, South Korea or China depending on market conditions. This is at odds with the view that CNPC follows the industrial policy playbook. And in fact the energy sector is a good example: the energy policy bureaucracy is so miniscule that it is clear the NOCs are in charge of outcomes, not the industrial policy planners, such as they are.

3. **Thirdly**, the Commission asks whether a heightened effort by Chinese companies to invest in the United States would be a legitimate reason for concern about the risks of technology transfer. I do not think so.

The vast majority of Chinese offers to purchase firms in the United States will not raise security concerns. Where they do, processes are in place. Export controls apply to all US-domiciled firms regardless of ownership, and CFIUS works. Innovation, meanwhile, does not stand still, and as long as the US is a net-seller of innovation we will continue to be at least one step ahead. In fact, our innovative capacity reflects capital market efficiency, intellectual property rights protection and a host of other institutional superiorities that will continue to advantage us in this regard for many decades (or until such time as China becomes even more like us, in other words). To maintain its innovative lead, the United States must focus on innovating rather than refusing to realize the value of our innovation whether by product sale or asset sale when the time is right.

It is obvious that if we apply a double standard to China, China will also apply a double standard to us, whether formally or informally. Our advantage is maximized by playing by the market rules we designed rather than shifting to closed economy rules we have fought tooth and nail against for almost a century.

Again, the principle impulse in Chinese outward FDI in the United States will be more rapid attainment of downstream business capabilities than would be possible through an organic growth strategy in a mature regulatory environment.

4. On the Commission's **fourth** set of questions, concerning the composition of US dollar denominated assets in the Chinese foreign exchange portfolio, my co-panelist has done in-depth econometric estimates and I will not try to improve upon those. However, I can offer my view on the question of dependency for the US arising from a large stock of US dollar securities in China.

In short, I believe the extent of vulnerability arising from Chinese holdings is greatly exaggerated. For four reasons. First, while China's holdings are large, the market for US treasuries and other dollar assets is much larger, and after an initial impact markets would likely absorb the dollar liquidity in short order. Second, the immediate costs to China from selling down its dollar position would be relatively high, high enough to deter a casual attempt to use this tool. Third, the longer-term consequences for China would be enormous, as the move would validate the hawkish view in the US and forever change the benign attitude of the United States toward Chinese dollar holdings. And fourth, over time I expect Chinese actors to purchase back the US dollars they have sold to the Chinese government in order to make purchases of dollar-priced goods and services and, especially, dollar denominated financial instruments as a long term portfolio investment.

For instance, as China's capital account normalizes to permit households and enterprise savers to diversify their long-term portfolio holdings to better reflect rational investment strategy (rather than 100% allocation in Chinese securities), a non home-bias portfolio level of perhaps 20% would seem fairly conservative. At present that would amount to $750 billion. If in turn 40% of this were placed in dollar-denominated securities, then $300 billion of China's for-ex would be required for this purpose alone. With assets saved in the banking system rising by about $900 billion per year, this translates into an additional $70 billion annually possibly ear-marked for US dollar assets. And this is just based on cash savings in the banking system being moved into an international equity portfolio, it does not include diversification of existing share holdings. And it does not include strategic investments overseas or commercial investments overseas.

In light of this analysis I am not overly worried about the level of Chinese foreign exchange holdings in the future.

PANEL V: Discussion, Questions and Answers

HEARING CO-CHAIR HOUSTON: Thanks to both of you. I'd like to start off with a question. Both of you have talked quite a bit about equity purchases, and I wanted to go into the non-cash FDI side of China acquisitions. Particularly in view of whatever political risks they perceive or choose not to perceive in going after such non-cash assets such as Burma with the trees or Darfur with the oil. They're looking to the capital markets in Iran as well as to consumer markets there. Moreover, they are going outward and building infrastructure in all those areas.

Of course, those are all areas that concern us from a national security perspective. When you're looking at this non-cash FDI coming out of China, do you perceive that they have any concern about the political liability they're engaging in or are they just driven enough by their goals that they ignore any kind of pressure from the human rights community or from other countries?

MR. ROSEN: Okay. I'll start with a few impressions. Most of the Chinese companies who handle natural resource going abroad appear to be making their choices in terms of where they go based more on commercial realities than any kind of marching orders they've been handed from the central government.

Of course, political risk is political risk no matter who is making the investment. We're concerned about political risk not just for geo-strategic reasons as a country or human rights reasons as moral human beings, but because it's a threat to business to be exposed to profound political risks.

I think Sinopec, China Aluminum, and the like are very concerned about the operating conditions under these states of concern. Our list of states of concern tends to overlap with the ones that have very high political risks. I think there are many profound concerns there. Even back on the government level, I think there are new questions arising. Whereas in recent years, many people at the National Development and Reform Commission in China thought there was really no geopolitical downside to China's energy companies going out hot and heavy into Africa and Latin America.

There's a new set of ideas percolating up in Beijing more from the Foreign Ministry that some of the goodwill China has been able to generate over the past three years is diminishing. While folks have said the U.S. was over focused on the Global War on Terror, the Chinese were too busy making hay. Well, the behavior of these energy companies in Africa is starting to turn some people off to China as well.

Now there's a debate in Beijing and it's not just a one-sided point of view on this question. There are those who want to more actively try to pull back those commercially motivated Chinese state firms from being so aggressive in some states.

HEARING CO-CHAIR HOUSTON: You're saying at the government level, there's a discussion?

MR. ROSEN: I think the question first arises as a commercial consideration within the boards and decision-making apparatus of these firms. This is notwithstanding the fact that the government is represented in those bodies. Ultimately it's been a commercial consideration that has driving decision making.

Now, it's gone beyond the narrow pecuniary interests of these firms to become one of China's soft powers. It is the unfettered support, rhetorical support anyways, of government for Sinopec going into Africa or Central Asia that is going to blow back at China because of the same issues that our firms get entangled with when they go into these regions?

HEARING CO-CHAIR HOUSTON: Right. Dr. Setser, did you have anything you wanted to add to that question?

DR. SETSER: Not much. I would note that I think it's pretty well known that it is hard for anyone to find oil resources to exploit anywhere in the world because most of the world's oil resources are controlled by state-owned oil companies that don't allow foreign participation. As such, Chinese companies are going into unsavory places but non-Chinese companies are also going into unsavory places.

HEARING CO-CHAIR HOUSTON: Okay. Commissioner Wortzel.

COMMISSIONER WORTZEL: Thanks very much for your time and testimony, both of you. I appreciate it. Dr. Setser, throughout your testimony you talked about U.S. foreign equity or foreign bond and stock investment in foreign countries, U.S. foreign bonds, and Chinese foreign bond and stock investment in the United States.

Related to that, I have a couple of questions. First of all, should we take a different view about whether the Chinese government is buying bonds or stocks? How does that really affect our economy depending on which way they're going?

Then, can it act as coherent directed entity? When the Chinese buy this stuff, whether it's bonds or stocks, can an entity be told this is what you're going to do to affect or not affect what's going on in the U.S.?

The opposite applies as well. I don’t think that it's the U.S. government that's buying foreign stocks or foreign bonds. Is it the same thing? Can the U.S. government go to hundreds of millions of investors and companies and say dump all your French stock? We're going to destabilize their market. Is it the same thing?

DR. SETSER: I think you almost answered your own question. No, it is not the same thing for precisely the reasons that you have identified. U.S. outward investment and U.S. portfolio investment is a result of decentralized decision-making. I wouldn't characterize it as quite as decentralized as you might. There are some very large pension funds and very large institutions in the U.S. which do have the capacity to move markets.

In China's case, it is effectively centralized. The State Administration of Foreign Exchange has the overwhelming majority of China's foreign assets and if the State Administration of Foreign Exchange is given a different directive about the desired composition of its portfolio, it would execute that decision accordingly.

I think one of the interesting questions that will arise is how will that change when it's not one institution but rather two or more that are managing China's portfolio? I think that's a very difficult question for the Chinese themselves because I'm pretty sure that the State Administration of Foreign Exchange doesn't want to be forced to buy more dollars because the State Foreign Exchange Investment Company is trying to sell dollars to buy something else.

There's going to be an issue of coordination amongst the two entities. However, the simple fact that China has become such a large player in the market would make it very difficult for China to radically reduce the dollar share of its overall portfolio. To reduce the marginal dollar purchases without putting additional pressure on the dollar would be even more difficult given the Chinese desire to continue to manage their exchange rate primarily against the dollar. Further pressure against the dollar implies pushing their own currency down further, not just against the U.S., but against Europe and against a range of other countries,

I think there are some difficult issues there, but in general, both firms will have to coordinate because the foreign asset purchases of the Chinese government are directed primarily to the goal of achieving an exchange rate target which requires some level of coordination.

Does it matter if it's debt or equity? Well, in the sense of financing the U.S. current account deficit, no. What matters is that you sell enough assets of either kind to cover the deficit.

Is there an issue of control potentially associated with equity that is not present with debt? Absolutely!

Has China's very large presence in the U.S. government bond market been one of the factors that have kept long-term U.S. interest rates relatively low? Yes.

Would a radical shift towards equities change that? Potentially, but I'm not convinced that China is going to fully move in the very short run towards equities.

MR. ROSEN: I have just one additional thought that sort of fits into the topic. We're talking about the $1.2 trillion in foreign exchange. There's also the Social Security Fund which is almost entirely in Chinese assets right now to consider. If you look at household and enterprise savings in China, it's an over $4 trillion pool of money that is essentially 100 percent in Chinese securities.

I don't think anybody in this room would be comfortable being 100 percent allocated in their retirement account to Chinese securities alone.

COMMISSIONER WORTZEL: I wouldn't be comfortable with ten percent.

MR. ROSEN: A little bit of diversification would be quite sensible. When we look at non-home bias ratios, a basic portfolio theory around the world, 20 percent non-Chinese weight in your portfolio would actually be fairly sensible. That would be $750 billion, looking to be moved into dollars, euro or yen, to be put into some other kind of instrument. We can continue to work through that if somebody else wants to follow through with the question, but I see your time is up.

HEARING CO-CHAIR HOUSTON: Okay. Commissioner Fiedler.

HEARING CO-CHAIR FIEDLER: Thank you. Mr. Rosen, I want to get to the FDI question of the heavyweight and the national champions that the Chinese recently elucidated. Let's take oil and coal. Oil and coal were absolute control companies, described as you can't buy it. Is that fair?

MR. ROSEN: Chinese energy companies?

HEARING CO-CHAIR FIEDLER: Right.

MR. ROSEN: Well, there have been investments. Are the national oil companies of China available for purchase by foreigners?

HEARING CO-CHAIR FIEDLER: Right.

MR. ROSEN: I would say no. The answer is probably no.

HEARING CO-CHAIR FIEDLER: So should ours be available for them to purchase as matter of policy?

MR. ROSEN: Well, that depends on whether we wish to have a quasi-socialist economy or whether we want to have a market economy. If we want to have a market economy, then we have to play by our rules even if those are different from the Chinese.

I think what we hope to see is that China comes around to our way of running an economy rather than vice versa.

HEARING CO-CHAIR FIEDLER: Your answer is yes, that we should allow them to buy our oil and coal companies when we cannot buy theirs?

MR. ROSEN: Our oil and coal companies are private and I think that the right to make that decision lies with the private owners of the oil and coal companies you refer to. I think it would do China well to consider privatizing some of its energy and resource companies for the same reason that it does us well to have private and energy companies. That's my view.

HEARING CO-CHAIR FIEDLER: Do you find any policy concern with the fact that the Chinese have decided on defining a serious number of sectors in their economy as off limits to everybody else?

MR. ROSEN: Well, in terms of number, the list of sectors of the Chinese economy that are off limits to foreign investment is rather small. In terms of equity capital of the country, in terms of what's traded, and in terms of the strategic significance of the economy, there are large, significant chunks that are not as open to foreign investment as the manufacturing sector.

Do I find that problematic from our perspective? Not so much. If we look at the trend line over a five-year period, 15-year period or 25-year period, it's moving in the right direction. I would prefer for China to have already arrived at a point where it doesn't have any investment controls on any sectors of the economy be it finance, energy, aviation, or shipping, as a few examples. To be fair, we still do have some controls for those areas in this country.

They're not there yet. I'm satisfied anyway that they're moving in the right direction in this regard.

HEARING CO-CHAIR FIEDLER: You think the decision to create absolute control companies and national champions, heavyweights, is a move in the right direction?

MR. ROSEN: Well, that decision was more or less made in 1949. I'm looking at the trend line since then which with some steps forward, some steps back, is manifesting itself in a direction we should be pleased with.

HEARING CO-CHAIR FIEDLER: So in 1949, 100 percent of the industry was state-owned and now it's less, and now--

MR. ROSEN: No, it took actually about ten years for them to fully nationalize the economy.

HEARING CO-CHAIR FIEDLER: Okay.

MR. ROSEN: But suffice it to say that by the time the reform started in the late 1970s, essentially the entire economy--

HEARING CO-CHAIR FIEDLER: But this is 2006 or '07--they made the decision in late 2006. They're allegedly moving towards a market economy. Is this movement towards a market economy including the decision to keep these sectors to themselves?

MR. ROSEN: The Chinese government has periodically over the reform period announced the extent to which it has committed to maintaining 100 percent state control over strategic sectors of the economy. Despite that rhetoric, the amount of central level control, particularly in these sensitive sectors has been diluted decade after decade, if not always year after year.

In the energy space, even though the firms are principally state owned, the prices affecting the marketplace are largely market determined and set by world price. There are some exceptions to that such as natural gas, but even in oil and gasoline, prices have converged with world price because the economy is opening up rather than closing off to the rest of the global energy market.

HEARING CO-CHAIR FIEDLER: May I ask one more question?

HEARING CO-CHAIR HOUSTON: You got about 20 seconds left.

HEARING CO-CHAIR FIEDLER: What does a heavyweight mean?

MR. ROSEN: You used the term, I think.

HEARING CO-CHAIR FIEDLER: Yes. It's their term actually, a heavyweight state industry. It's a second-class. First is absolute control. Second is heavyweight. Does heavyweight mean you can't buy it but you can own a piece of it?

MR. ROSEN: It's not a term I'm very familiar with frankly.

HEARING CO-CHAIR FIEDLER: But are you familiar with that tier of machinery, autos, information, construction, iron and steel and nonferrous metal?

MR. ROSEN: I am familiar with how they have designated strategic sectors in which they intend to maintain the state as the leading vision in determining the character and operation of the sector.

HEARING CO-CHAIR FIEDLER: Is leading vision no ownership?

MR. ROSEN: Autos is a good example where they have said that over and over again. Yet the largest automobile companies in China are foreign and indeed it's the foreigners that are driving how the industry is evolving to a great extent.

HEARING CO-CHAIR HOUSTON: Thank you. Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Thank you both for your testimony. It's very much appreciated. I want to get to some of the underlying questions of the quality and nature of the capital investments and what impact those may have.

Mr. Rosen, you talked about capital preservation being one of the driving forces behind that, but that demands some diversification in terms of their investments so that they're not all in T-bills or something else. It seems, though, that in terms of entering the U.S. market to diversify in equities/debt et cetera that they are engaging in certain transactions that are strategic in nature. You know we had the CNOOC and we had some others that were involved in resource acquisition. They've done that with iron ore mines, I believe, up in Minnesota.

They've engaged in what I'd call cash and carry transactions which entails buying U.S. assets and closing the facilities down and then taking those assets back to China. You see this now with Blackstone. However, this has happened before with the Lenovo transaction where the Chinese government purchased Maytag, Whirlpool and all those various companies so that they could enter the U.S. market and upgrade the vision that people have of Chinese products under a U.S. nameplate.

Now we have Blackstone entering the private equity market, which has mixed history here in the U.S. in terms of how people view private equity and what's actually happening behind the curtain. Are they just leveraging companies with debt, shedding jobs and moving on and taking huge profits?

None of those appear to be capital preservation strategies. They appear to be very aggressive strategies, brand acquisition, resource development or acquisition, or in the case of Blackstone, a fairly highly leveraged aggressive penetration of the U.S. market. If you could both respond to that and let me know how you view these entries?

Wouldn't it have been better for them to have a more neutral investment such as buying Vanguard S&P shares? Or perhaps doing some exchange traded fund shares or something else that does not bring control acquisition but rather investment and return implications?

MR. ROSEN: Different investors have different notions of whether they're better off holding Vanguard or better off buying a business and having a going concern. I would say of all the examples you mentioned, almost all of them were not government related purchases. Granted, CNOOC is a government-controlled company but as I said before, it was operating with more of a profit motive than a strategic motive.

Unocal, of course, was not a strategically significant share of U.S. overall oil assets. There's a lot of debate there.

There was an iron mine which was closed down, I believe in Minnesota; that a Chinese iron company offered to reopen and get back into production.

HEARING CO-CHAIR WESSEL: It’s a steel company with significant state investment.

MR. ROSEN: The Lenovo purchase was also a consumer goods oriented business rather than a strategic move. Blackstone is the standout there because the purchaser would be clearly a government entity. That stands out to me to be good evidence of what China can't do. The reason they're offering to buy at a premium a big stake in Blackstone is that they don't really know how to invest very well in China. Many of the economic problems we see across the Chinese economy are a reflection of that.

By taking a stake in Blackstone, they're basically admitting, “We don't know how to do what Blackstone does.” People will have different opinions about the behavior of Blackstone as a commercial entity. However, as a financial entity, it's an extremely profitable and effective one, far more so than any known Chinese investment entity.

HEARING CO-CHAIR WESSEL: I think it reflects that. In your sense you're looking--

MR. ROSEN: Brands and skill sets are what the Chinese are mostly looking to invest in.

HEARING CO-CHAIR WESSEL: Then you're talking about return and risk and not capital preservation. Although Blackstone has been very productive with high rates of return, it's still a fairly risky investment if you want to gauge it on everything from T-bills all the way up Ginnie-Maes. All the way through; correct?

MR. ROSEN: Far more so than a fixed income--

HEARING CO-CHAIR WESSEL: Right.

MR. ROSEN: --style investment that would be more typical of Chinese investment behavior in the past, which usually included T-

Bills. However, they want to have a spectrum of investments. Every portfolio has a spectrum of risk in it. What Blackstone does is something they have absolutely no idea how to do. However, investing in the Treasuries market? I think they've kind of figured out how to go about doing that.

Adding to that portfolio with a firm Blackstone which has had a very steady and predictable high return over a long period of time, I think that is something they don't know how to do and want to learn more about how to do. It's a $3 billion investment. It doesn't really rise to the level of a strategic investment in light of the size of the Chinese funds that we're talking about.

HEARING CO-CHAIR WESSEL: Dr. Setser, any thoughts?

DR. SETSER: Well, I guess I find it somewhat amusing that Americans question the financial wisdom of our largest creditor.

[Laughter.]

DR. SETSER: I have a different point of view--

HEARING CO-CHAIR WESSEL: That's a good point.

DR. SETSER: --about the motivation of the Chinese portfolio allocation. I think their number one goal is neither strategic nor capital preservation. It's exchange rate management. As a result of exchange rate management, they are forced to hold a level of dollars in their portfolio that is probably not consistent over the long run with value preservation. I think that the primary motivation facing China stems from that reality; their costs on the borrowing side of sterilizing their reserves are going up. They're looking to increase their returns.

To me, there's an interesting aspect to the Blackstone transaction which is as follows: China very recently privatized, no, not privatized, that would be inaccurate, rather they sold small stakes in what remains state-controlled commercial banks. They took in strategic investors before they did the IPOs and then they launched their IPOs and those shares have done very well.

The strategic investors who got in early on China's state-bank IPOs have done exceptionally well including a couple of very large U.S. banks. I suspect that that experience informed some of China's thinkers that when the opportunity to participate in the early stage of an IPO of a new category of U.S. financial institutions presents itself, they should take it. I think in that particular case, they were looking to move out, quite far out, on the risk return spectrum to balance what otherwise is still a very low risk portfolio.

HEARING CO-CHAIR WESSEL: Thank you.

HEARING CO-CHAIR HOUSTON: Thank you very much. Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you, Madam Chairman. What I get is a somewhat benign assessment of the prospects that this outflow might cause us. Let me just ask you each a question. Dr. Setser, given the sheer size of the potential outflows, whether or not they're completely orchestrated by central actors in China, when you go to bed at night, what are the three most worrisome possibilities that could arise in terms of the flows that we're talking about. Are you concerned about the couple hundred billion a year in flows, either in the equities and/or resource areas? The Chinese might not at this point even be considering, but we might want to worry about them given the size of the flows that we can experience here?

What are the things that we need to really worry about here in terms of forestalling dangers to our economy or to the shortage of timber and other kinds of resources or to distortions in the equity markets that might be troublesome for us?

DR. SETSER: I think what I worry about is if you project out the size of China's portfolio, when it's rising by somewhere between $400 and $500 billion a year and the pace of increase continues to get bigger, you're looking at an extremely large portfolio in the relatively near future.

By my forecast, by 2010 on the current trajectory, China's assets of the various state entities that manage China's external assets, will reach $3 trillion. That's a rather significant sum. If the exchange rate management objective means that a very large share of those are directed into U.S. markets, then that's a very significant increase in Chinese demand for a range of assets over the relatively near future.

One thing that worries me is that I think it is inevitable that China will seek to diversify that portfolio into equities. I think it is inevitable that the process will generate friction. Moreover, I think it is quite possible that as a result of those frictions, which so far have been a very stable and not terribly volatile process for financing the U.S. external deficit, the level of volatility and friction will rise. That could at some point generate less benign outcomes associated with our large deficit than we've seen to date.

I worry that China will continue to finance us at this level forever, and that that implies a very large transfer necessarily of U.S. financial assets of some kind to China. Then I worry that China will not finance us--

[Laughter.]

DR. SETSER: --and that will force an adjustment at such a sharp and abrupt pace that our economy will not be able to smoothly adapt.

One other scenario that worries me is what China did when the U.S. said you couldn't buy CNOOC. They ended up purchasing CNOOC for around $20 billion, which right now is less than China adds to our markets in a typical month. It's not that big. What did China do when we said no? They just bought more bonds.

I think it is possible that their future response might be somewhat different. That does worry me because it might shift from the relatively benign path of no adjustment to a path of very abrupt adjustment. I would like to see a benign path of some adjustment, and we haven't quite found that.

COMMISSIONER D'AMATO: So the question is whether we have any control of those scenarios at all in terms of the magnitude to change the size of those flows to reduce the scale of the impacts? I presume that that's what we would try to figure out.

I have just one question for you, Mr. Rosen. Would you be comfortable with government control of most of our major oil companies?

MR. ROSEN: Our government control?

COMMISSIONER D'AMATO: Any government control.

MR. ROSEN: Of our major oil companies?

COMMISSIONER D'AMATO: Our oil companies.

MR. ROSEN: I wouldn't think that would be a good harbinger of things to come.

COMMISSIONER D'AMATO: The reason I ask that is in response to the question that Commissioner Fiedler asked you before, you didn't seem to be worried about the CNOOC acquisition which would have left the Chinese government effectively in control of an American oil company. However, if you said then it would be okay to come into our oil patch and do that repeatedly, Exxon Mobil and a couple of others, then you're talking about big bananas, and you're talking about a foreign government control of our oil economy, putting it under the control of a foreign government. While we don't want to control the economy, their behavior would diminish our access of a major resource. We wouldn't want that outcome; would we?

MR. ROSEN: The point is taken. As I said before, I don't think that the case of Unocal represented a real strategic game shift for the United States' energy sector. I think the CFIUS process is appropriate. I think in the context of the larger U.S. energy international oil companies which would entail some kind of Chinese overture to roll them up and hence reduce global competition in oil space. I'm against that as I'm a big proponent of competition policy.

COMMISSIONER D'AMATO: Right.

MR. ROSEN: If any one actor, the Chinese government or any other, to attempt a roll up of the global oil business, I think we'd have real competition issues to consider in addition to the national security issues which is the task of CFIUS to consider.

COMMISSIONER D'AMATO: Thank you.

MR. ROSEN: I didn't mean to be dismissive--

COMMISSIONER D'AMATO: No, no, I know that.

MR. ROSEN: --of the point.

COMMISSIONER D'AMATO: I think there's a logical conclusion to the logic that you use, which is logic that most of us would agree with. However, when you get to the actors here and the financial resources available to them under an “anything goes” market scenario, then you may have an outcome you just can't live with.

MR. ROSEN: We may have to cross that bridge at some point. In the case of Unocal, I personally didn't think we were crossing it, and I thought we were--well, anyway.

COMMISSIONER D'AMATO: Yes.

MR. ROSEN: Those are my opinions.

COMMISSIONER D'AMATO: Thank you.

HEARING CO-CHAIR HOUSTON: Thank you very much. Chairman Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you very much. Thank you both to our witnesses for your testimony today, and also for your prior service to our government. I hope that at some time in the future, you find yourselves going back into the government and serving again.

I have a couple of observations and then a question. A couple of times in both of your testimonies, either written or verbal, you've essentially said that the Chinese, for people who don't know what they're doing, that they don't know what they're doing. My observation would be for people who don't know what they're doing, they seem to be doing it pretty well for the most part.

If you look at the challenge to many sectors of the U.S. economy, I think it is scary to think about what happens. There have been plenty of challenges now. The trade has grown, the economic development has grown at a pace and scale that is unknown of in history and I think it calls into question traditional trade theory.

We need to be thinking about those things. I was struck particularly, Mr. Rosen, when you mentioned that Blackstone is not a strategic investment, but it is. It is a strategic investment in terms of it could be the beginning of a model of which the Chinese government will use in the future and the Chinese have been very good at it so far. You move in, you learn what you need to learn, you take it back, and then you do it yourself. We've heard a couple of times this year already from people who are questioning some of the paradigms under which most of this is analyzed. Jim Mann questioning the paradigm that political reform will inevitably lead to economic reform. Clyde Prestowitz this morning used a great analogy, that we are playing soccer and the Chinese are playing football and that the rules are completely different.

My question is for what reason do you believe that the Chinese government is indeed interested or feels a need to move towards a free market economy any more than it currently is?

MR. ROSEN: China's growth has impressed us all on the march from being a failed state with $200 per capita to being a state that's getting on its feet with $2,000 per capita economy.

The kind of governance in place required to run an economy of $5,000 or $7,000 or $15,000 per capita is entirely different than what China is capable of doing today. It's already starting to bump its head very hard against a concrete ceiling, that it's not going to be able to get through without changing, and what strikes me most in this regard this week is the food crises we've had around the world as a result of Chinese governance practices and the operating environment for Chinese firms.

China needs to move its farmers from low value-added land intensive cropping, which they're totally ill-suited to do, to a labor intensive high value-added agriculture that we use where we import foreign workers to pick for us in the U.S. because we're not suited to do.

The problem is to charge $4 for a pound of grapes, like Chile does, you have to assure a baseline degree of assurance that there's quality control. China is not currently able to do that. When I think of China's competitive capability going forward from $2,000 per capita, where it is today, I see many weaknesses and impediments that are going to be a tremendous challenge to them in the years ahead.

In order for them to take what they learn at Blackstone and bring it back to China, they'll have to change a number of things internally. It's not like a machine that they just have to have the right adaptor to plug in. It's a process. It's an institutional environment that makes it possible to do what Blackstone does in the United States. What Blackstone does in the U.S. can't be done in China. It would have to be done offshore.

CHAIRMAN BARTHOLOMEW: Why do you believe that what the Chinese government is interested in doing is replicating the model of the free market in which we exist? I mean there are a lot of people who believe that what they're interested in is more a Singapore model or something along those lines? I mean you're still presuming that they are aspiring to become--

MR. ROSEN: Well, I'm not actually. Let me give you two reasons for my view. One is that the revealed reality is that for 25 years, the trend of marketization, movement toward free market mechanisms to run the economy, has been absolutely manifest. 95 percent of prices to the economy today are set by the market meaning they are not set by any kind of government pricing board.

The role of the private sector in the economy is well over 50 percent today. The change continues in that direction in a dramatic way. I gave you an example earlier of where the current style of non-market oriented government mechanisms is failing them.

In order to go forward and to continue the momentum that the Communist Party relies on to justify its role in the country, they will have to find new systems to manage the different kind of economic activities that need to take place if you're going to get beyond $2,000 per capita.

We need to look backwards at the evidence over the past 25 years and understand where they are now and what the impediments are today to them moving from a $2,000 per capita economy to a $3,000 per capita economy, which is where we were 125 years ago. Given that knowledge, I am absolutely certain that they will have to change the mechanisms they use to manage their economy, which will include both changes in market governance and political governance.

CHAIRMAN BARTHOLOMEW: I guess time will tell.

MR. ROSEN: I think it has. I think it will continue to tell.

HEARING CO-CHAIR HOUSTON: Commissioner Shea.

COMMISSIONER SHEA: Thank you. This has been a very interesting discussion. We've spent all our time this afternoon focusing on the potential of Chinese investment in the United States and I was wondering what your thoughts are concerning the potential investment by the Chinese government in Taiwanese or Japanese assets?

I'm wondering what benefits or costs would be considered by a portfolio manager in that regard?

DR. SETSER: Well, you happened to pick two of the currencies with the lowest interest rates in the world. I think they are the two currencies among which there are political issues with Taiwan. There are conceivably political issues associated with Japan as well, but if you look at the underweight of yen holdings in all government reserves, not just China's government's reserves, it seems to me the determining factor recently has been the very low interest rate on Japanese government bonds.

I think that's one of the ways in which the creation of a state-foreign exchange investment company loosens some of those constraints. If you look at the portfolios of other government investment companies, they have a much higher allocation towards Asia, especially towards emerging markets in Asia, than your typical foreign exchange reserve manager.

As part of its portfolio in the new State Foreign Exchange Investment Company, it’s likely that China will seek to increase its investments in Asian equities. I think that actually poses a lot of problems, not so much for Taiwan because I'm pretty sure that they're the one country which China won't be investing in. However, for the other countries in emerging Asia, most of whom have a current account surplus and are already attracting significant capital inflows from the United States and from Europe, I'm not sure that they would welcome an additional inflow from China. They are intervening quite substantially already to keep their currencies from appreciating. This is especially true at a time when China's holding its currency down and they don't want to see their currency appreciate relative to China.

I think that there are some extraordinarily difficult questions that would arise if China seeks to reallocate its portfolio away from the country which has the largest need for financing, which is the United States.

I think one of the challenges presented by China's is that as development has risen it is integrating into the global economy at an extraordinarily rapid pace, but its internal corporate governance standards haven't converged with global standards.

You can make analogies with some places in the Gulf where most of the countries' assets are controlled by the government in various funds. However, in general, countries that are this big a presence in global financial markets are marked by a diversity of actors, not a fairly unitary actor. There are some small players, but the core is a fairly central unified actor.

I think that the way in which China is integrating and evolving that doesn't really fit previous models. I don’t think that in the near term that that is likely to change. While you can tell a story about the broad nature of change inside China, in the financial sector, I wouldn't necessarily characterize that current development is a loosening of government control.

There's been some loosening of equity control and some allowance for foreign equity participation. However, on the lending side, the government has been forced to make very extensive use of administrative controls and administrative measures to keep Chinese banks from lending too much. They do this to keep the economy from overheating at a time when the exchange rate and the export side is stimulating the economy so strongly that the banks are forced to lend to the government to absorb some of the bills that the government issues on the domestic side and to take some of the money that it's creating as its reserves grow out of circulation.

That process seems to have been thwarted and stalled. Evolution towards a banking system that looks more like the United States is not looking like it’s going to happen in the near term.

HEARING CO-CHAIR HOUSTON: Commissioner Shea, did you have another question?

COMMISSIONER SHEA: That's fine. Thank you.

HEARING CO-CHAIR HOUSTON: Before we launch into round two, let’s take of two quick things housekeeping wise. Today has been a great day for information and as usual, our staff has been wonderful in preparing this day for us. I'd like to thank Paul Magnusson and Eric Lundh in particular. Thank you very much for everything you did to pull this together. Tomorrow morning, we will reconvene at 10 o'clock in the Russell Building next door, in room 385 Russell. You're welcome to join us.

Now on to round two questions, I have two real quick I think econometric questions. Dr. Setser, I'll start with you. How much does the currency manipulation of the Chinese government affect the assets and the reserves that the Chinese government has? If you take a number of roughly $800 billion, that we have contributed, could you make a guess as to how much of that is inflated because of the currency manipulation?

The second question is probably more for both of you. How does the growth of the stock exchanges in China, the Shanghai, the Hong Kong and the commodities markets, affect China's outward FDI and how do you see that trajectory shaping in the future?

DR. SETSER: I think if you asked 20 economists to answer your question, you would get 20 different answers. And so--

[Laughter.]

DR. SETSER: --I'll just give you mine with the proviso that it may be somewhat different than others. My baseline for a country like China would be that they should not be running a large current account surplus. I think if you look at China's current account position and China's reserve growth up until 2002, both the current account surplus and the pace of reserve growth were relatively modest. At that time, China had roughly $200 billion in reserves. It would probably need somewhat more than that now on a normal trajectory, but it wouldn't need to have increased its reserves to 1.2 by now. It should now be on track to 1.6 to 1.7 trillion in the future.

In my view, the vast majority of it is a byproduct of a policy decision on the part of China's government to continue to hold tightly to a dollar peg at a time when the dollar has started to depreciate against most other currencies in the world. I think you can debate whether that constitutes manipulation. They didn't change their policy but rather the world changed. The dollar started to depreciate and what previously had been an appreciating currency and appreciating trend became a depreciating currency and a depreciating trend at a time when Chinese growth accelerated. That would normally push the rate of the appreciation up. As a result, my view is that the effect has been very substantial.

For your second question, the equity market has served to pull money into China. While Mr. Rosen may believe that 20 percent of Chinese savings would like to get out of China and go into U.S. equity markets, I think the observed reality is that existing Chinese savings abroad has been pulled back into China to play the internal Chinese markets to the greatest extent possible.

That's partially a byproduct of the current policy that has been mentioned. You can buy Chinese assets with dollars at a discount. If you're a Chinese saver looking to buy dollar assets, you have to do so at a premium.

HEARING CO-CHAIR HOUSTON: Mr. Rosen, thoughts, comments?

MR. ROSEN: I guess I'll just fill in a little bit with regard to the last point. Indeed, there's not going to be that much appetite to diversify out of Chinese stocks in years when the Chinese stock exchange grows by 120 to 130 percent a year. The Chinese stock market is overwhelmed by individual investors, not smart institutional investors.

They're not smart investors at all. They're piling into a market with price/earnings ratios at 50, 60, 70, 90 times earning in some sectors of the economy. This won't last forever.

There will be a correction in the future. When people become accustomed to more normal rates of gain on the Chinese stock exchange and recognize the volatility involved with an emerging market exchange, there will be a much greater appetite for a more diversified portfolio than simply 100 percent Chinese exposure.

I certainly concede the point that last year and so far this year, it's hard to sell somebody a QDII product, which is a new Chinese product to allow people to have Lehman Brothers or Neuberger Berman or Vanguard manage their retirement savings rather than Hua'an Securities in China. After the last people to the dance loose all the money they extracted through a second mortgage in their home in the stock exchange correction later this year, they might take a different view on that next time they have a little surplus that they have to make an investment decision with.

HEARING CO-CHAIR HOUSTON: Okay. Great. Commissioner Fiedler.

HEARING CO-CHAIR FIEDLER: Yes. Underpinning your testimony, especially in the earlier part, you underscored the Chinese policy objective to manage their exchange rate. Did I get that right? What's the policy, what's the reason they want to do that?

DR. SETSER: If you ask 20 economists--

[Laughter.]

DR. SETSER: --you would get 20 different answers.

HEARING CO-CHAIR FIEDLER: How about this before you give me an economic reason: give me the political reason they want to do that.

DR. SETSER: I will give you my personal interpretation which is probably not the mainstream interpretation of either political or economic analyst. I think it's probably a mistake to try to pin a single motive to any policy that has been maintained and held for so long. It obviously has to have a complex broad set of support inside China or it couldn't be sustained.

I would emphasize several things. The most common argument is that it's a necessary byproduct of China's underemployed agricultural labor because this labor needs to be employed in a modern export oriented sector and it is necessary to support rapid job growth.

There was an excellent article in the Financial Times by Richard McGregor which showed that job growth in China hasn't been all that impressive. I think that's been a byproduct of the fact that in order to maintain this exchange rate, China has kept interest rates exceptionally low and encouraged the substitution of capital for labor.

I'm not convinced that it has actually been all that successful as a jobs policy. Nonetheless, there are now many jobs that are in the export sector and the people in those jobs, the people who have built those firms and the companies here in the United States that buy those products do not particularly want to see that change.

There's an interest group politics inside China and various groups that benefit from an undervalued exchange rate would like to see that undervalued exchange rate continue. I think that includes the export sector, domestic and external, and it also includes those who have benefited from the relatively low interest rate policy. Again, it's a very broad-based set of support.

Third, I think there's a sort of conservatism in the sense of resistance to change in China's institutions. Given that the world ended up changing around China. The policy of pegging to the dollar had consequences that were not fully foreseen and the policy consensus to shift away from that has always been maybe a little bit too timid relative to how quickly China's economy and the world economy was evolving.

Then, fourth, I think a lot of the costs are deferred in the sense that China's taxpayers are ultimately overpaying for U.S. assets. However, the costs of that are not visible and won't become visible until the fact that China has overpaid manifests itself, now you see the benefits but not the costs. Mr. Rosen may have a somewhat different interpretation.

MR. ROSEN: I agree with everything that Dr. Setser just said and I would only add to it a little bit on the perception side. No matter what the rational analysis might be on the Chinese side, I think there's a perception that not only could the export sector be harmed by a significant change. We have had change but we haven't had a truly significant change in the value of renminbi against dollar. As such, you can argue about whether the export-oriented sector would even really be harmed.

They certainly haven't been harmed over the past two and a half years or so where we've seen a seven or eight percent correction, have they? It's debatable on the merits.

Psychologically, there are concerns about the stability of the banking system and what its relationship it has to the exchange rate. There's concern about the stability of the equity markets now, which are very fragile in their current condition and are only marginally being fueled by hot money inflows around renminbi/dollar story. Yet it's only going to take one straw of hay on this camel's back to bring about a correction.

The property sector is also a speculative sector in China and could be a source of tremendous social unrest if there were to be a dramatic correction, is also tangled up in the question of the correct value of the renminbi against other currencies, especially the dollar.

As Dr. Setser was saying, the variety of different constituencies and interests with some amount of anxiety want to know what's the positive model of the new exchange rate policy we're moving to before they're willing to let go of what has been a pretty good ride..

HEARING CO-CHAIR FIEDLER: I appreciate the complicated nature of the dynamic, but I want to get to the political again, which you touched on by mentioning for the first time social unrest. The lack of job growth results in social unrest. Social unrest results in a threat to the existence of the Communist Party, right?

MR. ROSEN: Sure.

HEARING CO-CHAIR FIEDLER: So we're talking about managing the exchange rate because of alleged social stability. Yes, there are all kinds of economic factors that one could cite in it, but the bottom line is that we've got to artificially keep job growth going because if we don't, we're going to have social instability.

The Party--

MR. ROSEN: Yes.

HEARING CO-CHAIR FIEDLER: --I don't think it's a stretch.

MR. ROSEN: Well, social stability is one of those catch-all excuses for not doing anything. If you really try to dig through the issue, you end up thinking there are vested interests here that are not the little guy who is out of a job or at risk of losing his job.

HEARING CO-CHAIR FIEDLER: That's right.

MR. ROSEN: Just as in the United States, it's not always about that

HEARING CO-CHAIR FIEDLER: Rhetorical.

MR. ROSEN: Mythologically manufacturing jobs in Ohio? That's at risk. However, there are often other things in play.

HEARING CO-CHAIR FIEDLER: It's mythological--

MR. ROSEN: But there are very profound weaknesses in this economy such as the danger of social instability and the danger of environmental unrest. I could go on.

HEARING CO-CHAIR FIEDLER: Yes, that's okay. I'll take a third round.

[Laughter.]

HEARING CO-CHAIR FIEDLER: My time she told me was expired.

CHAIRMAN BARTHOLOMEW: Here I thought I was going to be giving a closing question that summed it all up, but apparently not. We've got--

HEARING CO-CHAIR FIEDLER: I got another question.

CHAIRMAN BARTHOLOMEW: It is a variation on what Commissioner Fiedler is asking. Mr. Rosen, I feel like you blew on by the significance or the impact of Chinese government officials sitting on these companies and participating in the decision-making process and that you are ignoring the fact that one of the goals of the Chinese Communist Party in managing its economy is to maintain itself in power. What does that mean?

Dr. Setser, you made two references to this in your testimony, but then didn't quite take it the next step. You said that China's government has a larger ownership role in Chinese companies than European governments have in European companies, let alone the U.S. government has in U.S. companies.

That implies as Chinese firms go forth that firms owned by the Chinese state will be going forth. I would just like some more elaboration on what that means when the Chinese state will be going forth. Add one more dynamic to it and that is it is still uncertain. I wonder what China's impact on the global system will be with China’s accession to the WTO. Mr. Rosen, as you know, the Chinese were very involved in the MFN fights. We still don't know the answer to that but what we do know is that every time the U.S. tries to exercise its rights under the WTO for dispute resolution, the Chinese government reacts as though it's a hostile act. We just saw that this week with Madame Wu Yi's comments.

There’s a range of thoughts out there, but I'd love for you to take it a little bit further. What is the role and what does it mean that the Chinese Communist Party is participating in these decisions?

DR. SETSER: I may not answer your final question. I may answer one of the earlier ones.

[Laughter.]

DR. SETSER: I might formulate the question that was posed around the WTO as a much broader question. Will China's participation in the global economy change China or will China's participation in the global economy change the global economy? I would say that to date we don't know the answer to that question.

If you asked how China's participation in the global economy has impacted the world to date, I don't think it's a mythical worker in Ohio who has lost their job. I think that's a real worker in Ohio who has lost their job.

CHAIRMAN BARTHOLOMEW: Yes. He says he's only mythical because the job isn't there anymore.

DR. SETSER: You know China's participation in the global economy has been very good for resource exporters. It's been very good for the financial sector. It has pushed interest rates down in the U.S. It's pushed interest rates down in Europe. It has provided a lot of the liquidity that has fueled the private equity boom.

It has had a profound impact on a range of different sectors and it's had a negative impact on certain sectors. Some of the latter are those people in tradable goods producing sectors and those people who own real estate in small Ohio towns who haven't benefited from the liquidity boom that has pushed up real estate prices elsewhere in the country. The terms of trade between a house in rural or small town Ohio and a New York City apartment have shifted against the person who has a home in small town Ohio.

There have been very profound impacts of China's integration to date into the global economy, especially on the U.S. economy. I think the only safe thing we can say is that it will continue. I'm a little bit cautious in asserting that China's participation in the global economy will end up changing China because China is in such a strong creditor position. The rest of the world's leverage over China to push for change in China is somewhat limited. China doesn't need inflows from us here in the United States. It doesn't need to import our capital. It may need to import our technology. I think that gives China a great degree of leverage.

Going back to the social stability question, I think the big puzzle in my mind has always been why China chose this strategy for social stability as opposed to others? Why not--

HEARING CO-CHAIR FIEDLER: Civil society--

DR. SETSER: Why not have more public spending and create a stronger rural health care system? Why was China willing to peg the dollar when the dollar was rising at a time when they were going through the state-owned enterprise reform and shedding jobs there? It's always struck me as a more complicated question that honestly doesn't have an answer. I took up too much time.

HEARING CO-CHAIR FIEDLER: That's okay. We have time.

MR. ROSEN: I think as is clear from my remarks already, I believe very strongly that China has changed quite dramatically over the past two and a half decades. If we look at the structure of the Chinese economy on the eve of reform, 1978-'79, there was essentially no light manufacturing, essentially no service sector to speak of, and certainly no value-added services. Agriculture was almost entirely limited to big grains with just enough rice and wheat to feed people.

There was no focus whatsoever on the energy intensity and energy efficiency of the economy. Now the country is four or five times more energy intensive than it had before they started reorganizing things.

Since then, using the rest of the world as an opportunity to be more economically competitive and efficient, China has systematically gone through and restructured almost every aspect of its economy. Most of the interface between the Chinese economy and the U.S. economy is in the manufacturing space. Most of that manufacturing is not the big state-owned industry that we've been talking about for most of today, which is heavy industrial outputs, energy, steel, and the things which lay the groundwork for manufacturing facilities. The manufacturers themselves have been mostly foreign-invested companies from the United States and elsewhere such as Japan, Europe, et cetera. There has been an emerging private Chinese light manufacturing sector.

That's a really dramatic change compared to what we used to have in China. Some of the credit for that goes to WTO, although almost everything China committed to in WTO was already on track and built into Chinese reform policy before they agreed to sign on the dotted line for WTO accession.

HEARING CO-CHAIR FIEDLER: May I?

HEARING CO-CHAIR HOUSTON: Yes.

HEARING CO-CHAIR FIEDLER: Two questions. One, I've asked this of other witnesses today. If it's not a non-market economy, it's not capitalism, it's not socialism, —then what is it? What would you call it? One thing that I'm going to hold you to because you are economists is that you always call it something. What is this economic entity phenomenon that we call China as a country? How would we classify it? How would you describe it in words? Not one that's changing, but —a description that tells us what it currently is

MR. ROSEN: Shall I go first? I generally describe it as a partially marketized economy. There is really no other way to describe it. It's neither one nor the other. It is a hybrid situation that is in transition. That may not be as satisfying as black or white, but it's the reality.

HEARING CO-CHAIR FIEDLER: I wasn't asking.

MR. ROSEN: Yes.

HEARING CO-CHAIR FIEDLER: I'm just asking how you do it.

MR. ROSEN: There are elements of the economy which are certainly still not market driven. There are equally profound, larger, elements of the economy which can entirely be understood using a market model of buyers and sellers.

DR. SETSER: I'm going to give you an entirely unsatisfactory answer. I've never really found non-market/market to be a terribly good categorization.

HEARING CO-CHAIR FIEDLER: Me either.

DR. SETSER: I've always believed that there are variations in national types of capitalism, variations in labor market regulation, and variations in corporate governance. I think China is a new variation. It's something that's neither a European model nor an American model. It is something unique. It's one that compared to the U.S. or compared to Europe has very little labor market regulation, although there obviously is some with respect to migration. It is one marked by a very heavy state participation in the capital structure of firms. Yet it still has state dominance over the financial sector which is I think something new.

HEARING CO-CHAIR FIEDLER: Finally, getting back to an earlier discussion we had, do you believe in reciprocity in trade? Do you believe in reciprocity in investment?

MR. ROSEN: In what sense do you mean reciprocity?

HEARING CO-CHAIR FIEDLER: To reach an agreement.

MR. ROSEN: As captured in the WTO system where we have reciprocal agreement on a most favored nation tariff that we apply to all of our trading partners and vice versa, though those may not be equal? Yes.

HEARING CO-CHAIR FIEDLER: Yes. You do?

MR. ROSEN: Yes.

HEARING CO-CHAIR FIEDLER: Which is why when we had that earlier exchange about I can't buy their oil company, but they can buy mine, you were satisfied with that. I was dissatisfied with that answer, which Mr. D'Amato took it out on scale. I wasn't really talking about Unocal. I was talking just in principle reciprocity.

The state control description that he gives is one of the problems that concerns members of Congress in that they're not companies in the common sense definition of company in the United States, meaning private. They are not private non-publicly traded, but privately owned. This phenomenon of state capitalism is one that I don't think anybody has come to grips with. Frankly, from listening to both of you today, I don't think either of you have come to grips with it either. But we must recognize that the politics of it are fast approaching.

MR. ROSEN: I think it's right and appropriate that we have hearings to raise our comfort level, our confidence level in how we understand the implications that corporate structures in other economies are different than a corporate structure as defined under U.S. law.

WTO, the concept of WTO, the whole Bretton Woods system for that matter, is not predicated on corporate forms being defined precisely the same in Europe or Asia or China or anywhere else as they are in the United States. The system is predicated on a common set of commitments, focusing on the case of trade having to do with tariff and non-tariff barriers.

You mentioned investment and the question of reciprocity in investment. As you know, we don't have a robust international system covering investment the way we do on trade. There have been some efforts under OECD auspices to try to create a multilateral agreement on investment. We're not there yet. Nor do we have a global regime to address the environmental consequences of how our two economies are organized very differently; right?

China's competitiveness, as we know it today, will be a cause for consideration in the future. This is as it's felt by workers in Ohio, who are not mythological but are real, although sometimes mythological cases are drawn as evidence without anybody having a person in mind.

HEARING CO-CHAIR FIEDLER: Right.

MR. ROSEN: If Chinese firms had to operate with the same environmental compliance obligations as U.S. firms, they would not be competitive at all. There would be an extremely rapid reversal of trade trends as we know them. It was asked earlier what keeps me awake at night when I look at potential scenarios for a rapid destabilization of the system as we know it.

I can imagine a Chinese scenario within five years where the environmental consequences of having government overly politicize elements of the marketplace are so severe that a rapid change in enforcement must be undertaken in a very short period of time. This would destabilize Chinese firms and cause problematic disruptions to supply and demand of goods around the world.

HEARING CO-CHAIR HOUSTON: I'd like to thank both of you. Sometimes people moan when they draw the afternoon sleepy straw, but you have really kept this a lively. Thank you both very much and to all of you who have joined us today. We'll see you in the morning.

HEARING CO-CHAIR FIEDLER: Thank you, gentlemen.

[Whereupon, at 4:25 p.m., the hearing recessed, to reconvene at 10:00 a.m., Friday, May 25, 2007.]

THE EXTENT OF THE GOVERNMENT'S CONTROL OF CHINA'S ECONOMY AND IMPLICATIONS FOR THE UNITED STATES

FRIDAY, MAY 25, 2007

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

The Commission met in Room 385, Russell Senate Office Building, Washington, D.C. at 10:00 a.m., Chairman Carolyn Bartholomew, and Commissioner's Jeffrey L. Fiedler and Michael R. Wessel (Hearing Co-chairs), presiding.

OPENING REMARKS OF COMMISSIONER JEFFREY L. FIELDER, HEARING CO-CHAIR

HEARING CO-CHAIR FIEDLER: Good morning. Today's first and only panel will address the outlook of two important U.S. industries. Our speakers will discuss the challenges that the U.S. steel and aerospace industries face when competing with China and the trends they see within their respective fields.

Barry Solarz is the Senior Vice President of Trade and Economic Policy at the American Iron and Steel Institute. Mr. Solarz joined AISI in January of 1982. Prior to that, he worked as an international economist at the U.S. Labor Department's Bureau of International Labor Affairs, Office of Trade Policy, and as a political and risk analyst at the Brookings Institution.

Dr. David Pritchard is Research Associate at the State University of New York at Buffalo at the Canada-United States Trade Center. His aerospace industry experience spans two decades and includes six aircraft launches.

He received his Ph.D. in international business at the State University of New York at Buffalo. His dissertation was entitled "Global Decentralization of Commercial Aircraft Production: Implications to the U.S. Manufacturing Base.

Welcome, gentlemen, and Dr. Solarz, we'll start with you.

PANEL VI: INDUSTRY PERSPECTIVES

STATEMENT OF MR. BARRY D. SOLARZ, SENIOR VICE PRESIDENT – TRADE & ECONOMIC POLICY - AMERICAN IRON AND STEEL INSTITUTE, WASHINGTON, D.C.

MR. SOLARZ: Thanks, Commissioner Fiedler and the other commissioners. My testimony is on behalf of our U.S. member companies who together account for approximately 75 percent of the raw steel produced annually in the United States.

The topic of subsidies and state support of industrial capacity in China is of critical concern, not just to the domestic steelmakers, but to all manufacturing.

My testimony will address the specific questions that the commissioners are focused on at today's hearing. I'll be emphasizing in particular the effects of massive government subsidies and a severely undervalued currency.

These factors, among others, have combined to fuel an uncontrolled explosion of Chinese steel capacity that's far in excess of China's domestic demand. That in turn has led to an unprecedented surge of exports of not only of steel but of steel-containing products to the United States and other world markets.

Before I continue, I'd also like to draw the Commission's attention to the fact that in our written statement, we refer to a number of documents. I believe there are four in total and we brought copies along with us. With your permission I'd like to submit these to the Commission for your use and records.

HEARING CO-CHAIR FIEDLER: Please.

MR. SOLARZ: To begin with your first question, how we are affected by the Chinese government's moves to consolidate control of so-called "strategic" and "heavyweight industries"? Let me be clear: the Chinese government is not in the process of "consolidating" control of its steel industry.

Steel in China has been government-owned and controlled for decades. In fact, thanks to subsidies and other non-market forces, the Chinese steel sector has now grown so large and so fragmented that even the central government is finding it difficult to implement some of the major aspects of its steel policies in the provinces and localities that are far from Beijing.

The end result is that the bad old days are back thanks to the massive build-up of Chinese steel capacity, which today is roughly one-third of total world capacity. Some of you may remember when a significant percentage of the world's steel capacity was owned and controlled by government and then we saw in the 1990s a lot of privatization.

Nine out of ten of China's largest steel producers are majority-owned by the Chinese government, and state-owned enterprises account for nearly 60 percent of total Chinese steel-production. Of course, sometimes it's difficult to see where the dividing line is between government and private.

But the critical factor to keep in mind, at least for us, is not only that the Chinese government is continuing to own and control steel-making in China, it's that Chinese steel companies--this gets to the heart of some of your questions--whether they're state-owned enterprises or not, are continuing to receive massive government subsidies.

In July 2005, China's National Development and Reform Commission, the NDRC, adopted a new National Steel Policy to guide the industry for the next 15 years. This central government industrial policy calls for continuing subsidization of key steel projects, exports, and technologies.

At a previous hearing, we provided this Commission with a copy of our July 2006 report, "The China Syndrome." It's an important reference tool. We also brought some copies with us today. It shows that China has the world's most heavily subsidized steel industry and that Chinese government subsidies take many forums. They cover the waterfront from preferential loans and tax treatment to subsidized raw material and energy inputs.

To answer your second question about the advantages that Chinese SOEs have over our firms and how they affect our industry: Chinese steel companies, whether they're state-owned or ostensibly "private," they face a number of competitive challenges. Not the least of which are high input and energy costs.

Contrary to popular opinion, Chinese steel firms are not low-cost producers. However, they have significant artificial competitive advantages in the form of government subsidies, an undervalued currency and government intervention in raw material markets. This is an issue of growing concern to steelmakers all over the world.

While these subsidies remain in place for Chinese steel producers, the U.S. steel industry is being directly and adversely affected by a surge of Chinese imports. In 2006, China shipped over five million net tons of steel products to the United States. That’s more than double the level the previous year and by the end of last year we were importing more steel from China than from any other country including Canada. In fact, we were importing more steel from China than from all the EU members combined.

In addition, the old standby that China is sending us mainly lower valued "long" steel products is becoming more of a myth each passing month. Government subsidies are allowing China to move up the steel value chain with the increasing production of advanced steel products such as cold-rolled sheet, corrosion-resistant sheet, and oil country tubular goods. These products are among the most valuable to our industry and Chinese state policy explicitly targets these products for subsidization and for export.

The U.S. industry is competitive with regard to high-value steel products. For instance, U.S. producers of corrosion-resistant steel increased their productivity by 78 percent between 2000 and 2006. On level terms, we can compete with steel producers anywhere; but we cannot compete against their governments, especially the government of China.

Addressing your third question on the challenges that we face from China's industrial policies and where they apply: both the U.S. government and U.S. producers have complained that this National Steel Policy limits the ability of foreign companies to invest in Chinese steel firms. There is a 49 percent limitation on direct foreign investment.

Our main concern about China's industrial policies is the effect that they're having on the U.S. steel market and our domestic customer base. We're also very concerned that if the obsolete steel capacity in China is not eliminated and if the other fundamental problems in the Chinese steel sector remain unaddressed, there could be truly disastrous spillover effects in world markets.

Government support for the Chinese steel sector has clearly led to the addition of capacity that has nothing to do with market signals or supply and demand. Chinese crude steel production more than quadrupled in the last ten years, growing from an estimated 100 million metric tons in '96 to approximately 420 million metric tons in 2006.

That's the rough equivalent of building three entire American steel industries in one decade. China's production growth has far outpaced growth in the rest of the world, and its share of world steel production skyrocketed from an estimated one-eighth in 1996 to one-third in 2006. That underscores the unprecedented nature and enormous magnitude of what's happening there.

In addition, Chinese government subsidies are harming our steel industry, our manufacturing base, and our economy through increasing what we call the U.S. “indirect” steel trade deficit with China in downstream markets of steel-intensive products. In 2006, fully one-third of imports of downstream products that are made entirely of steel came from China.

It matters little whether the subsidized steel distorts the market as a coil of corrosion-resistant steel or as a shipload of appliances. Neither the domestic steel producer nor their domestic manufacturing customers are going to be able to compete with Chinese government subsidies and mercantilist policies without the full and aggressive enforcement of our U.S. trade laws.

In terms of your fourth question, whether Chinese SOEs may be less willing than other firms in China to accept investment or joint ownership from foreign companies: we don't have firm evidence that where there is direct government ownership, Chinese steel producers may be less willing to accept investment or joint ownership from foreign companies other than the limitation that I previously mentioned.

However, there are many who see control moving increasingly to the provincial and the local levels. We do know that China's National Steel Policy seeks to micromanage many aspects of steel industry development including the number and size of major firms, the size of new plants, the location of such plants, and even the minimum size of blast furnaces to be installed. As mentioned before, it also bans foreign companies from controlling Chinese steel companies.

Regarding transparency, as an association, we don’t have direct commercial or investment experience in dealing with Chinese steel companies. We're therefore not able to advise the Commission on the clarity of their operations and financial dealings.

On your fifth question as to whether the SASAC designation of seven strategic sectors and five heavyweight sectors is a continuation of long-standing industrial policy in China or a new development: we view this designation as a continuation of long-standing industrial policy. China's Five-Year Plans, which address virtually every aspect of its economy, have reportedly ordered governments at all levels to support the ongoing technological renovation of the steel industry.

Regarding the SASAC and its direct role in the management and financial direction of state-owned enterprises, one could certainly argue that the formation of this body actually recentralized government control of SOEs. However, it's also clear to us that even without this development that China and especially its steel sector would not be in a market economy. Therefore, if we're to address effectively China's non-market and trade distorting behavior, our nation must have all available tools. This includes treating China as a non-market economy under antidumping law, applying countervailing duty law to China and other non-market economies, and addressing Chinese currency misalignment under anti-subsidy law.

To your sixth and final question on whether it's become more or less difficult to compete with Chinese state-owned enterprises: it's always difficult to compete with non-market behavior and subsidized foreign competition, whether state-owned or private. We'd also like the Commission to know that in our sector, the problems of Chinese government subsidies and excess capacity are worse than our government realizes.

Given the costly efforts of domestic steel producers to restructure, invest and enhance their global competitiveness, the last thing that we want to see is a replay of the Asian crisis of the late 1990s where overproduction abroad resulted in a flood of dumped and subsidized imports that puts our entire industry at risk.

The threat then was vastly underappreciated, especially by the administration of that day and as a result, our industry suffered deeply and unnecessarily. That's why it's time to act now before this situation gets any worse.

In conclusion, The U.S.-China trade relationship is the single-most important trading relationship for the United States in the 21st century. We had better get it right.

As our annual bilateral trade deficit with China approaches the politically-unsustainable figure of a quarter of a trillion dollars, we need a new policy model of dealing with China trade problems. We support as initial steps in the right direction recent U.S. government policy moves to apply countervailing duty law to imports from China and to pursue a WTO action against China's prohibited subsidies.

However, there are additional concrete actions that should be implemented this year to help avoid a worsening crisis, and these include addressing the China currency misalignment and maintaining, strengthening and enforcing our vital trade remedy laws.

I thank you and look forward to participating in the Q&A.

[The statement follows:]

Prepared Statement of Mr. Barry D. Solarz,
Senior Vice President – Trade & Economic Policy -
American Iron and Steel Institute, Washington, D.C.

Good morning. I am Barry Solarz, Senior Vice President for Trade and Economic Policy at the American Iron and Steel Institute (AISI). I appreciate the opportunity to be here today on behalf of our U.S. member companies, who together account for approximately 75 percent of annual raw steel production in the United States.

The topic of subsidies and state support of industrial capacity in China is of critical concern to domestic steelmakers and all American manufacturers. While my testimony will address the specific questions the Commission is focused on at today's hearing (China's use of central planning and state-owned enterprises to develop its economy), I plan to emphasize in particular the effects of massive government subsidies and a severely undervalued currency. These factors have combined to fuel an uncontrolled explosion of Chinese steel capacity far in excess of China's domestic demand, which in turn have led an unprecedented surge of exports of steel and steel-containing products to the United States and other world markets.

1. *How are U.S. firms affected by the Chinese central government's moves to consolidate control of "strategic" and "heavyweight" industries? Will U.S. companies be able to compete with Chinese state-owned companies that are able to tap government resources – including tax abatements, discounted land purchases, low-rate financing, and other subsidies?*

With regard to the Commission's first question, the Chinese central government is not "consolidating" control of its steel industry. Steel in China has been government-owned and controlled for decades. In fact, thanks to subsidies and other non-market forces, the Chinese steel sector has now grown so large and so fragmented, that even the central government is finding it difficult to implement some of the major aspects of its steel policies in the provinces and localities far from Beijing.

To cite three examples of how the Chinese steel sector is not operating as a market economy: (1) millions of tons of obsolete and heavily polluting steel capacity in China has not been eliminated; (2) steel capacity and production in China are continuing to expand geometrically in the face of domestic oversupply conditions; and (3) contrary to what has occurred in the Americas and in Europe, steel industry consolidation in China has yet to occur.

Accordingly, the steel sector has become a "poster child" for what is wrong in the U.S.-China trade relationship. However, the key point here is not about steel alone. No U.S. industry (regardless of how competitive) can compete against the government of China, and that is what we and many of our domestic customers are being asked to do.

The bad old days, when a significant percentage of the world's steel capacity was owned and controlled by government, are back – thanks to the massive buildup of Chinese steel capacity, which today is roughly one-third of total world capacity. Nine out of ten of China's largest steel producers are majority-owned by the Chinese government, and state-owned enterprises account for nearly 60 percent of total Chinese steel production. However, the critical factor to keep in mind is not only that the Chinese government is continuing to own and control steelmaking in China – it is that Chinese steel companies, whether state-owned enterprises (SOEs) or not, are continuing to receive massive government subsidies.

In July 2005, China's National Development and Reform Commission adopted a new National Steel Policy to guide the industry for the next 15 years. This central government industrial policy calls for continuing subsidization of key steel projects, exports and technologies. At a previous hearing, we provided this Commission with a copy of our July 2006 report, "The China Syndrome." It shows that China has the world's most heavily subsidized steel industry and that Chinese government subsidies take many forms. They cover the waterfront -- from preferential loans and tax treatment, to subsidized raw material and energy inputs.

2. *What advantages do Chinese SOEs have over American firms and how do these advantages affect your industry? What are the elements that affect you the most?*

With regard to the Commission's second question, Chinese steel companies (whether state-owned or ostensibly private) face a number of competitive challenges, not the least of which are high input and energy costs. Contrary to popular opinion, Chinese steel companies are not low-cost producers. They do, however, have significant artificial competitive advantages in the form of government subsidies, an undervalued currency and government intervention in raw material markets, which is an issue of growing concern to steelmakers in many parts of the world.

Following publication of “The China Syndrome,” U.S. steel producers have continued to research the issue of Chinese government subsidies, albeit hampered by the lack of transparency in the Chinese system. Last month, the Specialty Steel Industry of North America released a study on “Chinese Government Subsidies to the Specialty Steel Industry,” which I would like to submit for the Commission’s use and records.

In addition, just last week, AISI and four other major steel associations in North America presented a paper at an OECD Steel Committee meeting in Istanbul, Turkey, about the “Environmental Aspects of Global Trade in Steel.” It notes that worldwide production of steel has increased by about 470 million metric tons over the last decade, with most of the expansion occurring in countries, especially China, that in general have greater amounts of inefficient steel production and weaker environmental regulation or enforcement. This lack of environmental enforcement is also a form of subsidy. I would like to submit this document for the Commission’s use and records because -- with China already responsible for 50 percent of the global steel industry’s total greenhouse emissions -- it is a stark reminder that the climate change challenge requires a global solution.

I will not discuss at length the issue of China’s currency, but will submit for the Commission’s use and records the testimony of the China Currency Coalition (CCC) at this week’s Senate Banking Committee hearing. Among other points, this testimony stresses that: (1) China’s accumulation of $1.3 trillion in foreign reserves is serving to meet its economic, social and military goals; (2) the continued undervaluation of the Chinese currency by 40 percent or more is harming U.S. manufacturing, employment and national security; and (3) the problem of currency misalignment (which is the result of protracted large-scale intervention by, or at the direction of, a governmental authority) should be a countervailable prohibited export subsidy under U.S. trade remedy law.

Meanwhile, the U.S. steel industry is being directly and adversely affected by a surge of Chinese imports. In 2006, China shipped over 5 million net tons (NT) of steel products to the United States, more than double the level of imports from China in 2005. By the end of last year, we were importing more steel from China than from any other country – including Canada. In fact, we were importing more steel from China than from all EU members combined.

Moving downstream, the U.S. pipe and tube sector was especially harmed by this surge, as imports from China in 2006 assumed a 28 percent share of the U.S. market. Because this dramatic increase resulted in a rash of plant closings in the United States -- and because this represents such a good case study of the “China model” of subsidization, overbuilding, exports and injury -- I will submit for the Commission’s use and records a paper presented earlier this month by a representative from IPSCO, an AISI member company, entitled “Saying One Thing and Doing the Other.”

Moving upstream, we see that the Chinese government is intervening increasingly in raw material markets. This is another form of subsidy that is both benefiting domestic steel producers in China (by keeping raw materials at home) and harming steel producers in the United States and in other regions (by limiting the availability of raw materials in world markets).

The old standby that China is sending us mainly lower-valued “long” steel products is becoming more of a myth each passing month. Government subsidies are allowing China to move up the steel value chain, with the production of increasing amounts of advanced steel products such as cold-rolled sheet, corrosion-resistant sheet and oil country tubular goods. These products are among the most valuable to the U.S. industry, and Chinese state policy explicitly targets these products for subsidization -- and for export. We can see this policy of “channeling” exports clearly in the recent Chinese government announcements of changes in border tax policy affecting steel exports. These policies, allegedly intended to slow the production and export of certain steel products, have specifically exempted pipe and tube and other high-value products.

The U.S. industry is very competitive with regard to high-value steel products. U.S. producers of corrosion-resistant steel increased their productivity by 78 percent between 2000 and 2006. On level terms, we can compete with steel producers anywhere, but we cannot compete against their governments – especially the government of China.

3. *Do the challenges you face from China’s industrial policies apply only to your operations in China, or do they have consequences for you in other markets as well? Do they make it harder to invest in China? To export to China? To compete with Chinese exports in third country markets?*

With regard to the Commission’s third question, both the U.S. government and domestic steel producers have complained that the National Steel Policy limits the ability of foreign companies to invest in Chinese steel companies (there is a 49 percent limitation on direct foreign investment). However, our main concern about China’s industrial policies is the effect they are having on the U.S. steel market and our domestic customer base. We are also very concerned that, if the obsolete steel capacity in China is not eliminated and if the other fundamental problems in the Chinese steel sector remain unaddressed, there could be truly disastrous spillover effects in world markets.

Government support for the Chinese steel sector has clearly led to the addition of capacity that has nothing to do with market signals or supply and demand. With Chinese steel production exploding over the course of the last decade, a growing surge of Chinese steel has already impacted the global market. Between 2003 and 2006, we witnessed an historic shift of approximately 70 million tons in the net steel trade position of China, as it went from being a major net steel importer to a major net steel exporter to the world’s number one steel exporting nation.

Chinese crude steel production more than quadrupled in the last 10 years, growing from an estimated 100 million MT in 1996 to approximately 420 million MT in 2006. This is the rough equivalent of building three entire American steel industries in one decade. China's production growth has far outpaced growth in the rest of the world. Its share of world steel production skyrocketed from an estimated one-eighth in 1996 to over one-third in 2006. This underscores the unprecedented nature and enormous magnitude of what

China is doing in steel.

Moreover, the largest portion of China's steel production growth has occurred in just the last few years. Between 2003 and 2006, it is estimated that the increase alone in China's crude steel production was roughly equal to the total production of the United States in 2006. It is likely no coincidence that these are the years immediately following some of the largest reported Chinese government payouts to the steel industry. Though we are still working to understand the full implications of this absolutely unprecedented industrial expansion, one fact is clear: the Chinese market is not able to support the hundreds of millions of tons of production capacity added in the last few years, and this excess supply is already displacing steel from other countries to the United States, thereby significantly impacting the world market.

In addition, the Commission should keep in mind that Chinese government subsidies are also harming our steel industry, manufacturing base and economy through an increasing U.S. "indirect steel trade" deficit with China in downstream markets of steel-intensive products. In 2006, fully one-third of imports of downstream products made entirely of steel came from China. It matters little whether subsidized steel distorts the market as a coil of corrosion-resistant steel or as a shipload of "white goods." Neither the domestic steel producer nor its domestic manufacturing customer is going to be able to compete with the Chinese government's subsidies and mercantilist policies without the full and aggressive enforcement of U.S. trade laws.

4. *Are Chinese State-Owned Enterprises less willing than other firms in China to accept investment or joint ownership from foreign companies? Are the operations of joint ventures with SOEs less transparent to joint venture partners than would be the operations of joint ventures with non-SOEs?*

With regard to the Commission's fourth question, we have no firm evidence that, where there is direct government ownership, Chinese steel producers may be less willing to accept investment or joint ownership from foreign companies. There are many who see control moving increasingly to the provincial and local levels. What we do know is that China's National Steel Policy seeks to micromanage many aspects of future steel industry development -- including the number and size of major firms, the size of new plants, the location of such plants and even the minimum size of blast furnaces to be installed. In addition, it bans foreign companies from controlling Chinese steel companies.

In terms of transparency, AISI does not have direct commercial or investment experience in dealing with Chinese steel companies. Therefore, we are unable to advise the Commission on the clarity of their operations and financial dealings.

5. *Do you see the State Assets Supervision and Administration Commission (SASAC) designation of seven "strategic" sectors and five "heavyweight" sectors as a continuation of longstanding industrial policy in China or as a new development and a deviation from a path that otherwise would lead to a market-oriented economy?*

With regard to the Commission's fifth question, we view the designation of seven "strategic" industries and five "heavyweight" sectors as a continuation of longstanding industrial policy. China's five-year plans, which address virtually every aspect of the country's economy, have reportedly ordered governments at all levels to support the ongoing technological renovation of the Chinese steel industry.

Regarding the State Assets Supervision and Administration Commission (SASAC) and its direct role in the management and financial direction of SOEs, it can be argued that the formation of this body actually recentralized government control of state-owned enterprises. What is clear beyond any doubt is that, even without this development, China (and especially the Chinese steel sector) would not be a "market economy." Thus, if our country is to address effectively China's ongoing non-market behavior and its trade and market-distorting practices, the U.S. must use all available tools. This means: (1) treating China as a non-market economy under antidumping law; (2) applying countervailing duty law to China and other non-market economies; and (3) addressing Chinese currency misalignment under our anti-subsidy law.

6. *Has it become more or less difficult in the past several years to compete with state-owned enterprises? Do you discern a trend line in the future?*

With regard to the Commission's sixth question, it is always difficult to compete with non-market behavior and with subsidized foreign competitors (whether state-owned or private). We would like the Commission to know that the problems of Chinese government subsidies and Chinese excess capacity are worse than our government realizes.

Given the costly efforts of domestic steel producers to restructure, invest and enhance their global competitiveness, the last thing we want is a replay of the Asian crisis of the late 1990s, where overproduction abroad resulted in a flood of dumped and subsidized imports that put the entire American steel industry at risk. The threat then was vastly under-appreciated, especially by the Administration of that day. The signals were clear and the results predictable -- and not just in retrospect -- yet they went largely unheeded until almost too late. The American steel industry suffered deeply and unnecessarily as a result. That is why we believe the time to act is now, before the situation gets any worse.

The U.S.-China trade relationship is the single most important trading relationship for the United States in the 21st century, and we had better get it right. As our annual bilateral trade deficit with China approaches the politically unsustainable figure of a quarter of a trillion dollars, it is clear that we need a new policy model of dealing with China trade problems. AISI supports, as initial steps in the right direction, the recent U.S. government policy moves to apply countervailing duty law to imports from China and to pursue a WTO action against China's prohibited subsidies. However, there are additional concrete policy actions that we believe must be implemented this year to help avoid a worsening trade crisis. These include: (1) addressing Chinese currency misalignment; and (2) maintaining, strengthening and enforcing our vital trade remedy laws.

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Thank you for this opportunity to testify before the Commission today. I hope my remarks have provided some insight into the domestic steel industry's views on these important matters. AISI strongly supports the work of the U.S.-China Commission, and we consider your work to be an essential component of getting our China trade relationship "right." I look forward to our continued dialogue during the question and answer session.

HEARING CO-CHAIR FIEDLER: Thank you. Dr. Pritchard.

STATEMENT OF DR. DAVID PRITCHARD, RESEARCH ASSOCIATE, STATE UNIVERSITY OF NEW YORK, CANADA-U.S. TRADE CENTER, BUFFALO, NEW YORK

DR. PRITCHARD: Commissioners, I'd like to thank you for the opportunity to appear before and discuss the extent of government control on China's economy and its impact on the United States. I'll be focusing on the commercial aircraft industry.

I've conducted research for over 15 years, specializing in the area of globalization of commercial aircraft manufacturing. This has given me the opportunity to visit every major aircraft plant in the world. I've been on Airbus programs, Boeing programs, McDonnell Douglas programs, Tupolev programs, and I've also been in the Chinese aircraft plants several times since the early 1990s. I've seen the progression of how they're advancing.

I have firsthand visual observation on the floor. I've been in the industry and that's how I conduct my research. The commercial aircraft industry has long been a powerful symbol of Western technology leadership requiring high levels of design and engineering innovation.

This industry has been important to North America and Europe. We're talking Boeing, Airbus, and Bombardier. It's where all the major suppliers work. Many advanced manufacturing techniques developed by this sector have been successfully transferred to other industries. That's what's important, the technology spillover. If we're not inventing and innovating, we can't disperse among our own industries here in the United States. That's where the commercial aircraft industry is going.

However, Western manufacturers of commercial aircraft, Boeing, Airbus and Bombardier, will now likely embrace a system integration mode of development production. Under this system, key components and sub-assemblies will be designed and manufactured by external suppliers here in the United States and all around the world in the global network.

While this represents a sensible strategy from a financial perspective, there is a potential downside that foreign risk-sharing partners must receive infusions of tacit scientific and technological knowledge from the Western manufacturers.

Without these transfers, the system integration strategy would not effectively work because the risk-sharing agreements require much more than just build-to-print.

In the past, China would just build a flap for the 747. Today, they're working with Airbus, Bombardier, and Embraer. They design the part and they build the part. They've evolved. They've gone up the value chain.

This raises important questions that ought to be of interest to this Commission hearing. Specifically, how can technology transfer to the Chinese from all Western aircraft manufacturers have a positive long-term impact on the United States' commercial aircraft industry?

When shifting supply base for the airframers, we describe the system integration business model that everybody is evolving to. As an example, the 787, the new composite airplane that Boeing is working on, is 90 percent outsourced. If you go back to the 1960s when they did the 727 back up in Renton, about five percent was outsourced outside of engine production. You're taking the risk away is what you're doing.

They don't have to invest $10 billion to $15 billion. They have the risk-sharing partners to absorb that. The high technology commercial aircraft industry is an example of trading away intellectual property to risk-sharing partners. This is the same intellectual property that took decades to mature with internal corporate investment and public support from government-funded research laboratories such as NASA.

Private equity markets have never been willing to finance the development of large civil aircraft. Primarily, the aircraft manufacturers had to bet their company when they launched an airplane. This pushed most aircraft manufacturers toward global outsourcing under this risk-sharing partnership that has more complex subsidy configurations involving both domestic and foreign public agencies. The Western aircraft supplier is a niche group of companies that vie for long-term fixed contracts that participate in risk-sharing programs.

As an example, if you're going to contract on a new Boeing 787 program as a risk-sharing partner or a long-term partner, your contract is going to be in fixed U.S. dollars for a span of 10 to 15 years. Boeing or Airbus has their costs locked in. Who's going to take the currency fluctuation and all the issues of cost overruns? It’s the supplier. However, those suppliers are getting subsidies from their government so they're willing to take the low-cost bid package for the technology transfer for the long-term.

Today demands and the technical and financial resources of these suppliers are being strained to the point where many of these companies will not be able to meet production requirements or have the necessary cash flow. It takes a long time to recover your cash when you're a risk-sharing partner. Maybe you won't see any money for six or seven years. You're investing in technology design with no inflow of cash coming in until you deliver the first ship set that's going out to the customer.

The new government supported risk-sharing partners in the East, especially in China or Japan, will require Western suppliers to participate in various means of host-country production through outsourcing or offshoring. This will entail in-country design offices to service first-tier risk-sharing partners. Now that's when the tribal knowledge and technology leakage will occur.

What do I mean by tribal knowledge? You can look at a blueprint, but it doesn't necessarily tell you how to build the part. All that has to come from somewhere, the airframe manufacturer most likely. You have to be taught how to read the blueprint, and these partners will provide just that kind of information.

How can traders from the Western suppliers compete with foreign government-financed aerospace industries unless they make outsourcing an integral part of their production strategies? If you're a second or third-tier supplier and you want to get into a program and say, for example, where your 787 wing is being produced for the first time over in Japan, you're going to have to have a presence in Japan.

The same thing applies when China launches their airplanes, be it the ARJ-21 or their new large aircraft. If you're going to be part of the gang, you're going to have to have some type of participation in that country and you're inevitably going to leak technology doing that.

China has the golden keys of technology. China's efforts to develop a world-class design and manufacturing industry need to be taken seriously by the West. Boeing's 20-year market forecast for China projected a need of 2,880 aircraft valued at over $280 billion. That projection was made in 2006.

If you flash back to 1999, the Boeing market forecast at the time said $144 billion. This begs the question of how big is this market? If Boeing's contemporary market forecast was off by 100 percent, what is the real number? It's a huge potential.

In the past, Western aircraft industry analysts predicted that the market could be split 50/50 between Boeing and Airbus. That's still true today. When the Chinese launch, one year is a Boeing year for aircraft; the next year is Airbus. They're playing each other off.

However, no real consideration was ever given to the Chinese for developing their own commercial aircraft industry that would avoid outwardly investing in Western aircraft. For $288 billion or $280 billion, why would you think that the Chinese are going to invest in their own industry to develop their own technology and not outwardly invest in aircraft? A lot of ceremonies are made when China makes an Airbus or Boeing purchase. They may use it as a ceremony but the bottom line is that part of the purchase is a part of their offset program to gain more technology inside the country.

The Chinese have experienced a 20-year technology transfer program and have gained technical and tribal aircraft knowledge from all Western aircraft manufacturers. This includes Airbus, Boeing, and Embraer. Everybody is donating because they all want market access. They don't want to be locked out.

Today, the Chinese are currently in the final assembly stage of their ARJ-21 regional jet that features U.S. engines and avionics, GE engines, and Rockwell Collins avionics. Surprisingly, the FAA just opened a new office in China to support that FAA certification of the ARJ-21 even though no U.S. airline has purchased the aircraft.

In the past, the FAA never really got involved with foreign aircraft unless the U.S. airlines were going to buy it. I had discussions with them about three or four years ago when I was doing a research paper. They said we're not going to venture there. Obviously, it's changed.

It's not only the commercial aircraft manufacturers diffusing knowledge to the Chinese but government agencies like the FAA of the U.S. and the JAA of Europe. JAA is going to be involved with the new Airbus final assembly plant over in Europe.

Chinese state-owned enterprises have the financing to succeed. The long-term strategy for Airbus and Boeing could be to cede the China single-aisle aircraft market to the Chinese-owned enterprise industry. I'm referring to planes with just a single aisle with a capacity for 150 people or less.

The real money, the real margin, is in the large wide body aircraft. China's aviation ambitions require huge sums of capital invested in the Chinese SOEs. Recent estimates have the launch of this new airplane pegged to between $6 billion to $7 billion, which could have the prototype built by 2010. The Chinese government will be subsidizing billions of dollars to their air industry. The question that needs to be raised is: is this a violation of the WTO agreement?

Will the U.S. file a WTO case against China as they're launching this new large aircraft with over 150 seats? It will infringe on the Boeing market. Or will everybody go silent?

To conclude, my point is that major aircraft airframers have adopted a short-term global sourcing tactic that maximizes shareholder value at the expense of long-term strategic interests.

Today, it's a duopoly. Tomorrow it will be a triopoly with the Chinese presence. This has given the Chinese a broad array of technical and production expert competencies in the commercial aircraft sector.

[The statement follows:]

Prepared Statement of Dr. David Pritchard, Research Associate, State University of New York, Canada-U.S. Trade Center, Buffalo, New York

Commissioners, my name is Dr. David Pritchard; I am a Research Associate at the University at Buffalo-State University of New York-Canada United States Trade Center. I have conducted research for over 15 years specializing in the area of "Globalization of Commercial Aircraft Manufacturing". My aerospace industry experience spans over two decades that include six aircraft launches, which has allowed me the opportunity to visit many major aircraft manufacturing plants around the world. I am a graduate of the University at Buffalo-State University of New York with my Ph.D. dissertation titled "Global Decentralization of Commercial Aircraft Production: Implications to the U.S. Based Manufacturing Activity". I very much appreciate the opportunity to present my views this morning on the Chinese Commercial Aircraft Industry and its implications for the Western commercial aircraft industrial base.

The commercial aircraft industry has long been a powerful symbol of Western technological leadership in product-markets requiring high levels of design and engineering innovation. This industry has been an important North American and European export sector for more than 50 years, and many of the advanced manufacturing techniques developed by this sector have been successfully transferred to other industries (e.g. auto-production, machinery, metal fabricating). From now on, however, Western manufacturers of commercial aircraft (e.g. Boeing, Airbus, and Bombardier) will likely embrace a systems integration mode of development and production. Under this system, key components and sub-assemblies will be designed and manufactured by external suppliers. While this represents a sensible strategy from a financial perspective, a potential downside is that foreign risk-sharing partners must receive infusions of tacit scientific and technical knowledge from Western manufacturers. Without these transfers, the systems integration strategy would not be effective because risk-sharing agreements usually entail much more than build-to-print relationships. This raises an important question that ought to be of interest to Western trade policy analysts. Specifically, how can technology transfer to the Chinese have a positive long-term business impact on the Western commercial aircraft industry?

The system integration business model delivers short-term financial benefits at the cost of losing the knowledge-based value of the company over the long-term. The high-technology commercial aircraft industry is an example of trading away intellectual property to risk-sharing partners – intellectual property that took decades to mature with internal corporate investment and public support from government-funded research laboratories. Private capital markets have never been willing to finance the development of large civil aircraft, pushing most aircraft manufacturers toward global sourcing under risk-sharing partnerships and/or complex subsidy configurations involving both domestic and foreign public agencies. By transforming themselves from manufacturers to systems integrators, will Boeing, Airbus, and Bombardier be promoting innovation by transferring key technologies and core competencies to first-tier risk-sharing partners? Or, will it mean an end as we know them as "commercial aircraft manufacturers" as they transition toward institutions that market and sell aircraft?

Boeing has already opted for a systems integration mode of production for its new 787 model, whereby manufacturing and design processes are distributed across an international network of risk-sharing partners. Airbus and Bombardier plan to use this business model for launching their latest aircraft programs (A350XWB and C-Series), if only because this approach has clear financial advantages for the systems integrator. This approach allows aircraft companies to invest less capital into new launch programs, as compared to the self-funded launch initiatives that have traditionally characterized this industry. Today's commercial aircraft industry is far different from the early days of jet production, when each aircraft company invented on its own. In the future, system integrators will lose ownership of intellectual property to an industry that is moving toward open architecture. Specifically, the knowledge from research will be made "public" by the first and second-tier suppliers. Since the risk-sharing partners will not be allowed to pass along their non-recurring development costs, they will recoup their investment by amortizing the cost of product development across several manufacturers' aircraft programs.

The reluctance of companies to invest in their own aircraft programs is symptomatic of this sector's growing reliance on risk-sharing contracts with external suppliers. The widespread acceptance of the system integrator approach, which relies heavily on outsourcing design and sub-assembly production, seems to be taking hold with all three major commercial aircraft manufacturers. The Western aircraft supplier base is a niche group of companies that vie for long-term fixed- price contracts or participate in risk-sharing programs. Today, demands on the technical and financial resources of these suppliers are being strained to the point where many of these companies will not be able to meet production requirements (cash flow). Some of these companies might actually elect not to bid on programs. The system integrator approach for Airbus and Boeing will have them totally committing their launch process to high levels of design and production outsourcing, seeking long-term contracts in dollars, and sourcing to low-cost regions (e.g. China, Russia, and India). This is all bad news for the traditional North American and European supplier. The new "government supported" risk-sharing partners in the "East" will require Western suppliers to participate by various means in host-country production through outsourcing or offshoring, in-country design offices to service the first-tier risk-sharing partners (tribal knowledge transfer and technology leakage will occur), and possibly the licensing of production. Airbus has informed its first-tier suppliers that outsourcing to Asia is a requirement, and that failure to comply will entail significant penalties. These requirements will no doubt be down-flowed to second and third-suppliers, which will enable the first-tier group to meet its requirements. How can the traditional North American and European suppliers compete with foreign government financed aerospace industries in the "East" unless they make outsourcing an integral part of their production strategies?

China is committed to developing a family of aircraft that meet Western certification standards to support its domestic airlines. Decades of industrial cooperation with the main global airframers has helped China acquire basic production competence in several key areas (see Table 1). Currently, China is working with Boeing on 737 and 787 programs that have an estimated contract value of $600 million. Airbus has a Memorandum of Understanding signed with China for a 5% risk-sharing partnership on the newly launched A350XWB. The Chinese government has a policy not to have competing production lines for the same single-aisle "Western technology" aircraft. For example, China has the Embraer ERJ 145 co-production for the 45-55 seat aircraft, its own ARJ-21 for the 60-105 seat range, and has recently broke ground on a new final assembly line for the Airbus A320 with 130-160 seats that will be identical to the Airbus plant in Hamburg, Germany. The expected technology transfer from the Airbus joint-venture will assist China in its plans to develop its own commercial aircraft with at least 150 seats, which is part of China's 11th Five Year Plan (2006-10). Preliminary discussions are underway between China and Russia to produce a wide-body aircraft that would compete with Boeing's 787 and Airbus's A350XWB.

The Western aircraft suppliers will have to foster a strategy to have close proximity to the Airbus factory in Tianjin (China), and take advantage of investment incentives ranging from tax holidays to capital grants that will significantly lower the cost of their new manufacturing facility. Transferring low-end engineering work packages will lower development costs and avoid the 23% import duty on their products to support the Airbus joint-venture. There is no doubt that suppliers are expected to transfer technology to their Chinese outsourcing partners or offshore facilities that will be utilized for China's mission to develop its own large commercial aircraft.

It is often argued in the business press that China is decades away from developing large commercial aircraft, and that China lacks the technological capability to enter this market in the near future. I opt to challenge this perspective in light of the sheer volume of investment capital that the Chinese government can throw at its infant aircraft industry. At present, for example, China's official reserves stand at over $900 billion, and China has a recent GDP growth rate of close to 10% per annum. China is already producing advanced fighter aircraft under license agreements with Russia, and Chinese design bureaus are equipped with Western Catia V engineering software platforms that are needed to design commercial aircraft. More important, perhaps, is the fact that China has openly declared its intention to develop an indigenous commercial aircraft sector as part of a strategic economic plan to curb imports. This intention should be treated seriously by trade policy analysts, if only because the Chinese have already entered markets that were once viewed as exclusively Western (e.g. automobiles) or exclusively 'superpower' (e.g. space vehicles). In short, it would be unwise to dismiss China as a potential player in the Large Commercial Aircraft (over 100 seats) or Regional Jet markets simply because it took other players a long time to establish a credible foothold in this industry.

China's efforts to develop a world-class aircraft design and manufacturing industry needs be taken seriously by the West. The Boeing 20-year market forecast for China has projected a need for 2,880 aircraft valued at over $280 billion. In the past, Western aircraft industry analysts predicted that the market would be split 50/50 between Boeing and Airbus. No real consideration was ever given to the Chinese for developing their own commercial aircraft industry that would avoid outwardly investing in Western aircraft. The Chinese have experienced a 20-year technology transfer program, and have gained technical and tribal aircraft knowledge from all western aircraft manufacturers. Today, the Chinese are currently in the final assembly stage for their new ARJ 21 regional jet that features US engines and avionics. Surprisingly, the FAA has just opened a new office in China to support the FAA certification of the ARJ 21 even though no US airline has purchased the aircraft. Only a few years ago the FAA stated they did not have the resources or desire to assist the Chinese in the FAA aircraft certification process. So it's not only the commercial aircraft manufacturers diffusing knowledge to the Chinese but government agencies like the FAA of the US and JAA of Europe.

If anyone had any doubts about the Chinese being a player in the commercial aircraft industry, the agreement between the Tianjin Zhongtian Aviation Industry Investment Company and Airbus to open a joint venture A320 final assembly facility in Tianjin should put to rest any dissension on this matter. This joint venture will have a facility identical to Airbus's Hamburg plant and will give the Chinese aircraft industry the "golden keys" to complete their quest to be a global player in the building commercial aircraft to Western standards. Recently, Boeing Chairman and Chief Executive said "There is not doubt that (China) will be someday in the commercial airline business".

The long term strategy for Airbus and Boeing could be to cede the China single-aisle aircraft market to Chinese State-Owned Enterprise (SOE) aircraft, and then battle for market share on the wide-body aircraft requirements. In doing so, past industrial cooperation, current ventures and future risk sharing partners will give the Chinese SOE aircraft enterprises the knowledge and capability to design and build Western standard commercial aircraft. China's aviation ambitions will require huge sums of capital investment into the Chinese SOE's. Recent estimates have this launch investment pegged between $6.5 to $7.7 billion for the new China large aircraft program which could have the prototype built by 2010. The Chinese government will be subsidizing billions of dollars to their SOE aircraft industry so the question needs to be raised why is this not in violation of the WTO agreements? Will the USA file a WTO case against China as the new large aircraft program will infringe on Boeing's market?

My point, quite simply, is that the major Western airframers have opted for a short-term global sourcing tactic that maximizes shareholder value at the expense of longer-term strategic interests. Today's market for large passenger jets is a duopoly. Within 10 years, the market may start to look like a triopoly with a strong Chinese presence. This presence has been fostered by decades of technology transfer from Western manufacturers, which has given China a broad array of technical and production competencies in the commercial aircraft sector.

Table 1

China Aircraft Offset Programs

Assembly/Part	Program	Source/Offset
Vertical Fin & Tail	Boeing 737	Boeing USA
Empennage	Boeing 757	Vought USA
Final Assembly	MD-82	McDonnell USA
Nose & Wing	A320	Airbus Europe
Final Assembly	A320	Airbus Europe

Other sources of information:

Boeing in China: http://www.boeing.com/companyoffices/aboutus/boechina.html

Airbus in China: http://www.airbus.com/en/worldwide/airbus_in_china.html

AVIC1 Commercial Aircraft Co. Ltd- ARJ 21 Regional Jet Program: http://www.acac.com.cn/site_en/about.asp

Panel VI: Discussion, Questions and Answers

HEARING CO-CHAIR FIEDLER: Thank you very much, gentlemen. The first question will come from Commissioner Wessel.

HEARING CO-CHAIR WESSEL: Thank you gentlemen. I come away quite frightened and concerned by your presentations today because they raise two serious issues about the relationship, though there are probably many more.

First, when China was granted PNTR, many of the proponents argued that this would accelerate their move to a market economy. Mr. Solarz, I'd be interested in any thoughts you have about the evidence that we have moved to a market economy or that China has moved to a market economy. In the discussions during the bilateral Steel Dialogue, many of the U.S. negotiators say that China has no intent at the sub-federal level to deal with excess capacity because it would hurt employment. There's not a lot of evidence that China is changing its ways. In fact, the SASAC's activities last fall seemed to be going in the exact opposite direction?

Dr. Pritchard, my perception is that Boeing and others were talking about more than 2,000 aircraft that we're going to be supplying. It's sort of China is the crown jewel on their balance sheet. Your comments seem to indicate that that's probably not going to bear fruit long-term; that we've created possibly our own worst competitor.

MR. SOLARZ: There are various ways of answering your question. An excellent starting point is the close examination of the National Steel Policy for China written in July 2005.

This is a policy that was announced after China's entry into the WTO. As I indicated, it seeks to micromanage virtually every aspect of future Chinese steel industry development. We also believe that this policy affects the entire Chinese steel sector as well as some related sectors of the economy. Therefore, I was noting with interest an announcement of a request for public comment the other day on whether or not Commerce should be able to find on a company-specific basis whether or not Chinese steel companies may be "market oriented?"

My personal opinion is that the National Steel Policy and government control is so pervasive in China and especially in the steel sector. It is not possible to find such companies to try to parse out what's market and what's non-market oriented.

In addition, one can point to some very interesting specific examples of why we believe China is not operating as a market economy in the case of steel. First and foremost, tens of millions of tons of obsolete steel capacity in China are continuing to operate despite government pronouncements to the contrary.

Now, they may close down over the next several years or they may not. There have been pronouncements in the past yet it has somehow not occurred. We all know about the concerns regarding social stability. Those undoubtedly come into play. Concerns about employment and not wanting to see anything even approaching the type of rioting that we saw in Western Europe when steel mills were shut down in earlier decades. In China it would be much worse.

Second, steel capacity and production in China are continuing to expand geometrically in the face of oversupply conditions. If market signals were at work, given the tremendous price differential that now exists between steel prices in China and the rest of the world, we would be seeing less investment flowing into the Chinese steel companies, not more.

Finally, the consolidation trend that is so apparent here and in North America, in Europe, South America and elsewhere. Things are going in the opposite direction in China, notwithstanding government announcements of their intention to promote major firms of more than

10 million tons each, accounting for "x" percent of total steel production by year "y."

In our view, such a consolidation would be a natural outcome of market forces. However, it is not occurring in China for a variety of reasons. In fact, almost the opposite is occurring. There, the industry is increasingly fragmented and there is actually more investment flowing into smaller firms than larger firms.

HEARING CO-CHAIR WESSEL: Dr. Pritchard.

DR. PRITCHARD: I'd like to pose a question: why wouldn't China build its own commercial aircraft industry? Why should they outwardly invest $280 billion worth of their money to Airbus and Boeing? If you go back to the 1970s, the United States controlled 90 percent of the commercial aircraft market between Douglas, Lockheed, and Boeing.

In the early 1990s, the market was 65 percent Boeing and around 15 percent Douglas and 20 percent Airbus. What was interesting is when you look at the 1992 aircraft agreement United States took a laid back approach. Well, was the strategy at that time to play Airbus against Douglas and weaken Douglas so Boeing could dominate? One could speculate.

Is involvement in Airbus and Boeing who are trying to develop the regional jet market of China today equated with co-ventures to help try to defeat Bombardier and Embraer? Are the big airframers using China to weaken their competitors? Bombardier out of Montreal has fallen in position. They're in discussions of having their next C series airplane which is a competitor to Airbus and Boeing. The fuselage will be built in China.

We don't know if the fuselage is metal or composite yet, but it does not affect the weakened position of foreign companies. They've lost a lot of financial strength. The Chinese are going to play on this to bring more technology for their airplane.

Yes, China is a competitor. Today, they're going to have their own domestic needs. About three years ago, I spent a month in China visiting all the aircraft plants. I was talking to a GE consultant and I asked, “Why are you even bothering with 24 ship sets of small engines in China; it's not even worth your aggravation?” He said, “Pritchard, you're missing the point. The point is we don't care about the 24 engines. We want to outsource $6 billion worth of goods out of China plus we want access to the medical market in China.”

They're trading off commodities and goods in one sector to get access to another. Obviously GE is pretty big and if you're going to play the game, you're going to have to be involved. If you're a U.S. or a European supplier, you need to expect that the technology that you're going to be offering, be it your latest or oldest, is going to be taken and duplicated.

If you know that and you're going in and you're willing to do that, that's one thing. If you expect the Chinese to play by fair rules of not copying, you're leaving your own self at risk. To answer your question, yes; you've created a competitor.

HEARING CO-CHAIR FIEDLER: Commissioner D'Amato.

COMMISSIONER D'AMATO: I don't know whether I want to ask any more questions. This is not a very good story but I want to clarify a couple of points on the steel sector, Mr. Solarz.

First of all, maybe I missed it but I haven’t heard a coherent reason why the Chinese government is doing this? What is the purpose of expanding the steel capacity to the extent that it's overwhelming the international market including keeping all these obsolete plants?

Maybe there is not a coherent reason? Is it basically greed on the part of a number of managers? They want to make a huge profit and dominate the market or is there a national strategy that is coherent here?

Then I have two particular questions. What percentage of the product that's manufactured in China is being exported and how is that increasing? What percentage of their output is being exported? Obviously, they are producing more than they can use domestically, as I understand it. Also, is there anything in terms of what percentage of the steel market in China is foreign invested?

MR. SOLARZ: Your first question has to be put into the context of timing. One should consider the very rapid industrialization of China, this industrial revolution that has taken place there, the establishment of China as the world's manufacturing factory, the burgeoning development of manufacturing industries that use steel, automotive, appliance, et cetera.

Steel was viewed from the very beginning by the central government once alleged reforms began to take hold, as a key building block of the Chinese manufacturing powerhouse.

In recent years, particularly since 2000, things basically got out of control. The central government itself admitted that there had been overinvestment in the steel sector. There had been overheating of the Chinese steel sector to the point where the lines began to diverge between the domestic production growth rate in China and the domestic consumption growth rate in China.

The end result being, as I mentioned before, a massive domestic oversupply condition, a huge price differential now between China and the rest of the world, and as a result in a three-year period of time, a 70 million ton shift in the net steel trading position of China. It went from one of the biggest net importing countries in the world to being the largest steel exporting country in the world.

As a percent of China's total steel production, the roughly 55 million tons of steel exports when compared to their production of roughly 450 million tons looks like it's not that much. However, you put that much steel into play on the oceans of the world and it’s a problem. This is especially true given the fact that there had been traditional steel-exporting nations in Asia, such as Japan and Korea, and nations in South America such as Brazil, that are being squeezed out of export markets by low price China steel.

Countries like the United States, which remain large net steel importers, are really being impacted in two ways. This is both directly by a surge of imports of steel from China and indirectly because there's a whole lot of steel now in other countries that used to send steel to the United States. These countries are having to compete in the U.S. steel market and therefore must lower their price to compete against Chinese steel.

The Chinese government claims that it is aware of all these problems. They're aware of the problem of pollution associated with steel in China. This includes from the estimated 70-100 million tons, of obsolete and very heavily polluting steel capacity.

They're aware of the problems in terms of energy intensity, market overheating, and overinvestment. They've taken a variety of steps to try to clamp down on it but to some extent, they've lost control of the situation and the centers of power have moved to the provinces. That's why recently there was a reported agreement between the central government, ten provinces, and as many as 350 steel facilities to try to finally get a handle on the closure of obsolete steel capacity in China.

Will it work? Who knows? All we know is that, to date, this steel capacity continues to operate at the same level. It continues to depress steel conditions in China and really around the world. Meanwhile, new steel capacity continues to be added there despite these conditions.

Finally, the Chinese government is well aware, as are Chinese steel producers, of the ongoing threat of antidumping actions and now anti-subsidy or countervailing duty actions against steel exports from China now that it has become a major net steel exporting nation.

The Chinese government party line and the industry party line is that they're just meeting increased demand worldwide. However, they're very concerned about this. To give you one more example of why it's not in our view a market economy, the Chinese government uses economic measures and they use legal measures and they use administrative measures to try to control developments, certainly in steel.

One of the measures that they're currently using in the trade area is tax policy. They are manipulating or changing tax rates almost monthly now. They decreased or eliminated rebates of border taxes on certain steel products but not on others. Then they began applying licenses and taxes on certain steel products but not on others. Meanwhile, they have increased taxes on exports of raw materials; coke for example, a major steelmaking ingredient, and a variety of ferro alloys.

Again, this is another element of their policy, in our view, to try to target exports.

COMMISSIONER D'AMATO: Then the last question I had was do you have any sense of what percentage of this is foreign invested, if at all?

MR. SOLARZ: I don't know specifically. There has been some direct foreign investment in the Chinese steel sector but, as mentioned, due to the July 2005 National Steel Policy, foreign investors are not allowed to have more than 49 percent direct foreign ownership of steel enterprises in China.

My own personal view is that the central government for the foreseeable future is going to want to control the development of the Chinese steel industry virtually in all aspects. This will include the extent to which foreign firms invest in Chinese steel companies.

My personal view is that, with or without a specific written limitation on direct foreign investment in Chinese steel enterprises, you would still have a tremendous amount of government influence, both at the provincial and central government level, on who gets to invest and under what terms.

COMMISSIONER D'AMATO: Thank you.

HEARING CO-CHAIR FIEDLER: Commissioner Houston.

HEARING CO-CHAIR HOUSTON: Thank you. I have a question for you, Mr. Solarz, on the end use of the steel. It's a three part question. Number one, how does their steel differ from ours, as far as composition or end use goes? Also, what percent do we manufacture here in the U.S. and use here in the U.S. versus what we import from China and is the nature of the steel an issue there?

Then the third part of the question is if you're a manufacturer that's creating some kind of a widget using steel, you can either import the steel to make it here or you can go to where the steel is. I wonder if you have seen any kind of a movement of manufacturing to go to China to be closer to their domestic steel production. I assume that would be just a financial decision made by an American manufacturing company?

MR. SOLARZ: Okay. First, on your question on what are the differences between Chinese steel and steel made elsewhere, Dr. Pritchard and I were discussing previously the fact that technology does not know any borders. There is merchant quality or commodity grade steel where it's virtually indistinguishable from one another used to make lower-value steel products. There are also very advanced types of steels that we and other countries including China are making.

It is not accurate to say that the United States makes more advanced steel and China makes less-advanced steel. That's not a correct way of looking at this. Both the United States and China as well as other major steel-producing countries and regions in the world make both types of steel.

Obviously, there are different percentages in terms of long products versus flat products and advanced steels versus merchant quality steels in various countries. However, you cannot say that, "U.S. steel or domestically produced steel is of a higher quality than imported." It's also not correct, as some of our trading competitors have tried to argue, that they produce these very unique niche quality steels and only they can produce them and that we can't.

You know you're dealing with products that are often made to customer specifications but in general, you're talking about products where the metallurgies are pretty well known worldwide. You have similar types of steels that are being produced in various countries.

The issue for us is whether we're competing on a market basis with market-based foreign competitors or whether we have to compete against subsidized foreign competitors. Unfortunately in this case we have to do the latter.

On your second question, I'm not sure I fully understood it. You want to know what percentage of--

HEARING CO-CHAIR HOUSTON: Yes. What percentage we still manufacture steel here in the U.S. for domestic consumption.

MR. SOLARZ: Yes, we still have a steel industry in the United States.

HEARING CO-CHAIR HOUSTON: How much do we produce domestically that we use domestically versus how much we import?

MR. SOLARZ: Well, we had an all-time record year for imports in 2006. We had over 40 million net tons of imports. We also had about 10 percent of our steel production going to exports but about 80 percent of those exports go to NAFTA partners in Canada and Mexico. It's not steel that crosses the ocean.

We produced over 100 million tons of steel last year in the United States. Now that pales in significance to the more than 400 million tons in China but we are still a major steel-producing country. We have in recent years as an industry dramatically enhanced our global competitiveness by virtually every account including labor productivity, energy intensity, et cetera.

At the same time, there's been a fair amount of market-driven consolidation in this industry. My message on that is we cannot count on market-driven factors including consolidation to save us from non-market behavior. That's what we would like the Commission to be aware of. Non-market behavior, trade and market-distorting practices have to be countered because, if they're not, they'll destroy even the most competitive U.S. industry.

HEARING CO-CHAIR HOUSTON: Then lastly, do you see or have you seen manufacturing move to the steel?

MR. SOLARZ: We do, Commissioner. I'm not sure I would fully agree with exactly the way you characterized it as, "to be near the steel."

Let's take automotive as one example. Obviously, automotive and motor vehicle manufacturers are moving to China, not just U.S. companies. European, Japanese, et cetera; they're all moving to China. Are they moving to China because there is currently in China a large price differential in steel the price of steel in China and the price of steel in Europe or between the price of steel in China and the price of steel here? Also, one does not know how long these conditions will last.

Among other reasons, they're moving to China because of the growing Chinese appetite for motor vehicles with consumers having more and more disposable income in China. It's the world's fastest growing automotive market and they want to be close to that market. We understand that. However, I'm not sure I would agree that the reason that they're doing it is to, "be close to Chinese steel because of the current price differential of steel.”

I think in general manufacturers like to be close to local inputs and local markets. It just makes sense from an economic standpoint. Our concern, in terms of domestic manufacturing flight is that we don't want subsidies. We don't want to see subsidies be one of the reasons why we're losing domestic customers. In other words, foreign governments’ granting of subsidies. We think that some of that has been going on in China and that's a reason why the U.S. government has filed this WTO action against China's prohibited subsidies which have been going to foreign-invested enterprises.

HEARING CO-CHAIR FIEDLER: Commissioner Reinsch.

COMMISSIONER REINSCH: Thank you. Let me start with Dr. Pritchard and then I’ll come back to Barry later. I take your point about the business model we're in, with short-term gain and long-term loss for lack of a better term.

I started giving that speech 20 years ago. I think the difference between us is I've ascribed more of the blame, if that's the right word, to the Japanese first and then the Chinese rather than the producers. However, that doesn't matter for purposes of the question. Here we are now with all these years of the development of the model. At this point given the global supply chain that we've got, is there any other model that's viable?

DR. PRITCHARD: For commercial aircraft industry?

COMMISSIONER REINSCH: Yes, I understand the difficulties we face in terms of long-term. I agree with you completely. I'm not sure that there's anything that can be done about it at this point.

DR. PRITCHARD: I think that what you're talking about is a corporate policy from Boeing, Bombardier and to some extent Airbus in regards to a national policy of China and Japan who want to develop their own aircraft industry. Where do they cross? Who's going to tell Boeing they can't outsource 90 percent of their 787? No one. From their viewpoint a launch of a commercial airplane is $15 billion. If they can launch it with only $5 billion of their own money and have Washington State give them $3 billion of it, it's pretty much a free launch.

From a financial risk point, it's a winner. They've had very successful launch with the 787, over 500 airplanes, which is the fastest in history. However, you know you're gaining in the short term, we'll say five years, but now the Japanese have learned how to build a wing.

COMMISSIONER REINSCH: I understand that, but I'm trying to figure out that if you want them to make a different set of decisions, what is going to have to change in the external environment to permit them to do that?

DR. PRITCHARD: What you're going to have to have with the Chinese and the Japanese a WTO comprehensive agreement. If you're going to allow subsidies to the Chinese and the Japanese for their aircraft industry, then allow it for the United States, and allow it for Europe. You can't have one set of rules for Europe and the United States and then another set of rules over in China and Japan just because we are afraid to file a case against China and their aircraft industry.

It's a vital industry for the United States so why not fund it? Why not keep the technology here at the United States and have the technology spin offs to benefit other industries? What we're doing is we're setting a double standard. Europe and the U.S. have to live by the WTO. China and Japan, you don't. Where does everybody flee to? They flee to China for cheap capital and cheap labor. The suppliers have to follow because it's a niche group and they're going to have to give up technology to play the game.

Until you have a comprehensive WTO, which I don't see it happening, you'll have this current argument between Airbus and Boeing. They'll come up with some resolution but until you have a comprehensive one that covers all nations, including India, Brazil, et cetera it won’t affect the migration much. Brazil is not violating WTO stipulations right now, but you got to look at India as the next frontier for commercial aircraft manufacturing just based on their demographics.

COMMISSIONER REINSCH: What would happen if Boeing and Airbus got together and collectively decided not to play this game?

DR. PRITCHARD: Not to play the commercial aircraft game?

COMMISSIONER REINSCH: Not to play the game with the Chinese and the Japanese and simply agreed that they would make their investments somewhere else?

DR. PRITCHARD: I would think, assuming that you want the investment here in the United States, we would have--

COMMISSIONER REINSCH: Well, I guess I think a lot of this is driven by competition and--

DR. PRITCHARD: Yes.

COMMISSIONER REINSCH: --countries play one off against the other.

DR. PRITCHARD: If you look at the commercial aircraft industry, when you launch a commercial airplane, that model lasts 25 to 40 years. The 747 and the 737 that’s produced today were launched in 1965. What happens when you launch an airplane? You pretty much lock the technology of the day, the design, and also the manufacturing process. It stays with that program because you have to FAA certify it and you can't really change a lot of manufacturing processes. You can modify them.

When China comes along and launches their new ARJ-21, they're using the latest and greatest engineering software of the West. They're using Western manufacturing technologies. As such, they get a jump on whoever they're competing with. Today they're competing with Bombardier and Embraer. On top of all that, they have government subsidies to help them lower their costs. They want to supply their own domestic market but it's tough to change an aircraft production model after it's launched.

You can send out bits and pieces but at the end of the day, if you're going to launch a 737 in 1965 that's assembled in Renton, Washington, it's going to stay in Renton, Washington. The troubling issue was with the 787, which is the new system integration business model; you know you're lowering your financial risk. The final assembly value of an airplane is between four percent and six percent. That's what Boeing is doing up in Everett.

90 percent of the value of the airplane is dispersed around the world, some of it in the United States. Some of it is with engines here in the United States and also over in the UK, airframe in Italy, and airframe over in Japan. Those things aren't going to change now.

Those are cast in stone. Look at Airbus who has been weakened financially over the last few years on their issues of production. They got the WTO action and they're not going to go after subsidized repayable launch loan. They're forced to go to the system integration business model.

They're going to outsource over 50 percent of their airframe around the world to low-cost regions like China. Bombardier is just as financially weakened. They're resorting to this financial business model of system integration and they're looking to outsource. The wing is going to be their partner in Belfast, their sister company, but the fuselage in China. How is this good for North America or the United States?

The model has been cast. We have no national policy here to help this industry. It's all financially driven for lowering risk and lowering financials. Until that changes, we're just giving technology away.

COMMISSIONER REINSCH: I understand that. I think that was a very comprehensive answer to my first question. I sort of infer from the response the answer is there's not much that can be done--

DR. PRITCHARD: No, there's nothing.

COMMISSIONER REINSCH: --without a wholesale rethink.

DR. PRITCHARD: It's cast in stone.

COMMISSIONER REINSCH: I take that. One more question and I'll defer on Barry till a second round if we have one. You alluded to the Japanese and Chinese and the Japanese learning how to build the wing, for example.

DR. PRITCHARD: Yes.

COMMISSIONER REINSCH: My sense is the Japanese have been trying since the '50s to develop a commercial mainframe aircraft and haven't succeeded in creating a viable competitor. I'm inclined to believe that the Chinese may succeed, but why are they going to succeed when the Japanese haven't?

DR. PRITCHARD: Just look at the number of airplanes being produced for their own domestic market. Japan is pretty well locked into large body aircraft to fly out of the country. China has a large domestic market for internal use of regional jets and 737 size airplanes. You got to go up the chain. China developed and has a national strategy of not having competing product lines.

They have a joint venture with Embraer for airplanes between 50 and 60 seats. They have their own domestic airplane, the ARJ-21, between 60 and 100 seats. They're doing a final assembly line of the parts coming in from Europe for the A-320 airplane which is 100 to 150 seats. Now, they're launching their own airplane over 150 seats.

The Russians are doing the same thing, just in a slower fashion.

They're not going to have competing product lines but they're going to service their own domestic market. Japan doesn't have that luxury. That used to be a build-to-print supplier to Boeing. Now they're designing and building fuselages and wings. The wing is the core technology of an airplane. It's not only a metal airplane, they're the ones doing the first composite airplane.

COMMISSIONER REINSCH: Yes, but they developed a world-class auto industry,--

DR. PRITCHARD: Yes.

COMMISSIONER REINSCH: --a world-class steel industry, and a number of other industries too. You're saying they were able to do that on the basis of their domestic market? Why is aircraft different from them?

DR. PRITCHARD: Boeing, if you look at where they have gained all of their technology in the last 20-30 years, the 767 fuselage in the 1970s, the 777 fuselage, they've gone from a part of the fuselage to the full fuselage. Now they've gone to composite technology. What's interesting about that composite technology is that they're going to be the holders of the tribal knowledge. When the next generation 737 comes around, they're going to have a weaker base.

You got to understand the backdrop of what's happening here in the United States. The average age of the aerospace engineer and worker on the floor is 52 years old. They're retiring out 30 percent of them in the next 5 years. Our tribal knowledge for metal airplanes is going away. Japan is developing the tribal knowledge today on composite airplanes. We're not going to be in a position to build our own composite airplane. Thus, questions arise such as why hire people? Why be an employment agency here in the United States? You might as well just outsource it and control the overall design and system integration of it.

COMMISSIONER REINSCH: I should stop. Thank you. I hope we'll have a second round.

HEARING CO-CHAIR FIEDLER: I hope so, too. Mark.

COMMISSIONER ESPER: I've got a series of questions as well. I know my colleagues are waiting so if you can be brief. The first question I had was to ask in both cases, have there been WTO violations? Mr. Solarz, you answered you in your previous testimony that there are indeed.

Dr. Pritchard, how about from your perspective with regard to the commercial aircraft industry?

DR. PRITCHARD: It just so happens in 2003, I published a research paper out of the University of Buffalo on the current aircraft dispute before it was actually an aircraft dispute. This research paper is the baseline. You see a lot of figures in the media off this aircraft dispute. I've been following it for four years. Everyday of my life I get e-mails and phone calls on the subject. The bottom line really comes down to be the current dispute. Are we focusing on Airbus and Boeing? Is that what you were looking for?

COMMISSIONER ESPER: I'm aware of that dispute. I'm talking about the issue that you brought up with regard to Western aircraft manufacturers and China. Are there WTO violations by China occurring?

DR. PRITCHARD: The issue is will Europe and the United States file a WTO case against China for their $5 billion worth of subsidies, assistance, et cetera against the backdrop of other industries?

Alternatively, does Airbus and Boeing want the USTR or the European Commission to file on their behalf? I —think they're going to be silent on this. They want the market (a) to sell their airplanes and (b) to get low-cost production. There will not be a filing. How can you have a level playing field around the world if you exclude two government national policy-directed industries against the West?

COMMISSIONER ESPER: Let me ask a question for both of you. Obviously, you're portraying problems in each industry. Do you feel that in each case, the commercial aircraft industry and the steel industry are strategic industries that demand or deserve some type of government protection or intervention?

MR. SOLARZ: I'll take that first. I'm assuming that you're asking whether we believe that the U.S. steel industry is some kind of a strategic industry that deserves some kind of protection. Is that what you're asking?

COMMISSIONER ESPER: That's exactly what I asked.

MR. SOLARZ: We believe, and the Specialty Steel Industry of North America as well as others issued reports on this as well, that steel is an industry that remains important to the national security of the United States.

We object strongly to the notion that we deserve some kind of special protection. We would like the Commission, Congress, and the administration to be focused on what we consider to be the real protectionists and the real subsidizers, which are in China and other parts of the world. Particularly in Asia, where there's been an economic model in place, as Bill Reinsch is well aware, literally for decades.

The Chinese model is a bit different from the Japanese model, but you're basically still talking about a whole lot of government direction. The Chinese industrial policy is attempting to pick the winners and losers. They are targeting specific industries to champion and then channeling of a whole lot of government money and influence along with a lot of corruption.

Basically, we have to compete against some governments and the Chinese government is, among all the governments that we have to compete against, probably the toughest.

COMMISSIONER ESPER: Okay. Dr. Pritchard?

DR. PRITCHARD: I guess the question you have to ask yourself is 20 years from now do we want an aircraft industry or do we want to be totally dependent on outsourcing sub-assemblies around the world and be a final assembly house?

If you even look at the Joint Strike Fighter, I think over 50 percent of them are produced around the world. Are commercial airlines important as a national security issue or not? That's what needs to be questioned. I mean--

COMMISSIONER ESPER: That's what I'm asking you. What's your view with regard to the commercial aircraft industry?

DR. PRITCHARD: I personally think the industry needs some type of protection. Other countries such as Japan and China have national policies. If we don't, our commercial airline industry is going to be given up and it's going to be left to corporate policies which are going to look at short-term financial gains. It's not in the best interest of the country.

COMMISSIONER ESPER: Dr. Pritchard, in your testimony, you raised that the issue of “corporate policies” a few times. Prior to your testimony, were you able to talk to senior officials at Bombardier, Airbus, or Boeing about their policies or their strategies?

DR. PRITCHARD: I talk and talk when I go to air shows and different occasions like that. They're not really happy with my research all the time, but--

COMMISSIONER ESPER: Your presumption is that they're not looking out for their shareholders, their board, or their industry?

DR. PRITCHARD: They are looking out for the shareholder all right. Their short-term financial gain.

COMMISSIONER ESPER: Isn't that their responsibility to their shareholders? I guess it builds on Commissioner Bill Reinsch's point with regard to what you both are saying. The United States is a country built on capitalism, free markets, and entrepreneurship. Yet we're competing in some ways with mercantilist countries that have a different way of doing things. The question is do we want to adopt their style or do we want to bring them our way?

It gets back to whether you believe in free markets, which I do. If so, do you then allow businesses to compete as they see fit unless, as I asked earlier, there is some type of national security imperative? It sounds to me like both of you want to see more of a national policy by the United States or more direction from the government to U.S.

corporations on these matters?

MR. SOLARZ: If I can elaborate slightly on what our view of what should be done. We do not want to see a comprehensive industrial policy for steel in the United States. We do not want to see the United States adopt the Asian mercantilist model. We do believe that it is absolutely essential that the United States use every available tool as aggressively as possible to counter trade and market distorting practices and non-market behavior that we have to confront in the marketplace as market-based producers.

COMMISSIONER ESPER: I'm sorry to intercede, but in the interest of time, I understand that. I agree with you, Mr. Solarz. There should be a free market where we compete evenly because I happen to believe that U.S. industry, the ones you're both studying, will do extremely well.

DR. PRITCHARD: For the commercial aircraft industry, you're not going to change China or Japan, so how are you going to help the European or the U.S. markets' manufacturers? You're going to have to have some type of industrial policy. Otherwise, ten years from now we're just going to be snapping together airplanes with true value of four percent to six percent? How does that help the industrial base in the United States? It doesn't.

All the second and third and fourth-tier suppliers will be migrating over to Japan or China doing production over there. It's not the airframer itself. Twenty years ago when I used to work with suppliers in Detroit, everybody had Lockheed work, Boeing work, and Douglas work. Today all those suppliers are out of business. It's just not the big guys; it's all the second, third and fourth tier buying the steel to build the fixtures to build the airplane. All of that is overseas now. If you're not interested in the whole industrial base of the United States, then you don't need an industrial policy. It's like digging in a ditch. When are you going to stop?

COMMISSIONER ESPER: The question gets to Commissioner Reinsch's other question. That is, what's the alternative? We live in the 21st century. Globalization is a fact of life. Companies in many industries outsource because they find that it's more economical or they get better product. At end of the day, who benefits but the consumer, arguably? The question gets back to this: what is the alternative in today's global environment? Short of government intervention, which in many cases is anathema to our national values, what options doe we have? I'm asking a question to find out where you think we should take this.

I completely agree with leveling the field. I'm not sure I understand the point regarding corporate decisions, but I'll yield at this point.

HEARING CO-CHAIR FIEDLER: Yes.

MR. SOLARZ: Again, last point on this--

HEARING CO-CHAIR FIEDLER: A short point.

MR. SOLARZ: --to make it clear. There are times when government, and certainly our government, needs to "intervene"--

COMMISSIONER ESPER: Right.

MR. SOLARZ: --in the marketplace to restore market forces. That's the purpose of our trade remedy laws against dumped and subsidized imports. Government intervention to restore market forces is not mercantilism. It's not industrial policy. However, it is essential if we're to have any semblance of rules-based trade and a level playing field that will enable the most efficient companies, and we have some of the most efficient steel producers in the world in this country, to win out in the marketplace.

HEARING CO-CHAIR FIEDLER: Thank you. Chairman Bartholomew.

CHAIRMAN BARTHOLOMEW: Thank you very much. Thank you, gentlemen, for your testimony. Commissioner Esper is relatively new to the Commission, so it's always interesting for us to hear his thoughts on issues pertaining to China. I'm probably going to engage in a discussion with him as much as with you guys.

Mr. Solarz, thank you in particular for providing one of the most coherent sentences about just what are the challenges that our industries face. This concept that our industries are competitive but they can't compete against market-distorting practices and non-market behavior is quite telling. It seems to me that there is quite a large gap between the way the system is supposed to work and the way it's actually working.

One of the questions I have, Dr. Pritchard, is that you mentioned we need some sort of comprehensive WTO. I wondered is it that we really need some sort of comprehensive WTO or do we need to know that when countries accede to the WTO, they intend to comply with the provisions of the WTO. It seems to me that if China did, wouldn’t we be a whole lot better off than we are now? We have to keep struggling every step of the way. Is it that it is not sufficient or is it that we just can't get compliance?

DR. PRITCHARD: Well, if you look at the current trade case between Airbus and Boeing, the U.S. filed a case against Europe. Europe filed a case the next day against the U.S. I guess you have to file a case to start it. If no one files, if other interests are more important than the commercial aircraft industry, and the USTR is not going to file a case against China and the subsidization of the aircraft industry, how are they going to be put in line? There's no magic you're violating and still have to compete.

CHAIRMAN BARTHOLOMEW: Yes. If you're not going to use the mechanism--

DR. PRITCHARD: I don't see the USTR going there. I don't see Europe going there. There are too many other important industries and political factors that are going to override the aerospace decision.

CHAIRMAN BARTHOLOMEW: We're struggling a little bit with defense industrial base and what the role is of industries in our defense industrial base. How much do we need our own ability to manufacture in order to carry forward on our military security? That's going to be an ongoing discussion with us.

To my colleague, Commissioner Esper, I would only plant one of the things that I keep thinking about. Is this in some ways a Chinese government wait-it-out strategy? Everyday that these practices continue, we are losing tool and die manufacturers. The on-the-ground reality is changing as this stuff is going on at this higher level and people are thinking about what is it that they should be doing. Not only are we losing our small and medium manufacturers, but we're losing the people.

You mentioned the 52-year-olds. Whose child is going to go off and become an aircraft engineer or a tool and die manufacturer? We're losing the productive capability.

I only wanted to make one other point. Sorry, I usually ask more of a question. There was just a story in The Wall Street Journal about the Boeing CEO, Jim McNerney, saying Wednesday in an investor conference that he expects a third airplane maker will emerge to challenge Boeing and Airbus. He suggested such a rival could come from China. He goes on to say that China is respected in the aerospace industry because it has the market size capability and experience in the field. What I found is quite ironic is nowhere there does he take any credit for Boeing's technology or expertise transfer that is helping to fuel the emergence of this third aircraft manufacturer.

HEARING CO-CHAIR FIEDLER: Thank you.

COMMISSIONER ESPER: If I could just comment on your one point? That's why I asked the question. In the context of what's being raised by Dr. Pritchard, it's the commercial aircraft industry side. That's why I was trying to make a distinction between commercial and defense with regard to the aircraft issue.

With regard to both industries, national security is the one issue that may justify some type of government policy or government intervention. Otherwise, there are the other tools available through the WTO to make sure we have a level playing field. Beyond that, if you subscribe to free markets and capitalism, you let the market run its course and stay out of it as long as the market is unfettered by subsidies or other distorting activities.

I appreciate what we're saying about the defense industrial base and I'm quite concerned about that as well, but in this context I was referring to the commercial side of the industry.

CHAIRMAN BARTHOLOMEW: I think that the issue that we need to struggle with is that it's not as though there is just one or the other. A lot of these third and fourth tier people and the material producers are people who are producing for both.

COMMISSIONER ESPER: Absolutely.

CHAIRMAN BARTHOLOMEW: We need to think about that.

COMMISSIONER ESPER: Absolutely, but part of that, too, is that one way you sustain a defense industrial base is by having the export markets and the ability to trade and sell and do those things that can sustain a base. I think there are levels beyond what has been discussed here that we really need to get into.

You raised tech transfer a few times. Commissioner Reinsch and I know that issue far too well and arguably there are too many controls on technology for different reasons in different areas. That's a whole other issue in and of itself. There's a lot more to this argument which probably demands more attention. Thank you.

HEARING CO-CHAIR FIEDLER: I am going to defer my own questions to a second round by Mr. Wessel and Mr. Reinsch. If everybody will keep each person's round to five minutes, that would be great. I actually will defer to Dennis who didn't weigh in first.

COMMISSIONER SHEA: Well, I apologize. I wasn't here for most of your testimony. I wasn't here at all for your testimony, Mr. Solarz. However, I heard a little bit of yours, Dr. Pritchard.

I have a rather cosmic question. We hear a lot a lot about how--

HEARING CO-CHAIR FIEDLER: But a brief answer.

[Laughter.]

COMMISSIONER SHEA: We hear a lot about how market reforms will inevitably, lead to political liberalization in China. I was wondering if we could look at it the other way? If China in some date in the future were at least minimally democratic, minimally responsive to its citizens, do you think its its national policies vis-à-vis the two industries you're here talking about, steel and civil aviation, would be different in any way?

I told you it was cosmic. Is this purely an economic nationalism?

MR. SOLARZ: Yes.

DR. PRITCHARD: Yes, no.

MR. SOLARZ: Very briefly. This will not be a cosmic answer.

[Laughter.]

MR. SOLARZ: Steel has been a poster child in our view for a lot of what's wrong in the U.S.-China trading relationship. This includes not just the government subsidies but also a lack of transparency in what is going on and an incomplete transition to the rule of law and a continuation of a whole lot of political influence, practice who you know over actual merit, et cetera.

My personal view is that China, in general, and stepping away from steel a little bit, is in a transition phase and God knows how long it's going to last. Decades, maybe more. It is not yet at the point where it is either within reach of a market economy as we would define it. That would entail where the rule of law is enshrined the way we are used to it.

It's in a transition phase that I think is going to last quite some time and involves this effort by the Communist Party of China to spread the wealth and try to avoid severe instability in the Chinese west. The Chinese north and parts of the country that have not yet experienced the burgeoning growth of the middle class so the party must work harder to hold on to power.

HEARING CO-CHAIR FIEDLER: Thank you.

DR. PRITCHARD: Nothing to add.

HEARING CO-CHAIR FIEDLER: Mr. Wessel, briefly.

HEARING CO-CHAIR WESSEL: Two quick questions and if you want to respond afterwards in writing, that would be fine as well. Dr. Pritchard, you talk in your testimony about the activities of the FAA and how they were not going to assist in the past but now they are. We had testimony last year; I believe it was, about the concern about gray market counterfeit airplane parts and how that could potentially create huge health and safety concerns for us.

Is the FAA participating in that as well? What are their activities? If this isn't a short answer, if you could provide something long term that would be helpful.

Mr. Solarz, the other quick question is the Commission had been on record a couple of years ago about China's limit on exports of coking coal, which is a WTO prohibited action. What's the status of that? Are they now doing exports? Has the U.S. government been able to resolve that? If it's quick, great. If not, could you add it onto the record later, please?

DR. PRITCHARD: For the FAA question, the only thing that I'm aware of is that they're assisting on certification standards of that ARJ-21 over there. So it's--

HEARING CO-CHAIR WESSEL: Are they involved in the certification of parts and do we have knowledge that counterfeit parts are not going into U.S. airframes?

DR. PRITCHARD: I don't have the answer for that.

MR. SOLARZ: China still uses an export license system for coke. As far as I know, neither the U.S. nor the European Union

Commission is currently planning, as they were sometime ago, to raise possible WTO consultations on that issue.

What is of current concern and there's been a persistent rise in the price of coke coming out of China for the last year, is that the Chinese have once again increased the tax, which is WTO legal. However, they've increased the tax on coke exports from 5 percent to 15 percent.

I'd also like to add a point, Commissioner Wessel, that there are people in our industry, particularly a bit downstream, that are also concerned about some safety issues involving steel that may not meet the specifications for the required use. There have been a few examples of that downstream and sometimes people are unsure where to go with their concerns and complaints about the issue.

HEARING CO-CHAIR WESSEL: If you could provide any information on that afterwards, as well of structural steel going into our buildings, bridges, or any product, we'd welcome that. Thank you.

HEARING CO-CHAIR FIEDLER: The final question goes to Commissioner Reinsch.

COMMISSIONER REINSCH: Thank you. I guess I'll limit it to only one, which is sort of a philosophical question for Mr. Solarz. You know I spent 17 years of my life trying to help your industry with some success and some conspicuous failures, we both know.

Then I got a reprieve. I haven't had to do that for awhile. Looking back at the long-term trend line over longer than that, over 40 years, it seems to me the trend has been consistent throughout, despite short-term victories. Also, even despite the business cycle, in what is clearly I think a cyclical industry, the long-term trend is the sand is leaking out of the bag.

If we do everything that you want on the trade front: CVD, dumping, and on the currency; how much difference would it really make? You don’t need to detail your prescriptions as Congress already did that. Is it going to make any real change in the long-term trend? An unfair question, but I'll ask it anyway.

[Laughter.]

MR. SOLARZ: We and other industries that rely on trade remedy law to help level the playing field certainly believe that it will make a difference. We don't know what other alternative we have other than to attempt to use existing procedures and to strengthen existing rules governing international trade.

I don't think that the Chinese right now are very happy about the fact that it's not just U.S, but steel producers around the world that have been using or threatening to use trade remedy law against steel imports from China. They're very concerned about that.

They're also very concerned about the application of, in particular, countervailing duty laws most recently to imports from China, whether steel or other products. The Chinese are obviously concerned and think that it could make a difference. We and other trade law using industries believe that we really have no alternative but to try to continue to improve our rules-based trading system.

COMMISSIONER REINSCH: Well, I hope you're right. At the time I always made what I thought and still think were two irrefutable arguments: the industry is critical to our manufacturing base, to our security, and you have incontestably been the victim of unfair trade practices. I don't think there is anybody who can say that you haven't.

The case is good. At the same time, looking at the long-term trend, it's not entirely clear that even the prescribed remedies end up satisfactorily addressing the problem. However, I think you've made a fair answer and I appreciate it.

MR. SOLARZ: Could I add one final point, Bill, on that? I think we would totally agree with you. In fact, I'll just cite one example in that regard, which is included in our written statement, but I did not include in my oral, that concerns the environment and what's going on in the environment. This is in particular with regard to steel, but you can apply it to other industries as well.

According to the chairman of the International Iron and Steel Institute China has currently over 50 percent of the global steel industry's emissions of greenhouse gases. One can argue that pollution is being used as a "comparative advantage" in China. Is it subject to WTO rules, though? No.

It is another example of why, when we make efforts at—making a "leveling the playing field" and/or addressing global issues that leave China out, we're making a big mistake. China has to be included.

HEARING CO-CHAIR FIEDLER: Thank you very much, gentlemen. I hope, Dr. Pritchard, you don't run into any commercial aircraft problems on your way home.

[Laughter.]

HEARING CO-CHAIR FIEDLER: Thank you. The hearing is adjourned.

[Whereupon, at 11:30 a.m., the hearing was adjourned.]