

**EXAMINING THE EFFECTS AND CONSEQUENCES
OF AN EMERGING CHINA**

HEARING

BEFORE THE

SUBCOMMITTEE ON EAST ASIAN
AND PACIFIC AFFAIRS

OF THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

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MARCH 19, 2003
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WEDNESDAY, MARCH 19, 2003

U.S. SENATE,
SUBCOMMITTEE ON EAST ASIAN
AND PACIFIC AFFAIRS,
COMMITTEE ON FOREIGN RELATIONS,
Washington, DC.

The subcommittee met, pursuant to notice, at 2:30 p.m. in room SD-419, Dirksen Senate Office Building, Hon. Sam Brownback (chairman of the subcommittee), presiding.

Present: Senators Brownback, Alexander, Hagel, Allen, Voinovich, Kerry, Rockefeller, Feingold, and Corzine.

Senator BROWNBACK. Thank you all for joining us today. I want to thank everybody for participation in exploring an important set of topics regarding China, economic emergence in Asia, and the possible consequences this could have for the region and for U.S. policy.

At the outset, I want to say that this is really just an overview of an immense topic, one I feel it is important for us to explore. I come from a heavily agricultural state. I know how important trade is to our economy. And trade with China is an increasingly important part of the overall economy for the United States. Total trade between the United States and China reached \$147 billion a year in 2002 making China the fourth-largest trading partner with the United States. I would note I met recently with an international buyer for Wal-Mart, and they buy so many products out of China that Wal-Mart itself is the tenth-largest trading partner with China.

As with any important trade relationship, it is important for American policymakers to ensure that U.S. interest is being served. In the case of China, we are only starting out in the process of WTO implementation. After 1 year, we are already encountering some difficulties. China is in violation of its WTO commitments regarding tariff-rate quotas, export subsidies, and regulations on genetically modified organisms, which negatively affect agricultural producers in my state and across the country, especially considering that China is the fastest-growing export destination for goods from Kansas. USTR must be vigilant in its efforts to ensure China complies with its WTO commitments in these areas and in general.

China is also infamous for its failure to adequately protect intellectual property rights. While we have seen improvement, more clearly needs to be done. IP piracy losses in China amount to \$1.85

billion in 2002, and piracy rates continue at over 90 percent across all copyright industries.

When I was last in China in December, just outside of our hotel they were selling the new James Bond movie on the street corners. I had not yet seen it in theaters, and I do not know if it just comes late to our state or it gets early to China and the vendors, but they were selling some pretty good-looking cover copies of the new James Bond movie at that time.

Trade is only part of the issue we will be exploring today. Another key concept to examine is the rapid rate of foreign investment, which China has steadily drawn in the past few years. There has been a strong focus on investment reforms and incentives over the past 10 years, which has led to a steady flow of foreign capital into the country. We can see the impact of this growth by looking at the levels of foreign direct investment [FDI]. In 1983, China's FDI was \$636 million, about two-thirds of a billion dollars. In 2002, China's FDI was approximately \$53 billion. In terms of percentages, the U.N. reports that FDI into China grew by nearly 13 percent in 2002, even while it fell by 27 percent in all countries for the same time period.

While all this growth is encouraging for China, it does raise some possible questions about China's role in the region if it continues on this path of growth, to the exclusion of other countries in the region. Of particular concern for me is India, a country of nearly the same size and population as China, but whose economic reforms have not moved forward nearly as swiftly despite attempts at market reform for the past 10 years.

We should explore the potential consequences that could come from China being an economic powerhouse, as it is and as it continues to grow. Would the profit be used to remake the Chinese military? Would this economic growth lead to more or less aggressive behavior toward Taiwan? Will the political leadership in China use the profit from their country's growth in ways that may be damaging for long-term U.S. security interests?

By no means am I suggesting that we should vary from our position supporting free trade with China. I voted for PNTR and remain a supporter. But it is important for us to examine some of the long-term consequences of the economic growth going on in China so that we and our friends in the region can approach the future from a more informed perspective.

That is the intent of this hearing. We will hear from a number of expert witnesses. Our first panel, from the administration, I am delighted to have present Mr. Randall Schriver. He is Deputy Assistant Secretary of State for East Asian and Pacific Affairs. And then Mr. Charles Freeman, Deputy Assistant U.S. Trade Representative—one of my alma mater institutions; I was there in 1990–91—he is with the Office of U.S. Trade Representative, and works on issues regarding China.

[The opening statement of Senator Brownback follows:]

OPENING STATEMENT OF SENATOR SAM BROWNBACK

Coming from a heavily agricultural state like Kansas, I know how important trade is to our economy. And trade with China is an increasingly important part of our economy. Total trade between the U.S. and China reached \$147 billion in 2002—making China our 4th largest trading partner.

As with any important trade relationship, it is important for American policy-makers to ensure that U.S. interest is being served. In the case of China we are only starting out on the process of WTO implementation. After one year we are already encountering difficulties. China is in violation of its WTO commitments regarding Tariff Rate Quotas, export subsidies, and regulations on genetically modified organisms, which negatively affect agricultural producers in my state, especially considering that China is the fastest growing export destination for Kansas goods. USTR must be vigilant in its efforts to ensure China complies with its WTO commitments in these areas, and in general.

China is also infamous for its failure to adequately protect intellectual property rights. While we have seen some improvement, more needs to be done. IP piracy losses in China amounted to \$1.85 billion in 2002, and piracy rates continue at over 90 percent across all copyright industries.

Another key concept to examine is the rapid rate of foreign investment which China has steadily drawn in the past few years. There has been a strong focus on investment reforms and incentives over the past ten years—which has led to a steady flow of foreign capital into the country. We can see the impact of this growth by looking at the levels of foreign direct investment, or FDI. In 1983, China's FDI was \$636 million. In 2002, China's FDI was at approximately \$53 billion. In terms of percentages, the U.N. reports that FDI into China grew by nearly 13 percent in 2002 even while it *fell* by 27 percent in all countries for the same time period.

We should explore the potential consequences that could come from an unchecked economic powerhouse in China. Would the profit be used to remake the Chinese military? Would this economic growth lead to more or less aggressive behavior toward Taiwan? Will the political leadership in China use the profit from their country's growth in ways that may be damaging for long-term U.S. security interests?

By no means am I suggesting that we should vary from our position supporting free trade with China. I voted for PNTR and remain a supporter. But it is important for us to examine some of the long term consequences of the economic growth going on in China, so that we, and our friends in the region, can approach the future from an informed perspective.

[A statement submitted by Senator Lugar follows:]

PREPARED STATEMENT OF SENATOR RICHARD G. LUGAR

I would like to thank Senator Brownback for chairing this important hearing. Those of us who have watched China's remarkable growth during the past two decades can only marvel over how much has changed since the dark days of the Cultural Revolution. Economists now tell us that at current growth rates, the size of China's economy will double every 10 years.

China's economic growth has meant rising standards of living for millions of its people, who can now buy apartments and own cars and other goods unimaginable just a decade ago. Along with that has come an increase in personal freedom. Average Chinese citizens can travel, start businesses, file suits in court and surf parts of the Internet. China is now the world's second-largest market for personal computers.

This increasing wealth and China's recent membership in the World Trade Organization have created many opportunities for the sale of American-produced goods, agricultural products and services. China is the largest foreign buyer of U.S. soybeans, and overall the seventh biggest market for American exports.

We in the United States have encouraged China to spread the benefits of growth more widely throughout the country and to crack down on corruption. We also have pushed China to embrace democracy, political freedom, and respect for human rights.

Clearly the emergence of a more prosperous and self-assured China is a positive development for East Asia and the world. No one has benefited more from this progress than China itself. But with those benefits come responsibilities, and as China becomes a more significant player on the global stage, it must take on more of the duties of global citizenship.

In the area of trade, in particular, China must follow through with the commitments it has made in the WTO by enforcing its laws against counterfeiting and piracy of intellectual property. The illegal copying of software, music, movies and other copyrighted material in China cost American firms and individuals an estimated \$1.85 billion in lost sales last year alone.

Likewise in agricultural trade, the United States Trade Representative late last year raised serious concerns about China's willingness to fully implement its WTO obligations. In January the Bush administration protested China's moves to delay

approval of certain bio-engineered crops for import. Industries in the service sector and elsewhere have complained that China has either not passed regulations required by the WTO or is not implementing them fairly. Beijing must live up to the promises it has made in the international trade arena.

China must also acknowledge the responsibilities that go with its status as an economic force within the Asia-Pacific region. Other countries also need the foreign investment that is flowing into China, and many of China's exports compete in world markets against the exports of its neighbors. China must engage its neighbors so that its success benefits other developing countries in the region.

I thank today's witnesses for agreeing to appear before us, and I look forward to their testimony.

Senator BROWNBACK. Gentlemen, welcome. I am delighted to have you here. And we will open the floor up. We will take your full written statements into the record. If you want to give those, you can. If you would like to summarize and make your key points, that is up to you, as well. We are delighted to have you here.

Mr. Schriver.

STATEMENT OF RANDALL G. SCHRIVER, DEPUTY ASSISTANT SECRETARY OF STATE FOR EAST ASIAN AND PACIFIC AFFAIRS, DEPARTMENT OF STATE, WASHINGTON, DC

Mr. SCHRIVER. Thank you, Mr. Chairman. And I appreciate the opportunity to participate in this hearing today, particularly since there are other international issues that are rightfully occupying the headlines and occupying everyone's attention. It is important not to lose sight of longer-term and, I would argue, strategic challenges that we are facing. And I cannot think of any challenge more important than how to deal with the long-term consequences of China's emergence.

I would like to submit my full statement to the record and give a brief summary now.

The administration has worked very hard over the last 2 years to improve our relationship with China, and I think the progress has been quite remarkable given that the EP-3 incident was a mere 2 years ago, even less than that. We have tried to achieve a point where we can have a more constructive and cooperative relationship with China, and I would in no way minimize the important differences that we have, issues such as Taiwan, human rights, and religious freedoms, and nonproliferation, but I think we have achieved a state now where the U.S./China bilateral relationship is one that carries great potential to be a more constructive and cooperative relationship, certainly much more so than in the past.

And if I could just briefly cite a few areas, China has been a partner in the war on terrorism. China voted in favor of U.N. Security Council Resolution 1373, they publicly supported our campaign in Afghanistan, and they contributed to reconstruction efforts in Afghanistan to the tune of about 150 million U.S. dollars. Quite significant. They have engaged in bilateral discussions with us on counter-terrorism, and we are developing, I think, a very positive agenda. At the same time, we know that there are those in China who are interested in using the issue of terrorism to crack down on some who are merely expressing their views and their opposition to the government, and part of our dialog is, of course, to not

support those efforts in any way and, in fact, to make sure that China's counter-terrorism efforts are consistent with our own.

On Iraq and North Korea, it is known that China voted in favor of U.N. Security Council Resolution 1441, and they have criticized Iraq for its failure to disarm and to comply with U.N. Security Council resolutions.

With respect to North Korea, China has condemned North Korea's decision to withdraw from the NPT. They have voiced their opposition to nuclear weapons being introduced on the Korean Peninsula, and they voted in favor of referring the issue of DPRK's noncompliance in the IAEA Board of Governors to the U.N. Security Council.

So although on these three issues I mentioned, we are not in complete agreement with China, these are the major issues of the day, and I think it is fair to say that our cooperation with China has been more productive and constructive than in the past. Again, we were not in complete agreement, but there is a dialog and there is some constructive cooperation.

Surely, this is not destined to be a static relationship, though. China is growing and evolving. And as the topic of this hearing suggests, we need to understand and account for the consequences of China's emergence.

Primarily, when we talk about China's emergence, we are speaking, as you suggested, Mr. Chairman, of China's economic growth and economic emergence and how that translates into comprehensive national power. So I would like to briefly discuss China's economic growth and its modernization efforts.

I think it is inevitable that China is going to modernize and grow, so it is incumbent upon us to have the kind of relationship where we can channel that in productive ways. It is in our interest to promote China's economic reform as it modernizes. We want China to be a responsible member of the world community living by global trade and financial rules.

They are in the midst of an economic transformation. It gives us an opportunity not only to promote ties, economic and commercial ties, between our two countries, but, through that, to contribute to China's political evolution and to a more liberal society, albeit subtly and albeit it with limited influence to do that from the outside, but I think it is an important element of the commercial relationship.

You mentioned foreign direct investment has contributed greatly to China's economic growth. We see this as also exposing China to modern business and labor practices, another, I would argue, subtle benefit to these kinds of relationships that we are developing.

Mr. Chairman, you mentioned that China is our fourth-largest trading partner, it's our seventh-largest export market, and our fourth-largest source of imports. The total two-way trade between the two countries has expanded greatly from about \$33 billion in 1992 to almost \$150 billion in 2002.

China's entry into WTO, I think, is the greatest signal that it is committed to further opening and reforming its economy. Monitoring and enforcing China's implementation of WTO commitments is, of course, the centerpiece of our economic relationship and, in fact, our overall bilateral relationship. And I know Mr. Freeman

will discuss that in greater detail. But we do have serious concerns about WTO compliance, especially in the areas of agriculture, services, and intellectual property.

Largely, we view China's integration into regional and global organizations as a largely positive development. Not only does China commit itself, by joining these organizations, to play by the rules in a different fora, but it has an increasing stake in seeing that others play by the rules. But we do need to be vigilant with respect to second- and third-order effects related to this economic growth. And Mr. Chairman, you mentioned one. As China grows economically, certainly the military will be a potential beneficiary of that economic growth. That is why we feel it is important to sustain a modest military-to-military relationship with the People's Liberation Army consistent with the guidelines that Congress has given. We think it is important that as the People's Liberation Army modernizes, that we have windows on that modernization effort, we have some transparency, so we can better understand it as it evolves. Also, through a relationship with the PLA we have the opportunity to avoid miscalculations and misjudgments. This can actually contribute to a deterrent effect so that they understand our very important interests and what we are prepared to do to protect those interests.

I think it is also important to understand that China's economic growth and modernization does not translate directly, necessarily, into an upward trajectory of increased comprehensive national power. It is more complicated than that. As China is integrated into the global economy, several challenges are, in fact, heightened that China is dealing with. Stripping themselves of their bloated state-owned enterprises, which are a drag on the economy, carries the potential for great social unrest, which China is dealing with. Corruption remains a serious problem. Chinese have tremendous issues related to urban unemployment. There is a great disparity, of course, between what can be earned in rural China versus urban China. This has led to a floating population of either underemployed or unemployed Chinese internal migrants. China is a net energy importer, and its dependency on foreign oil is increasing significantly year by year.

These challenges are coupled with other significant challenges—for instance, dealing with HIV/AIDS in China, which is a serious, serious problem—as well as the rapid industrialization they are undergoing and the effects that that is having on the environment. This, if not dealt with by the Chinese, will have serious repercussions for their interest in sustaining economic growth.

Responsibility for these challenges will rest largely with China's fourth generation of leaders. I think conventional wisdom is that these leaders are younger, more technocratic, and seemingly open to confronting these vast economic challenges. I think the reality is they remain largely an unknown quantity. In the Chinese system, you make your way to the top by not deviating from the script and reading your talking points for 12 years. So now that they have assumed the mantle of power, we will see actually what their governance will look like.

I want to briefly also mention three important issues we have with China. First, human rights and religious freedom, and I know

this is an issue very dear to you, Senator, as I know you addressed the Commission on International Religious Freedom just last week and made some remarks. We had some positive momentum last year in the area of human rights, and we began a dialog with the Chinese headed by our Assistant Secretary, Lorne Craner. I think there were some positive feelings that came out of that initial effort. Unfortunately, the last 3 months there has been a series of setbacks and some very negative experiences. Secretary Powell, when he was in Beijing last month, mentioned this publicly as part of his press conference, that we were greatly disappointed in these setbacks.

The Chinese have also taken some positive steps in the area of nonproliferation. They have promulgated some export control laws, which, if implemented, carry the potential to vastly improve their system. But implementation is certainly the key. We are aware that there is only a small number of people, a handful of people, at MOFTEC who work on export controls. They need to vastly increase their resources and increase their attention to training and understanding how you implement an effective export-control system, and we are willing to work with them on that.

And finally, Taiwan, which, from the PRC perspective is always the most sensitive issue in our relationship. We regard Taiwan as a great success story in the United States. Taiwan has made tremendous progress with respect to democratization and economic modernization. Through our unofficial relationship with Taiwan, the United States will continue to promote Taiwan's story as a success and as a model for others. President Bush has emphasized to China that our policy is consistent. We do have our one-China policy, which is defined not only by the three communiques, but also by the Taiwan Relations Act. We have abiding interest, above all else, in a peaceful resolution of cross-trade differences, and we've urged China to renounce the use of force and open a dialog with Taiwan.

To conclude, the U.S./China relationship remains a work in progress. Despite difficulties, we have reached a point where we are today where we have a great deal of high-level interaction—three Presidential visits in a little over a year—and a recognition that China and the United States do share some common interests on some of the most pressing matters of the day. We know that a China that contributes to the common solution of global problems, that increasingly shares our commitment to world peace and stability, open markets, and cooperation, as well as individual freedom, is clearly in our interest. Of course, the great trick is how we get there, and that is what we are working on, and we will remain vigilant in that effort.

Thank you, Mr. Chairman, and I look forward to your questions.
[The prepared statement of Mr. Schriver follows:]

PREPARED STATEMENT OF RANDALL G. SCHRIVER, DEPUTY ASSISTANT SECRETARY OF STATE FOR EAST ASIAN AND PACIFIC AFFAIRS, DEPARTMENT OF STATE

Mr. Chairman, thank you. I appreciate the opportunity to testify before this subcommittee today.

President Bush, Secretary Powell and all of us in the Administration have worked over the last two years to forge a candid, constructive, and cooperative relationship with China. As China modernizes and grows, it is in our interest to promote China's

continued economic reform. We want China to be a responsible member of the world community, living by global trade and financial rules. China's ongoing focus on market-oriented economic development holds promise that it will increasingly contribute positively to economic growth in the region.

While not minimizing the significant differences that remain between us in important areas like human rights, nonproliferation and Taiwan, I can report to you that the Administration's approach to China has resulted in a U.S.-China relationship that carries great potential to be more cooperative and productive than in the past.

Let me cite some examples where the United States and China are working closely. China has been a strong partner in the war on terrorism. China voted in favor of UNSCR 1373, a rare vote under Chapter VII of the UN Charter which potentially authorizes the use of force, publicly supported the coalition campaign in Afghanistan, and contributed \$150 million of bilateral assistance to Afghan reconstruction following defeat of the Taliban. Shortly after 9-11, the U.S. and China commenced a counter-terrorism dialogue. The third round of that dialogue was held in Beijing in February. While we recognize that China faces its own terrorist problems, we have been steadfast and clear that China must not use the war on terror to justify any crackdown on those who call peacefully for greater autonomy, religious freedom, and political rights.

China voted in favor of UNSCR 1441 and has criticized Iraq's failure to destroy its weapons of mass destruction. China has stressed its opposition to the DPRK's decision to withdraw from the Nuclear Non-Proliferation Treaty, its concerns over North Korea's nuclear capabilities and its desire for a non-nuclear Korean peninsula. It voted to refer the DPRK's noncompliance with its IAEA obligations to the UN Security Council in New York.

Turning to economics, I want to highlight the importance to the United States of China's ongoing economic transformation. Not only has this transformation resulted in economic growth and expanded commercial ties between our countries, but it also has contributed to China's political evolution to a more liberal society. Market reforms and economic engagement have unleashed individual initiative and entrepreneurship. Foreign direct investment has both contributed to economic growth and exposed China to modern business and labor practices. China's economic growth is a bright spot in the global economy and today China accounts for about four percent of the world economy. Per capita income has increased at an annual average rate of almost nine percent since 1980. China attracted \$52.7 billion worth of foreign direct investment, in 2002 becoming the world's top destination for foreign direct investment.

China today ranks among the world's half-dozen largest trading nations. It is now our fourth-largest trading partner, seventh-largest export market and fourth-largest source of imports. Total two-way trade between the U.S. and China has grown from \$33 billion in 1992 to almost \$150 billion in 2002. With growing imports, particularly from Southeast Asian nations, China has become one of the most important engines of growth for both the region and the world.

China's entry into the WTO signaled its commitment to further open and reform its economy. WTO membership will accelerate China's economic reforms and provide more export and investment opportunities for U.S. companies. This will translate into more jobs for Americans. Monitoring and enforcing China's implementation of its WTO commitments is a centerpiece of our efforts. For the most part, we credit China for making significant progress in implementing its WTO commitments during its first year as a WTO member.

We do have some serious concerns with China's WTO compliance, especially in the areas of agriculture, services, intellectual property rights enforcement as well as the cross-cutting issue of transparency. We are working closely with USTR, the Commerce and Agricultural Departments and through our Embassy with the Chinese government, to address these concerns. Although progress is not easy, we remain encouraged that China's leaders have repeatedly confirmed their intentions to implement China's market access commitments. At the same time, when these intentions do not translate into positive results, we also stand ready to use multilateral means, including WTO dispute settlement, to enforce those commitments.

China's economic growth has made it an increasingly important regional and global player. The PRC is pursuing a Free Trade Agreement (FTA) with ASEAN. It is pursuing the Closer Economic Partnership Agreement with Hong Kong and has explored FTAs with Korea and Japan. China has been an active participant in APEC for years and served as a host in 2001. Having acceded to the WTO in December 2001, it is now playing an increasingly visible role in that organization. In our efforts to successfully conclude the WTO Doha Development Agenda, the United States has already begun consulting with China on areas of mutual interest—such as reducing barriers to agricultural trade.

We view China's integration into regional and global organizations and arrangements as a positive development. Not only is China committing itself to play by the rules of a different fora, but it has an increasing stake in seeing that others do the same. And as its economy and prosperity become linked more closely to relationships with trading partners, it has a greater stake in peace and stability in the Asia-Pacific region and the world.

We also need to be aware that the Chinese military is a beneficiary of China's economic growth. Thus, as we proceed in our overall bilateral relationship, it will remain important that we sustain a modest military-to-military relationship with the People's Liberation Army within the guidelines established by Congress. This will allow for better understanding of the PLA as it modernizes, and will give us lines of communication to PLA leaders so as to reduce to possibility of miscalculation.

Of course, integration into the global economy and its institutions also highlights challenges for the Chinese government. A high level of nonperforming loans weighs down its state-run banking system. Capital markets are immature. Bloated state-owned enterprises are a drag on growth. Corruption remains a serious problem. Income disparities between coastal urban and inland rural areas are rapidly growing and Chinese concerns about urban unemployment and surplus rural labor hinder the pace of economic reform. China is a net energy importer and increasingly dependent on foreign oil. These economic challenges are coupled with other threats. China is already experiencing a rapidly growing HIV/AIDS epidemic. It faces large-scale desertification and water shortages, while rapid industrialization has damaged the environment. Successfully dealing with all of these problems will not be easy.

Responsibility for these challenges will rest largely with China's "fourth generation" leadership. Over the past six months Beijing has begun setting this new leadership in place, through a partial transfer of power. These leaders are younger, more technocratic and are seemingly open to confronting vast economic and political challenges. We look forward to working with China's new leadership to promote better economic governance and encourage political reform in China.

Let me briefly comment on three other important issues we have with China. Human rights and religious freedom remain serious issues of concern. Despite some positive momentum last year and greater signs that China was willing to engage with the U.S. and others on this topic, there has been some serious backsliding in recent months. We were encouraged in 2002 by the release of a significant number of political and religious prisoners, and by China's agreement to interact with UN experts on torture, arbitrary detention and religion. However, we have seen virtually no movement on these promises. We recognize that China still has a long way to go in instituting the kind of fundamental systemic change that will protect the rights and liberties of all its citizens. Congressional support for our democracy, human rights and rule of law programs is helping to promote just this kind of change. We have not relaxed our efforts to promote respect for human rights and religious freedom in China.

The Chinese also have taken some steps to curb the proliferation of missiles and WMD. In August 2002, China promulgated missile-related export controls and in October 2002 issued updated regulations on the export of dual-use chemical and biological agents, in addition to its 1997 nuclear export controls. Getting these commitments is important, but the challenge is full implementation and effective enforcement. We look forward to working with China to that end.

Taiwan remains one of the most sensitive issues in U.S.-China relations. Over the last two decades, Taiwan has made tremendous progress with respect to democratization and economic modernization. Through our unofficial relationship with Taiwan, the United States will continue to promote Taiwan's story as a success and as a potential model for others. President Bush and others have emphasized to China that our policy is consistent and unchanged. We are committed to our "one China" policy and the three communiqués, as well as to our obligations under the Taiwan Relations Act to ensure Taiwan has an adequate self-defense capability. We do not support Taiwan independence. We have an abiding interest, above all else, in the peaceful resolution of cross-Strait differences. We have urged China to renounce the use of force and open a dialogue with Taiwan.

To conclude, the U.S.-China relationship remains a work in progress. Despite difficulties, we have reached the point where we are today—an unprecedented three presidential visits in a little over a year, a recognition that China and the United States have common interests on some of the most pressing matters of the day, and a strong, growing economic relationship clearly in the interest of both nations and the global economy. A China that contributes to the common solution of global problems, that increasingly shares our commitment to world peace, stability, open markets, cooperation, and individual freedom is clearly in our interest.

Senator BROWNBACK. Thank you, Mr. Schriver.
Mr. Freeman.

**STATEMENT OF CHARLES FREEMAN, DEPUTY ASSISTANT U.S.
TRADE REPRESENTATIVE, OFFICE OF THE U.S. TRADE REP-
RESENTATIVE, WASHINGTON, DC**

Mr. FREEMAN. Thank you very much, Mr. Chairman. It is an honor for us to have the opportunity to appear here today and to testify. At USTR, we tend to be somewhat obsessive in our focus on economic relations, but we are aware of what is going on in the greater world around us, so it is doubly important for us that we are here today carrying on with our work, and so we appreciate the opportunity.

I am going to speak almost exclusively on WTO implementation issues with respect to China and leave the more weighty matters to Mr. Schriver in his questions.

But just, as you are aware, Mr. Chairman, the USTR publishes every year a report to Congress at the one-year anniversary of China's accession to the WTO, which is December 11, a report on China's implementation progress to date. We had our first report in December of last year, and many of my remarks today derive from that report, so I commend that to the Chair and to the members and to the general public for a broader assessment of China's implementation record to date.

But I will say, without giving a thumbs up or a thumbs down on China's implementation progress, China certainly has made significant progress in implementing its agreement, although, as Mr. Schriver says, implementation is a work in progress similar to the relationship with the United States. Progress was made on many of the systemic changes that were required under the accession protocol, particularly in terms of implementing the framework of laws and regulations required by the protocol. I think China, by mid-2002, had changed or repealed some 2,500 trade-related laws and regulations. And there are similar reviews that are ongoing with respect to other laws and regulations throughout not only the central, but the local governments.

China also had devoted a great deal of attention to restructuring its government to meet the challenges of WTO. There are a variety of ministries and agencies in China that have a role in overseeing implementation and overseeing trade in goods and services, and there were a variety of things that China did to react to the demands of WTO.

Another major effort that China made over the first year after accession was an effort to train and educate broadly throughout China. It is not only the different agencies and the officials within China, but also the general public, about what it means to be WTO consistent. And those efforts have, without doubt, proved very beneficial.

That said, you know, China did undertake to make tariff reductions; for the most part, they came on time. I think, without question, the tariff climate for U.S. businesses attempting to gain market access to China has improved significantly since accession. So, for the most part, a lot of the mechanical steps on accession were

handled without incident. And so although those are not without problems, that is something we can take some comfort in.

That said, there are a number of serious problems that you, Mr. Chairman, mentioned, and I will talk a little bit about it in brief. We grouped most of the problems that we saw over the first year into four rough categories. The first one primarily was one that was cross-cutting on transparency. China, by its WTO accession commitments, was required to not only publish laws and regulations, but have a more open and transparent process by which they regulated and legislated. And that, I have to say, has been done, in some cases, very well, but, for the most part, very unevenly, and, in some cases, not very well at all. So that is something that we are very concerned as USTR and throughout the administration on this year two after accession and looking forward, is trying to ensure that China's regulatory process is transparent, that U.S. companies and, indeed, all companies, whether they are United States or Chinese, know what they are getting into when they embark on doing business in China.

Apart from that systemic concern, there were three major sectoral issues or areas that we noted problems with. Agriculture, as you noted, was perhaps the most problematic area in the first year. We had a tremendous degree of problems with China's efforts to regulate biotechnology products, which affected our soybean trade to the tune of a billion dollars each year. That was something that was a tremendous concern to us very early after accession and continues to be not completely resolved, but looks to be better resolved thanks to a great deal of work by not only the USTR and the State Department and Commerce and USDA, but also the White House.

Aside from biotechnology, in agriculture there are tremendous problems with China's administration of its tariff rate quota system. That has, I think, primarily affected the cotton trade this year, but we can see, for other bulk agriculture commodities, whether it is wheat, corn, or others, there are significant problems going forward. It is one of the highest priorities of the administration in terms of our attempts to ensure implementation.

Aside from that, and as I said earlier, the tariff system has improved dramatically, and tariffs have lowered; but, in their place, non-tariff barriers have sprung up. We have seen, particularly in agriculture, in the implementation of new sanitary and phytosanitary measures and inspection requirements, which have made it very difficult for some of our competitive agricultural products to enter into the marketplace. This is something we are working very hard, both in Geneva and with our counterparts at USDA and in the Chinese Ministry of Agriculture and other ministries, to try to improve, and we have had some success. There is, again, much work to be done.

On intellectual property rights, it is hard to overstate the problem on IPR in China. It is rampant. It crosses everything from DVDs, like the James Bond DVD, to car parts, to airplane brakes, to practically anything that you could conceivably brand and send out into the marketplace, it is being counterfeited or pirated in China. The good news is that China's central government is very aware of the issues with respect to IPR, very intent on doing something about it. The question is, what can they do and when, and

what kind of dent in the marketplace can you make? They have what appears to be a better regulatory process in place and a better framework of laws to deal with IPR, but, again, the question is enforcement, and that remains the \$64,000 question.

There is a lack of coordination between the judiciary branch, the administrative branch, and the legislative branch on IPR issues, which really requires a great deal of overhaul, and this is something that we have been pushing pretty hard—again, with some progress. It's difficult when you hear from the central government leadership, when they say, "Yes, we recognize we have 99 percent piracy rates in some products. We recognize we need to do a lot about this. We are working very hard on it. We need your help." It is difficult when you are facing that kind of lack of pushback. When we at the USTR typically deal with what we consider to be a recalcitrant country on IPR issues, they tend to say, "Oh, our IPR is just fine." China does not say that. They say, "We know we have got lots of problems. We are working hard on it."

So I guess the good news is the central government realizes the role of IPR in a mature economy, and we need to make progress at the local level and in terms of getting the deterrent-level penalties necessary to prevent IPR violations.

On services, another area that Mr. Schriver raised and is, sort of, the fourth major area that we have seen problems in, there are a variety of issues, not least of which is the high capitalization costs for not just financial services, insurance, and banking, and non-bank financing for motor vehicles, et cetera, but throughout China, and almost every sector has high cap rates, and that is really preventing a lot of market access of U.S. firms that may not have the capital or want to invest the capital necessary to build the book of business over time that is required to justify dumping that level of capital into China at the outset.

The good news on that is, we are getting some recognition that this is preventing China's growth. We are talking about it in Geneva, and that is having some effect, but we have a lot of work still to do on that front.

Aside from that, there are a variety of other areas in which agencies in China that have traditionally performed both a commercial and a regulatory function have, as they have tried to split regulatory and commercial functions aside, they tend to bleed into one another, and so the competitor of U.S. companies in China is also their regulator. This is something that is particularly noticeable in the express courier area. We have made progress there. China Post, who is the regulator of express couriers, de facto and now de jure, has agreed to, or has been instructed to, separate its regulatory and commercial functions and have a regulator that has nothing to do with the business side of it.

But again, these are areas where we continue to work. We continue to work on every level in government, in the administration. We continue to work with every agency in China. We continue to work with every province and every municipality every chance we get. We will focus on it extensively in Geneva at the WTO.

And the good news is, we are making progress. We rarely, if ever, get from China a flat, "No, we are not going to do anything about it." And that is the good news. The bad news is, we still have

not gotten as far as we need to go, especially in some of our critical products that we need to get in for market access purposes.

Mr. Chairman and members of the committee, thank you for your attention, and I look forward to your questions.

[The prepared statement of Mr. Freeman follows:]

PREPARED STATEMENT OF CHARLES FREEMAN, DEPUTY ASSISTANT U.S. TRADE REPRESENTATIVE, OFFICE OF THE U.S. TRADE REPRESENTATIVE, WASHINGTON, DC

Thank you for inviting me to appear before you today to discuss the Administration's perspectives on the United States' trade relationship with the People's Republic of China and, in particular, the topic of China's WTO implementation.

INTRODUCTION

For much of the past two decades, China had been gradually transitioning toward a market economy from what in the late 1970's was a strict command economy. In acceding to the WTO, China was required by the United States and other WTO members to agree to accelerate this process of market reform in order to comply with WTO requirements. China's WTO accession agreement embodies a set of extensive and far-reaching commitments on the part of China to change its trade regime, at all levels of government.

Overall, during the first year of its WTO membership, China made significant progress in implementing its WTO commitments, although much is left to do. Progress was made both in making many of the required systemic changes and in implementing specific commitments. At the same time, serious concerns arose in some areas, where implementation had not yet occurred or was inadequate.

In December 2002, USTR submitted a report to Congress detailing China's WTO compliance efforts, along with the Administration's corresponding monitoring and enforcement efforts. Let me give you a brief summary of what we found.

IMPLEMENTATION PROGRESS

As expected, the principal focus of China's first year of WTO membership was on its framework of laws and regulations governing trade in goods and services, at both the central and local levels. China's trade ministry, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), reports that the central government has reviewed more than 2,500 trade-related laws and regulations for WTO consistency. By mid-2002, it had reportedly repealed 830 of these laws and regulations and amended 325 more. It had also reportedly drafted and adopted 118 new laws and regulations. Similar reviews are taking place at the local level, although the local governments are generally not as far along in their review process.

Beginning early in 2002, China also devoted considerable resources to the restructuring of the various government ministries and agencies with a role in overseeing trade in goods and services. Some of these changes were mandated by China's accession agreement, while others were undertaken by China to facilitate its compliance with WTO rules. With the recently concluded National People's Congress, we are seeing even further restructuring, which should promote WTO compliance.

Another significant focus for China during the past year involved education and training. China embarked on an extensive campaign to teach central and local government officials and state-owned enterprise managers about both the requirements and the benefits of WTO membership, with the goal of facilitating China's WTO compliance. The United States and other WTO members, along with many private sector groups, contributed substantial technical assistance and capacity building resources to this effort.

As a general matter, China took positive steps to implement many of its specific WTO commitments during the past year. It made required tariff reductions, to the benefit of many U.S. industries. China also began the process of removing numerous non-tariff trade barriers, and it continued to improve its standards regime. For the most part, these steps were managed without serious incident, and market access for U.S. products in the affected sectors has generally improved. Although not without problems, China also took the necessary legal steps to allow for increased market access for foreign service suppliers in a variety of sectors.

IMPLEMENTATION CONCERNS

While the efforts of China's leadership to implement China's WTO commitments should be recognized, the Administration also found a number of causes for serious concern during China's first year of WTO membership.

One area of cross-cutting concern involved transparency. In particular, China implemented its commitment to greater transparency in the adoption and operation of new laws and regulations unevenly at best. While some ministries and agencies did take steps to improve opportunities for public comment on draft laws and regulations, and to provide appropriate WTO enquiry points, the Administration found China's overall effort to be plagued by uncertainty and a lack of uniformity. The Administration is committed to seeking improvements in China's efforts in this area.

Apart from this systemic concern, three other areas generated significant problems and warrant continued U.S. scrutiny—agriculture, intellectual property rights and services.

The area of agriculture proved to be especially contentious between the United States and China. While concerns over market access for U.S. agriculture products are not unique to China, particularly serious problems were encountered on many fronts, including China's regulation of agricultural goods made with biotechnology, the administration of China's tariff-rate quota (TRQ) system for bulk agricultural commodities, the application of sanitary and phytosanitary measures and inspection requirements. The United States and China were able to make progress toward resolving some of these problems, particularly with regard to biotechnology. Other problems remain unresolved, however, with the most troublesome being China's inadequate implementation of its TRQ commitments.

In the area of intellectual property rights (IPR), China did make significant improvements to its framework of laws and regulations. However, the lack of effective IPR enforcement remained a major challenge. If significant improvements are to be achieved on this front, China will have to devote considerable resources and political will to this problem, and there will continue to be a need for sustained efforts from the United States and other WTO members.

Meanwhile, concerns arose in many services sectors, principally due to transparency problems and China's use of prudential requirements that exceeded international norms. Progress was made in 2002 toward resolving these concerns, but much work remains to be done.

In our experience, China's compliance problems are occasionally generated by a lack of coordination among relevant ministries in the Chinese government. Another source of compliance problems has been a lack of effective or uniform application of China's WTO commitments at local and provincial levels. China is taking steps to address both of these concerns, through more effective inter-ministerial mechanisms at the national level, and through a more concerted effort to reinforce the importance of WTO-consistency with sub-national authorities. In other cases, however, compliance problems involve entrenched domestic Chinese interests that may be seeking to minimize their exposure to foreign competition.

When confronted with compliance problems in 2002, the Administration used all available and appropriate means to obtain China's full compliance, including intervention at the highest levels of government. The Administration worked closely with the affected U.S. industries on compliance concerns, and utilized bilateral channels through multiple agencies, at all levels, to press these concerns. The Administration also initiated a regular dialogue on compliance issues between USTR and China's lead trade agency, MOFTEC, with the goal of bringing all involved Chinese ministries and agencies together when the resolution of particular problems warrants it. Where possible, the Administration also multilateralized its enforcement efforts, by working with like-minded WTO members on an ad hoc basis, whenever particular issues have had an adverse impact beyond the United States.

CONCLUSION

Mr. Chairman and members of the Subcommittee, thank you for providing me with the opportunity to testify. I look forward to answering your questions.

Senator BROWNBACK. I rarely tell my mother-in-law a flat no, either; and yet there are a lot of things that she suggests that I just somehow do not get done.

I am not suggesting China is my mother-in-law or yours, but when you were talking about the IPR, and this has been an issue around here for a long period of time—you know, I am in Beijing, step outside of the hotel, walk about two blocks away, and several people are trying to hawk this latest James Bond movie to me. At the same time, I go to a restaurant—they double concertina wire all the embassies, put extra troops around to make sure that no

North Korean refugees make it into the embassies to get out to be able to go to South Korea or somewhere else. And where there is a will, there is a way; and where there is not a will, no way is found. And it seems like on the IPR issues, China has consistently found no way to do this over an extended period of time, to great harm to the United States and to businesses and, I think, long-term harm to China, as well. But I would hope we could put a lot of pressure on them about this.

Can I ask you, how would you grade, Mr. Freeman, this past year's compliance with their WTO agreement, China? If you gave them a letter grade, how would you grade their compliance overall?

Mr. FREEMAN. I cannot really give them a grade. It is, I would say, pass, if that is—

Senator BROWNBACK. You are passing, or they are passing?

Mr. FREEMAN. I was hoping to get away with that one, but—no, I think, in general, they have passed because of the work to be done in terms of putting into play the framework of laws. That really was not an insubstantial task. And in our view, they did a tremendous amount over the first year. Really the rubber meets the road in year two and three to see whether these laws and regulations that they have put in effect are effective. And in our sense, they are working on them, even on IPR, but, you know, we are not there yet.

Senator BROWNBACK. So passing, but no better than that?

Mr. FREEMAN. I would hesitate to give them better than that. To be honest, it is tough to come out with one solid grade. I mean, they have taken something like 400 courses, and in some cases they have clearly failed, in some cases they have done very well. I have not averaged it out yet, but I am going to saying it is passing.

Senator BROWNBACK. How are they doing on agriculture?

Mr. FREEMAN. On agriculture, I have to say in our view, their passing grade is in the balance, to be quite frank. Market access, specifically under the TRQ system, has been a real problem. There seems to be some genuine attempts by different agencies within the Chinese Government to maintain the kind of non-market environment for agriculture that they have exercised in the past. So that is an area that we are watching extremely closely.

Senator BROWNBACK. Bertie, let us run the clock at 7 minutes. And we have got a vote that is coming up sometime, so I want to make sure that Senator Allen has a chance to ask some questions before we go over. And we will take a short recess and then come back.

I am concerned that we may not push China quickly enough to comply; that in our history we, I think, sometimes have let these trade issues simmer for a long period of time before we finally decide, OK, we are going to need to bring a WTO case against them. And I would urge you not to do that in this case. This is too large of a market; the trade between the two countries, \$150 billion, most of that coming this way. I do not know what the imbalance is of the export/import, but I think \$120 billion of that is probably coming this way and \$30 billion back the other way. You can correct me on the number. Do you know what it exactly is, Mr. Freeman?

Mr. FREEMAN. That is about right.

Senator BROWNBACK. We need to be able to get access to that market. And the more we push them, the earlier, I think, the more likely they are going to be to comply across the board, because this is a large trading relationship back and forth.

I would ask you, though, as well, I hope we do not subject our other interests in Chinese diplomacy, Mr. Schriver, and subjugate, then, our economic issues here, as well. You have noted that China has been a partner on a number of issues, and concerning on others, whether it is dealing with Iraq, North Korea, nuclear proliferation on the Korean Peninsula, we have got a litany of things.

I would ask you, has China been cooperating as much as they can with the United States on the North Korean issue? They are the closest partner with North Korea. They have a generally open border with North Korea. They have been sending refugees back into North Korea against the agreements that the Chinese have signed. Have they truly been working with us on dealing with North Korea?

Mr. SCHRIVER. Well, I think we have been very frustrated, primarily with the North Koreans and their provocative acts, and the Chinese share some of our concerns related to that situation. You fall perhaps short of saying they share common interests because when we start to talk about what to do about it, there is some divergence. And it is difficult to answer your question in a precise way, because we do not always know what the Chinese are doing diplomatically behind the scenes with the North Koreans.

I think they are sufficiently concerned about the situation that they would like to move it in a positive direction, not as a favor to us, or not because they see this situation just as we do, but because they recognize it is getting extremely serious. I think the aircraft intercept really caught their attention. So it is difficult to say, are they doing enough? Could they do more, because we do not have a hundred-percent transparency on what they are doing.

The issue of refugees is a very serious issue to us. It is raised in virtually every setting now when North Korea and the nuclear issue is discussed. I just returned from Beijing. I raised it in every meeting I had, and we note to them that it is important that they meet their commitments. After all, they have signed international protocols saying that they will cooperate with the U.N. Commission on High Refugees to screen these people and find out which ones have legitimate concerns about returning to North Korea, and, frankly, that would probably be just about all of them, given the conditions there. And we have told them that this is an issue that they're not going to get a pass on. And frankly, Mr. Chairman, your leadership and the leadership of others who have heightened sensitivities to this issue is helpful to us in this regard. China does care about their international reputation and how they are viewed publicly, and they know that people who are committed to this issue will not let it go.

So we need to focus on, No. 1, making sure that we can get assistance to the people who do make it across the border. We are working with NGOs in that area to provide assistance. We need to make sure that China stops the forced repatriation, sending people back to those horrible conditions. And we need to make sure that

China cooperates with the U.N. High Commission on Refugees to have a process in place to screen these people and help them.

The way I have put it, and others in the leadership have put it, out of all the things we are working on with China, some are really in the hard basket. This one is not in the hard basket. If they really believe that these are economic migrants and people are coming across the border for economic reasons or to settle, then greater transparency through the High Commission on Refugees would certainly reveal that. And so the way we have put it is, this is not a hard one to help yourselves on.

Senator BROWNBACK. Senator Allen, thank you very much for joining us.

Senator ALLEN. Thank you, Mr. Chairman. Thank you for holding this hearing on this very important matter to trade opportunities for American businesses, consumers, as well hopeful improvements in human rights for the people of the People's Republic of China.

I was listening to your questions, and they are many of the same concerns I have. Overall, I would say China, in listening to the testimony here and reading the witnesses' testimony, compared to 20 years ago, has improved. But if you give it a grading scale, it is a pretty low grading curve. It might be called "social promotion."

And then there are some areas where they have passing grades, and there are others that I think are clear failures, even if you are a very lenient teacher.

The area of the North Korean refugees, that is an abject failure. These people are leaving a tyrannical dictatorship, and if there are countries, whether it is the United States or South Korea, that are willing to take those refugees, allow them to do so. Sending them back means they will be killed or they are going to be tormented and imprisoned. And that is an abject failure.

I am glad to hear Mr. Freeman talk about intellectual property rights. That is an abject failure. Ninety percent piracy rates, under the most lenient of all grading curves, would be a failure, and I encourage you to keep working. And I know there will be other witnesses coming forward in later panels who will be addressing it, and it is important for you all to ride herd on that. It is important. This is property rights. It is not just affecting businesses; it is the artists, it affects creation, the research, the development, whether that is in business software, whether that is in the recording industry, regardless, those are property rights.

One other area where I see a failure, which was not addressed by either of the two gentlemen here, which I wish to bring to your attention, has to do with the WTO and semiconductor chips. As I understand it, they put a 17-percent value-added tax on all semiconductor chips. In the event, though, that the chips are fabricated within the People's Republic of China, instead of paying 17 percent, I believe they get an 11 percent rebate, so they pay 6 percent. In the event that they are also designed and fabricated within China, they get a 14 percent rebate, or, in other words, 3 percent. To me, this seems to be a clear violation of WTO agreements.

The point is, is that if you are going to have fair trade, and I am one who, with a great deal of trepidation, worry, concern, so forth, did vote for normal trading relations with China, figuring that with

technology more people in China will be able to disseminate their ideas and have their own independent thought not dictated to them by a government. Now, I understand they try to curtail that, but ingenuity and free minds and human instincts of hating restrictions and limits, I figure the creative nature of technology will bypass the bureaucrats and the pack-mule mentality of those who want to control thought and ideas.

So when they start doing this with semiconductors, what do you all intend to do about what seems to me to be a clear violation of WTO rules, insofar as treating semiconductor chips, no matter where they are fabricated, whether they are fabricated in China, the United States, Taiwan, Korea, what do you all intend to do about this? And I will be writing, once again, Ambassador Zoellick on this, and I know other Members on the House side, on a bipartisan basis, have a great deal of concern of this discriminatory tax treatment.

Mr. Freeman, I will let you, since you are the grader.

Mr. FREEMAN. I am not going to give them a grade on this one. We have started looking at this issue pretty directly recently. This is still a new issue for us. I tend to agree with you that, at first blush, there does not seem to be any rationale for it according to WTO commitments. But we are looking at it. We have raised it with the Chinese. We have not had a tremendous degree of success in what we have—in terms of getting to acknowledge that there's a problem yet, although they have said, "Oh, well, look at this in the WTO context."

You know, our sense is that there is a broad use of the value-added tax system to try to encourage different industries to set up shop in China. If they are going to use it in this manner, though, obviously this raises WTO issues. We are looking at this extensively, and I can get you more information as we, sort of, develop a final position.

But I would strongly urge you, at the same time as you write to Ambassador Zoellick, to copy our friends in China on this, because they need to hear directly from the U.S. Congress that this is something that is of concern not just to the pencil-necks in USTR, but to other folks in the—

Senator BROWNBACK. Senator Allen, if I could, just really quick—we have been hit with a vote at 3:10. Why do you not go ahead with your questions, and then we will go to Senator Corzine. I am going to try to run over and vote. I can get back before it closes down. If I am not able to, Senator Corzine will put us into recess briefly and then I will be right back.

Senator ALLEN [presiding]. I will just followup—thank you, Mr. Chairman—follow up, but yes I will copy them. You could understand why they are doing it. They want to favor those that are fabricated and add a favoritism to those that are designed and fabricated within China. However, that is not the way that WTO rules operate. I guarantee you if we were doing something like that in this country, they would be pretty hard on us maybe not China, but other countries. So I think it is important that if we are going to have faith in these organizations in these countries, that they live up to their agreements.

They have made progress. I do not want to just focus on the negative. China has made progress. It is better than it was 10 years ago, 20 years, and significantly better than it was 30 or 40 years ago, and I do think engagement is a good idea. But nevertheless, there is a great deal of improvement that needs to be made in semiconductors and intellectual property, as well as a few other areas of human rights.

I thank you. I am going to turn it over to my compatriot and colleague and counterpart and everything, Senator Corzine, I have to vote, on trying to get more jobs and energy independence, on the floor.

Thanks.

Senator CORZINE [presiding]. Senator Allen, I am glad you are not grading my efforts in some of my outside activities in DSCC.

I think this is a truly important topic to be discussing, and sometimes with all the other elements that are challenging us on the international front, we lose track of—probably America's biggest challenge is its relationship with China if you look at it in a long-term perspective—a great nation, a great culture that certainly is advancing and positively competes in many ways and some—I worry about whether it is always positive.

I really have two questions. One has to do with a general geopolitical situation today. We saw the Duma in Russia decide to withhold consideration of the Moscow Treaty, a treaty that passed here 100 to 0. Are there political actions that have been an outgrowth of some of the debate with regard to the potential for conflict in Iraq, looks quite imminent, in our relationship with China that have been brought forward? And I apologize if you have talked about it in your opening statements, but I have not—I would be curious if you could respond.

Mr. SCHRIVER. If you are asking about something that is very similar to that kind of move by Russia to withhold consideration of the treaty, I am not aware of any moves by China that would fall into that category. They voted in favor of U.N. Security Council Resolution 1441. They have consistently said Iraq needs to comply with that resolution, as well as all previous resolutions. They have urged Iraq to disarm and to cooperate. However, they have publicly said they are not in favor of the use of force.

So although they would fall into the camp of wanting more time for the inspectors, they, in the end, do not have any great affection for Saddam Hussein, are not particularly interested in seeing him stay around on the scene. So they have indicated that they are not to be an obstacle to us in this endeavor, and that is how they've approached it.

So I am not aware of any moves of retribution or anything like that.

Senator CORZINE. And you feel there are no long-run implications to these current events to our relationship in the evolution.

Mr. SCHRIVER. Well, you know, I think there is actually some good news. The Chinese, as a member of the U.N. Security Council, were grateful that we took this issue to the Security Council and did not approach it entirely in a unilateral way, which was, sort of, the public buzz, that we would do so. China has been consulted very closely on these matters. Secretary Powell has met with his

counterpart—at least he was his counterpart until a day ago—five times in about 6 weeks—met with him in New York and in Beijing. President Bush speaks frequently to former President Jiang Zemin and has already had a conversation with President Hu Jin Tao. So I think, through this process, although there is not complete agreement on what may ultimately be military action, the Chinese are grateful that they are being consulted closely, that we have treated the U.N. seriously, arguably more seriously than many of the member states, because they are willing to let it go the way of the League of Nations, perhaps. And the Chinese are happy that we have taken that approach and included them, as a great power, in looking at these very challenging issues.

Senator CORZINE. And there have been no public statements with regard to preemptive strike policies?

Mr. SCHRIVER. I would have to check the record. They have clearly said they are not in favor—that they would like to see a peaceful resolution and a diplomatic resolution and are not in favor of military action. That is been part of their public statement. I would have to check the record and see if they mention “preemptive” in a specific way.

Senator CORZINE. I would just comment that one of the worries that some have expressed and it is a concern of mine is that one can use as a pattern, potentially, preemption in cases when people feel that they are threatened, and that, therefore, might apply in other situations that we would not necessarily want another nuclear power necessarily exercising that. There have been domino theories talked about among some.

I want to go to another area, and that really is one that I feel more comfortable on the ground on, and that is China’s trade imbalance, which is spectacular and is growing at rather phenomenal rates, at least I would like to grow earnings of a company if I were managing at these rates. We are over \$100 billion trade deficit. It has grown about 25 percent since the year 2000. How do you assess, how do we look at our trade situation? Is there any reason to believe that we are moving into a position of changing policies in a way that would lead to a different outcome than an exploding deficit that seems to be attracting, based on cost advantages, particularly with regard to labor, much of the manufacturing of the globe, in many ways? If I understand it correctly, a lot of the auto manufacturing that previously was in Mexico had gone and is moving into China. But have there been steps taken to address this imbalance? Do we think there are steps that we need to be working on to address something that—I can tell you I was given a question to ask you about wire hangers, which happens to be a business that is in New Jersey that basically lost its reason to be, from a cost standpoint. And I run into this on a regular basis across both my own State and as I travel the country. I wonder what is the administration’s response? Where do we think the outgrowth of this will be?

Mr. FREEMAN. Well, obviously, when you get up over \$100 billion in a trade deficit, it is a striking number, and it is something that we are obviously very focused on. But I think the way that we are approaching this, the administration is approaching this, is not so

much to get worried about what the deficit is, but to look at what the growth of the trade relationship is, generally.

What we are looking at is improving market access to China. That is what our primary focus is. I think that if we—we are certainly not about throwing up new barriers here to reduce the competitiveness of our domestic industry. What we are trying to do is encourage more growth in China and more purchasing of U.S. goods and services in China. And we think that the U.S. business person, the U.S. worker, and the U.S. consumer will take care of the rest.

So, you know, our focus is—again, is not so much on reducing the deficit for the deficit's sake, but to improve market access and improve the growth of Chinese purchases.

Senator CORZINE. Do we think that is happening in the banking sector, the capital market sector, the manufacturing sector? Do we have specific points where we are—to use Senator Allen's analogy, where we could give high marks for the opening up of these sectors for export opportunities?

Mr. FREEMAN. Well, believe it or not, I mean, in some of our agriculture sectors, we have the highest sales of U.S. agriculture products into China that we have ever seen. Citrus has been a huge, a huge, success story in China, U.S. citrus into China. There have been a variety of other products where we have seen increasing competitiveness. And very frankly, in things like insurance and other U.S. services, we have seen an increased access to there. And one of the things that we are trying to do is reduce some of the costs of doing business over there so that it become easier for more U.S. insurers, more U.S. service companies, more U.S. businesses, generally.

Senator CORZINE. You give them high marks for the opening up of the financial services industry?

Mr. FREEMAN. No, I am suggesting that—I did not mean to say that—I am saying that they are getting better. I mean, I think it is too early, in many cases, to give them final marks on anything. This is a work in progress. And so, you know, we are continuing to push very hard on all fronts.

And again, \$100 billion trade deficit is striking. There is no way to get around that.

Senator CORZINE. The rate of growth is even more striking, a compounded 25 percent growth rate.

Mr. FREEMAN. Correct.

Senator CORZINE. A pretty astounding end result.

I apologize, but the hour is late on the vote, so I am going to put us into recess until Senator Brownback comes back. I apologize for cutting short. This is a very important topic. Fixed exchange rates and a lot of other issues, I think, need to be seriously examined if this issue is not to become a serious irritant between our two societies as time goes on. And while other things are maybe priorities for the moment, this may end up having some of the greatest import for one of the most important countries in the world.

Thank you.

[Recess.]

Senator BROWNBACK [presiding]. We are sorry for the momentary delay.

Gentlemen, thank you for continuing. I have got just a couple more followup questions and then we will go to our next panel.

Mr. Schriver, just a couple of questions. What has been the growth of the budget for the Chinese military over the past 5 years? Do you know what that has been?

Mr. SCHRIVER. I would resist putting a number on it. The Chinese have official statistics, which are about anywhere from 7 or 8 or 9 percent growth a year. So, even by official statistics, the growth has been very significant. I think most analysts do not regard those number as accurate and would put them somewhere higher. So it is difficult to pinpoint.

And I think the important point, and one that is not in dispute, is the Chinese have been investing heavily in their military modernization, mostly directed at Taiwan, mostly in the area of ballistic and cruise missile development and deployment, and that is of great concern.

Senator BROWNBAC. Have they increased their spending on space programs, as well? Do you know of anything in that nature?

Mr. SCHRIVER. They have. Not only are they pursuing manned space launch, it is a goal of the Chinese—I think national prestige has something to do with that—but military space programs across the board, satellites for communications, trying to develop more sophisticated—what the military would call C4I capabilities, and some of that is in the area of space.

Senator BROWNBAC. Has this raised any areas of concern or alarm at State Department or Defense Department?

Mr. SCHRIVER. The broader issue of military modernization is something we watch very carefully. In terms of space programs, we have strict export controls, and we have a history there. In fact, we just levied a penalty on a couple of U.S. companies involved in cooperation that was outside the law. So we are concerned about the developments, and we try to ensure that any kind of cooperation with the Chinese does not go to People's Liberation Army end-users, or if an item is in the area of dual-use, that any transfer does not contribute to military modernization.

Senator BROWNBAC. Is the Chinese leadership in the country moving toward democracy across the nation? Can we say that, or is that not taking place?

Mr. SCHRIVER. I think it is a mixed bag. If you want to see the glass half full, you would say that there has been a trend over many years of increasing village elections at the local level, increasing abilities for people to participate in choosing their own leaders at the local level. We just saw a transfer of power in the National People's Congress, which was hardly reflective of a democratic process. So it is a mixed bag.

Senator BROWNBAC. My indications are that—what I have been reading is that they are moving toward some sort of democratic reforms at the local level, the closest local level, and that may be to deal with corruption as much as anything. But at the national level, there is no intent, nor movement, toward democracy. Would that be a correct bifurcation of the situation in China on its movement toward democracy?

Mr. SCHRIVER. I think that is accurate. Again, if you want to be an optimist, you would say that the movements at the local levels

are a precursor for other things. But, again, what we just saw at the National People's Congress was hardly the result of a democratic participatory kind of system.

Senator BROWNBACk. Does any of the Chinese leadership ever express to you a willingness to move at the national toward democratic governance?

Mr. SCHRIVER. The Chinese leadership is mostly interested in stability, as they define it, and that does not include moving in that direction, as far as I am aware.

Senator BROWNBACk. Mr. Freeman, it seems to me that much of the market access U.S. firms get in China is contingent on their willingness to take a minority stake in a Chinese partner. This is part of China's WTO agreement. And why? Should we not have required that the same to China has here, that we have access there into their market or into their groups or companies?

Mr. FREEMAN. Well, one of the things about the accession is that it provided for a phase-in, including phase-in of the ability of United States and other foreign companies to have a greater share of a Chinese company. In fact, it is increasingly popular, if not the only preferred way to do business is to get a wholly owned foreign entity in China. So, increasingly, most of the firms that are doing business in China, foreign firms, are wholly owned and moving away from a strict JV, joint venture, structure. So we are seeing movement there.

Senator BROWNBACk. Good. What about pressing them on this genetically modified organism case? When would you anticipate bringing that or getting some sort of final resolution instead of this year-by-year issue? I am concerned that we are continuing to sow difficulties in our agricultural markets. You mentioned it is about a billion dollars a year in soybeans that is being impacted here. When are we going to be able to press them to finally resolve that issue?

Mr. FREEMAN. Well, it has always been our view that the attempts to regulate soybeans, in particular, were uncalled for. Most of the soybeans that they have tried to do tests on to see if they are food safe or they are environmentally safe have been going into China for something like 7 years. So it's always been our view that it's a bit of a smokescreen to test these products, because any environmental event that would have happened, or that could happen, would have happened already. These are safe products. We have tested them extensively. They have been tested in much more rigorous markets than the United States before—excuse me—more rigorous markets than China before, and they have always proved safe. So we don't think that there's a need to test these products to the extent the Chinese are doing.

That said, what China has done is they have agreed the testing of soybeans, in particular, or other genetically modified organisms, will not impact trade. So what they've done is they've extended now the period for testing, the interim arrangements under which soybeans are coming in, and other GMO products, until April 20, 2004, which should allow the testing to finish and they can officially seal these as safe.

So, at the end of the day, we do not think we are going to see an impact, again, on soybean and other GMO trade into China. So

that is the good news. We really feel this is one of the relative success stories of U.S./China engagement on agriculture and economics in particular. But it has not been easy, and it has been a lot more adversarial than we would have appreciated.

Senator BROWNBACk. I just want to go back to an earlier point and just mention it one more time, is that I think we really need to press them early in their WTO process of getting in compliance, and early with cases, too, that I think if we do that early, we are going to have more success over the longer term than if we wait a couple of years and say, well, OK, we are going to kind of let it slide a little bit. If you let it slide at the front, it is going to slide further at the back side of it. And it is just such a large economy and a large market force. I really hope you will push them aggressively at an early stage.

I presume that discussion is going on internally now. And at what point do you start really pulling the trigger with cases against them to get in compliance?

Mr. FREEMAN. Well, again, our sense is that when you bring a case, because of the time that it takes not only to go through the WTO process, but the time to implement the WTO solution, it is far better to solve your problems bilaterally so that you do not have to go to the WTO and dispute the resolution.

Again, you know, there are a couple of issues—you have raised a couple here—where we are farther along in the process of throwing up our hands and saying it is time to take a case, but this is something that the administration will have to decide upon as a whole and not something that USTR on its own would do.

Senator BROWNBACk. And toward the general administration, I hope we do not subjugate trade to the broader issues that are involved here. I think we should deal with trade issues on trade, trade agenda and the broader issues in their field, as well, but not tie those two in together.

Gentlemen, I have two questions that Senator Biden wants to submit for the record. And, if you could, I would appreciate your responding to them as soon as possible and we will include them in the record. Thank you very much for joining us today.

Our second panel will be Dr. Robert A. Kapp, president of the US-China Business Council here in Washington, DC, and Ms. Hillary B. Rosen, chairman and chief executive officer of the Recording Industry Association of America.

Dr. Kapp, Ms. Rosen, delighted to have you here. Dr. Kapp, we will go with your testimony first. You are free to submit your full full statement, into the record and summarize, if you would like to, or read your statement, whichever you would prefer.

STATEMENT OF ROBERT A. KAPP, PH.D., PRESIDENT, THE US-CHINA BUSINESS COUNCIL, WASHINGTON, DC

Dr. KAPP. Thank you very much, Senator Brownback. I am delighted to be here. I want to thank you in particular for proving just how nonpartisan the US-China Business Council is. I have appeared before this subcommittee or the full committee at the invitation of members of the Democratic contingent on a number of occasions, but this is the first time to be here invited by a Republican, and I am delighted to be here.

Senator BROWNBACK. Good.

Dr. KAPP. I did present written testimony. It, unfortunately, did not get up here until just a few minutes ago. It is, I believe, now on the back table, and I would ask that it be in the record; I will speak only briefly to some of the points I made.

Senator BROWNBACK. Without objection.

Dr. KAPP. You know, we meet at an interesting moment. None of us needs to be reminded of that. I spent the hours before I came over here reading the Federal Emergency Management Agency pamphlet "Are You Ready?" in order to get ready for my own meeting of our small staff to discuss who was going to bring the bottled water and who was going to bring the blankets and so forth to our office. It is a very strange moment, in which Washington is aware of the dangers that the world presents.

We had an article in the Washington Post yesterday called "Pearl Harbor 2003?" which suggested that the American military is now very, very thinly stretched and could be even more thinly stretched in the near future, with critical implications for our security.

So as we meet today about China, I guess, on the one hand, I feel very grateful to you, Mr. Chairman, and to the subcommittee and the full committee, for convening on this topic at a when so much else is going on. I think that is critically important.

At the same time, I think the world that we look out upon from the windows is one which ought to make us take a deep breath and think as broadly as we can about the U.S.-China relationship, past, present, and certainly future, as is implied in the title of this hearing, implications of China's emergence.

In that regard, I sent to members of the committee and staff of the committee—I was unable to make it available fully to the press—copies of the brand new issue of our magazine, "The China Business Review," because it is about the 30th anniversary of our group and is filled with articles by scholars and members and government figures on U.S.-China relationship at 30; what China, itself, will look like 20 and 30 years into the future. Former Representative Lee Hamilton has a very serious and thoughtful piece in here. President George Herbert Walker Bush was kind enough to sign his name to a greeting at the front. But, taken as a whole, I hope the people on the committee will be able to read some of these essays, by Chinese as well as American writers, about where China is going and where the United States-China relationship might proceed in the future.

I am here as the representative of the US-China Business Council, a private, nonprofit corporate-supported organization celebrating, as I mentioned, its 30th anniversary. And the simple message of the business sections of this testimony is that business is growing rapidly. The volume of trade expanded very substantially last year, both imports and exports rising by more than 20 percent. The trade deficit, as you know, has risen significantly, as well. American companies, by and large, view China today with a sense of expanded opportunities, and that applies not only to big companies. We find that smaller companies, who, until now, have viewed China as so mysterious and so obscure as to be off limits to people with shallower pockets, are now beginning to call us with greater frequency to say, "We would really like to see how we can economi-

cally, but effectively, maximize our opportunities over there.” American businesses are seeing a China in which a large domestic market is clearly in evidence in many, many fields. Autos are the classic case that we read about in the newspapers now, with car sales going very, very dynamically. But the same is true about other familiar subjects. China, the largest cellular phone market in the world, with American brands prevalent, or at least very highly present. And increasingly, not only in Beijing, Shanghai and Canton on the coast, but in the major cities of other provinces, as well.

Broadly speaking, American business views China as still a tough place to do business. It has always been that. But anyone who has been there for more than a year views it as a better place to do business today than in the past. And anyone who’s been there for 5 or 10 or 15 or 20 years, or who goes back to 1977, as I do, recognizes that a great deal has moved in positive directions, from the standpoint of business.

We are very supportive of the interest that the Congress takes in our trade and economic relations with China, including China’s WTO implementation process. It is not, I think, excessively associating with the Chinese view of the world to recognize and acknowledge that what China signed in the WTO agreements that it made first with us in November 1999 and then in Geneva, with the entire WTO, at the end of 2001, demands of China a degree of social and economic and even political change—certainly, administrative change—which is very difficult for us even to imagine doing, and certainly bigger, I think, than anything that any international agreement has imposed on the United States at any time. We have tended to be the power that has pretty much drawn up the rules. And in this case with China, the PRC has accepted a set of commitments that are enormously far-reaching and very difficult to accomplish.

So we support very strongly both the Congress’ and the Commerce Department’s and the USTR’s very strong and systematic efforts to monitor and watch the process by which China seeks to accomplish these huge changes.

I do have a message for China today. You know, whenever one speaks in a meeting like this from a position like mine, one understands that the audiences are multiple. And my message for China today is an expression of congratulations on the seamless transition to a new leadership. It is, by far, the most peaceful and non-destructive, noninvasive political transition of leadership that we have seen in the history of the People’s Republic. The people who have taken office are experienced and talented. And as I say in my written testimony, the rule of the great man is a thing of the past in China. These are well-turned-out, experience, administratively savvy, sometimes internationally adept, professional political leaders, and we congratulate them on their accession to their new offices.

At the same time, as they settle into their new offices, it is very important that the WTO implementation process on which China embarked so boldly at the end of 2001, not be allowed to slip into a side office or—no matter how pressing the domestic priorities of a new regime are—be relegated to a secondary position. And the reason for that, of course, is essentially you, Senator Brownback,

and the U.S. Congress, in particular, but also the administration and also the American business community. The rest of the world cannot wait for China always to reach the right moment when everything domestically is lined up in perfect order in order to turn to the implementation and realization of its international commitments. We think the Chinese understand that, and we believe that the Chinese leaders who brought China into the WTO against enormous resistance—even after they were in, enormous resistance—understood and that their successors understand that the implementation of China's obligations, or realization of those obligations, is, in fact, very good for China in the medium to long run.

We also know that they know that they are looking at tens of millions of people already laid off from the creaky state-owned sector, which may go into further decline under the pressures of the international community through the WTO. We know that they are very, very concerned about the future of the hundreds of millions of people on the farms whose products and crops are simply not price-competitive and quality-competitive with international imports moving into China.

But our message is, please do not let this drop or let this fall to the side. You are only in the second year. There is a long way to go. The world and the United States are watching.

Now, having said that, I have attached to my testimony a very short essay which summarizes the testimony that the council provided to the Trade Policy Staff Committee coordinated by USTR last fall, and there is a very short essay summing up our positions, particularly about the salience and critical importance of year two, which began last December 11, in this WTO phase in process, in the written testimony.

Beyond that, however, the testimony goes a little further, and I want to take just a moment, because of the circumstances in which we meet, to make a somewhat broader and a more wide-ranging argument.

We have got a new leadership in Beijing. We are not in crisis with China. In fact, it is better than that. Mr. Schriver in his remarks today made clear how much has progressed forward between the United States and China since the calming down of the EP-3 affair. Those of us who have been in Washington since the mid-1990s can list, as I do in my testimony, the hammer blows through which the United States-China relationship went in 1995, 1996, 1997, 1998, 1999, even up to the EP-3, itself. That, for the moment, and hopefully for more than a moment, is in abeyance. My hope is that the Senate Foreign Relations Committee, and this subcommittee, in particular, will act in a sustained, thorough, and engaged way to grapple with the fundamental questions of where the U.S.-China relationship is going to go, before the next crisis comes along. We tend to drift from moments of acute interest and excitement about China in the American political system to moments of almost complete disinterest. I think it is very important that this subcommittee and its parent committee use the opportunity to really ask some very fundamental questions about the United States and China and how we can evaluate our own and the other side's mutual areas of interests and mutual areas of concern and see about managing those for the long-term.

There is an inter-parliamentary exchange now, which Congressman Manzullo has taken the lead in impelling forward. We hope that more members of the Senate and more Members of the Congress, as a whole, will become involved in that.

What I am trying to say is that we in the business community understand that the core of the positive advance in U.S.-China relations in the last 15 to 20 years has been an economic one. Just look at the magnitude of this economic engagement now. We are their number-two trade partner; they are our number-four. We know the investment numbers, and so forth. But we also understand that if the other dimensions of the U.S.-China relationship are not managed carefully and with a mutual view toward long-term progress, ultimately the trade and economic relationship cannot carry the freight all by itself, just as, in the old MFN annual renewal days, we used to feel that if trade were cutoff, the rest of the relationship could not be held on an even keel, either. The two are intertwined. I sympathize, Senator Brownback, with your point about not conflating everything and dealing with trade matters as trade matters and not hauling in the kitchen sink and mixing everything together. But realistically, if the U.S.-China relationship, at the level of who we think we are, who they think they are, and where we think we are going, is not consciously and energetically addressed by both sides, including this committee, then I think, over the long-haul, the prospects for all of our engagements with China, even including this huge economic one, will not be as bright as they could if we put the effort into defining this relationship now.

Without that kind of effort at conscious definition, anybody can read the numbers and come up with any conclusion he wants. You can read the trade numbers, you can read the armaments numbers, everybody can say, you see? I told you so. This just proved they are this, they are that. And the Chinese do it to us at the same time.

So what is needed, and hopefully in this committee we will find the source of that energy, would be an effort to really work, domestically and also across the Pacific, on coming up with some clear understandings between the two countries about where we really think we are going. Because if we do not do that, it can drift into very, very serious, very serious conflicts, of a magnitude that make the North Korea problem or the Iraq problem, at least potentially, look small, indeed.

Thank you very much.

[The prepared statement of Dr. Kapp follows:]

PREPARED STATEMENT OF ROBERT A. KAPP, PRESIDENT, US-CHINA BUSINESS COUNCIL, WASHINGTON, DC

Mr. Chairman, members of the Subcommittee:
Thank you for inviting me to appear before you today.

I. INTRODUCTION

I am Robert Kapp, president of the US-China Business Council. The Council (www.uschina.org) was established in 1973. The Council, a tax-exempt nonprofit business association under Section 501(c)(6) of the Internal Revenue Code, is the principal organization of American companies engaged in trade and investment with China, serving approximately 225 leading corporations and firms from its Washington headquarters and field offices in Beijing and Shanghai. The Council provides a combination of business advisory services, written information and analysis (pri-

marily online), meetings and programs of all kinds, and advocacy work on public policy issues of concern to its broad business constituency, both in the US and in China. The Council has long enjoyed productive and close engagement with many Members of the Senate and House, many Committees and Subcommittees, and many members of Congressional Staff. We welcome such contacts, and believe that the Council can provide dispassionate and accurate information and perspectives to our counterparts on Capitol Hill, as we do to many in the executive branch and to our business constituents.

The Council publishes the leading magazine on US-China trade and economic relations, "The China Business Review" (www.chinabusinessreview.com). As it happens, the new issue of our magazine, celebrating the Council's 30th anniversary, has appeared only this week. Most of the article content of this issue, by authoritative American and Chinese analysts, deals with the very subject of today's hearing. I have taken the liberty of making copies of this issue available to members of the Subcommittee, in the hope that they or their staff will find them useful in exploring the themes of today's hearing.

I congratulate this Subcommittee for getting an early start in the new Congress on the broad subject of US-China relations. China has a way of bursting upon the Congressional agenda in times of acute crisis, and then disappearing almost without trace from Members' priorities when things settle down. This relationship is too huge, and its implications not only for America's interests but for the interests of world peace and prosperity too significant, for it to be treated in this manner. The Senate Foreign Relations Committee and this Subcommittee can do the Congress and the nation a major service by staying the course on our relations with China, year in and year out, hearing the good and the bad, the positive and the negative, and placing the US-China relationship into the broadest context of American interests and policies worldwide.

II. US-CHINA TRADE AND ECONOMIC RELATIONS: "THE DATA"

It is no secret that our country and China now participate in a vast economic engagement that places the US second on China's list of trade partners and China fourth on our own. In a year of economic sluggishness, US-China trade in 2002 grew rapidly. US figures show US exports to China up more than 15% over 2001 the largest and most rapid export growth booked with any of our trade partners. Chinese exports to the US continued to expand very rapidly as well, and the merchandise trade deficit reached unprecedented levels.

China's economy continued to move ahead strongly, driven by a combination of domestic market growth, government deficit spending to deter deflationary trends and mitigate reform-driven unemployment, stronger than predicted export performance, and strong incoming FDI levels. The bulk of China's very large FDI inflows continues to come from Asian points of origin, most notably Hong Kong, Taiwan, and Japan, with more Asian investment booked under British Virgin Islands.

Chinese figures show the top six import suppliers to the PRC as Japan, Taiwan, South Korea, the US, Germany and Hong Kong, with Taiwan's exports to the mainland rising 39% in 2002. China's top export destinations continue to be the US, Hong Kong, and Japan, with South Korea and Germany running far behind.

China's total foreign trade grew by nearly 22 percent in 2002; exports and imports both rose by more than 20%. China's overall positive trade balance of around \$30 billion was higher than that of 2001, about the same as that for 1999, and lower than that for 1997 and 1998. China's trade with the Asia-Pacific region grew most rapidly. Overall, China's top 6 trade partners in 2002 were (in order): Japan, the U.S., Hong Kong, Taiwan, South Korea and Germany. Taiwan replaced South Korea in the #4 slot, its trade with the PRC rising by 38.1 percent.

Exports from non-state-controlled firms rose more than 27%, a sign of the growing international activity of non-governmental enterprises as China, under WTO, further opens the door to international business by domestic firms. Economists have long noted that the non-governmental sector of the Chinese economy is far more dynamic and far more effective at generating employment than the state sector, but that the state sector continues to enjoy far greater access to capital than do non-state firms.

In the first nine months of 2002, 60% of all incoming investment came from the Asian region, with the U.S. accounting for 10.5%. Exports from FIBs—foreign invested enterprises—accounted for 52% of all Chinese exports in 2002, according to Chinese numbers.

Among the key features of the Chinese economy in 2002 were the accumulating evidence of a large domestic market for consumer durables and consumer goods, exemplified by the rapid growth of auto sales, and the concurrent deepening of income

and wealth disparities within Chinese society, both on the rural-urban continuum and between the heavily advantaged coastal region and the more poorly endowed interior and “rust belt” regions. One informed observer has argued that widespread privatization of housing ownership has had a very powerful stimulating effect on China’s domestic markets.

The central government has continued to pour resources into infrastructure development—dams, pipelines, modern highway networks, telecommunications systems, and so forth—whose economic returns may not be immediate. The government (as of today, the new team that has just taken high office) faces huge challenges in dealing with persistent budget deficits, widespread industrial unemployment and rural economic distress, and the twin burdens of adhering to WTO market-opening requirements while simultaneously ameliorating the economic dislocations that such adherence is widely expected to entail. Meanwhile, the vast enterprise of shrinking the role of the public authority in the economic and social life of the populace while maintaining and even increasing the effectiveness of national authority across the length and breadth of China’s huge land mass grinds ahead, bounded on the one side by the looming danger of excessive audacity and on the other by the impossibility of holding back the tide of continuing economic reform.

Faced with the broad range of economic and social challenges merely hinted at here, the regime has given strong signals in the past year that a stable international situation, including a stable relationship with the United States, is an important prerequisite for the domestic economic progress on which it must concentrate. For one expression of that viewpoint, I commend to your attention the article by Prof. Huang Renwei in the issue of “The China Business Review” that I am presenting to members of the Committee. We expect the heavy focus on pressing domestic demands to continue under China’s new leadership.

III. CHINA IN THE WTO: THE “DATA” OF A WORK IN ITS EARLY STAGES

Evaluation of China’s “performance” in adjusting its institutions, laws, and practices to the requirements detailed in its WTO accession papers began almost from the day China joined the WTO in December, 2001. American businesses, who had played such a significant advisory role in helping the government to define the far-reaching obligations that the United States insisted China accept if it were to be admitted to the WTO, viewed China’s entrance into the WTO with optimism, in the belief that a China committed to conducting its now-massive international commerce under rules and dispute mechanisms established by the global trading community would prove a more congenial and dependable trade counterpart than a China left to its own devices outside the framework which governed the conduct of the rest of the world’s trading nations. That remains their view.

Partly because China’s WTO accession was unprecedented in the complexity and detail of its commitments, and partly because of the intense political controversy surrounding the PNTR debate in the United States, this country has established multiple governmental mechanisms for examining China’s continuing progress toward full implementation of its commitments, not only at the outset of its membership in the WTO, but each year for the long period of its phasing in of required market openings. The WTO itself has subjected China to annual review of its performance as well.

Thus, the US-China Business Council offered to the Trade Policy Staff Committee, coordinated by the Office of the U.S. Trade Representative, its preliminary assessment of China’s earliest progress as a WTO member, in testimony last September.

I attach an article I wrote at that time, “WTO: Toward Year Two,” which summarized very briefly the much more detailed analysis the Council produced (the longer document is available at the Council web site, www.uschina.org, at “China and the WTO/Public.”)

We concluded, in essence, that after only ten months of Chinese membership in the WTO, it was premature to form sweeping conclusions about the extent, the effectiveness, or the forthcomingness of China’s WTO conformity efforts. We observed that, near the end of the first year, the WTO glass was half full, not half empty, primarily because China had reduced tariffs on time and in full keeping with its first year obligations, had made very extensive efforts to amend existing laws and regulations or put new WTO-compatible laws on the books; and that the government was clearly involved in a wide-ranging effort to introduce the notions and the methods of a WTO-consistent economy to tens of thousands of administrators and cadres who were essentially confronting an entire new conceptual and administrative universe for the first time.

We noted, as well, however, that the first year had begun to reveal a number of emergent problems which demanded resolution in the second year of China's WTO membership.

These included inadequacies in the establishment of the "tariff rate quota" systems, for both agricultural and non-agricultural products; delays in instituting stable import policies on GMO commodities; the absence of timely establishment of WTO-required auto-financing systems; continuing lacunae in the critical area of legal and regulatory transparency, despite some examples of noticeable progress; the nascent practice of posting excessively high capital requirements on new service-sector businesses in a manner that militated against international companies' full realization of new WTO-mandated market opportunities; manipulation of certain tax practices, notably relating to the "VAT" or Value Added Tax, in ways that suggested inappropriate favoritism toward domestic products; opacity in the critical area of trading and distribution rights for foreign invested enterprises; and the perennial problem of intellectual property rights protection and enforcement.

We noted, further, that with "Year Two," the process of phasing in key Chinese market opening commitments would begin in earnest, and expressed the hope that such phase-ins would proceed as smoothly and definitively as possible.

Now, in March 2003, we are moving into the middle portion of "Year Two." The United States Government has engaged directly with Chinese authorities on a number of the most significant issues mentioned in our list of concerns above. China is just finishing a period of political transition that began with the Party Congress last November and concluded with the end of the National People's Congress on March 18. Some of the key Chinese agencies responsible for policies and actions central to fulfillment of China's WTO obligations are being reorganized, merged, or redirected. A period of uncertainty as to who reports to whom and who has the power to do what in the WTO implementation realm may be before us; we hope that any such hiatus will be short.

While the US-China Business Council recognizes that "Year Two" has a long time to run, we are of the view that the months since submission of our TPSC report last fall have shown few significant advances in China's WTO acclimatization and implementation. As we have noted to our Chinese interlocutors many times, time is passing.

The list of our concerns has changed little since the fall of 2002: the TRQ regime, opaque or discriminatory use of technical standards whose effect is to block access of foreign products to China's markets, continuing excessive capital requirements in most service sectors, telecommunications sector licensing requirements, inadequate progress on the establishment of trading and distribution rights for certain foreign-invested firms, inappropriate use of VAT rebates in a manner that discriminates against imported products, the drawn-out GMO controversy, the unresolved problem of rampant intellectual property abuse—all remain of concern to the Council and its members.

At the same time, we are well aware that United States agencies are receiving rising numbers of requests for protection against Chinese imports, both from traditional heavily protected sectors of the US economy and from individual makers of products now facing Chinese competition in US markets. Further, China itself has developed and is now using its own anti-dumping rules and institutions with increasing frequency and thoroughness.

IV. ECONOMIC AND COMMERCIAL RELATIONS: A QUICK SUMMATION

Taken as a whole, the immense process of economic and social change rolls on. China continues to move in the directions that, presumably, Americans want to see it go. The economy is very heavily marketized now. The profit motive has trumped the planned economy to a degree unimaginable a few years ago. The heavy hand of the state has been removed from many aspects of Chinese citizens' lives. The Chinese government continues to move away from the remnants of the Stalinist planned economy, often against entrenched bureaucratic vested interests and often at the cost of cutting once-dependent constituencies adrift. An important trend gradually moving ahead now is the reduction of the stultifying and corruption-ridden but all-pervasive system of bureaucratic approvals and licensing in favor of a more equitable and routinized system that places fewer obstacles in the path of productive economic activity—for Chinese and non-Chinese alike.

China's domestic market is an established fact of real significance to many US firms. Chinese companies and entrepreneurs increasingly have assimilated the language and the methods of global commerce. Contrary to the familiar portrayal of deluded and befuddled business people throwing their money down the drain in the vain pursuit of the mythical China market, many of our Council's member compa-

nies are doing well there, and view China either as a short-term bright spot in an otherwise bleak business landscape or as a compelling mid- to long-term venue for business development. Smaller US companies are unquestionably stirring as well, beginning to see China for the first time as a place where they, too, might seriously explore profitable opportunities.

The economic development of China, including the improved economic circumstances of hundreds of millions of Chinese citizens and the expansion of the modern Chinese industrial economy—are widely seen by American companies as highly positive developments—especially since U.S. products are best suited for more advanced economies and for consumers with money to spend.

China has proven, as well, capable of manufacturing a vast array of products to world specifications at highly competitive prices, and has established itself as a supplier of many manufactured goods to foreign markets, including the United States. Clearly, China has become an integral component in many firms' global marketing and sourcing strategies. This trend is likely to continue.

This "emergence," as the Subcommittee has called it, of China in the world economy is important news for China's trade partners, including the United States. And it is this complex mixture of good and bad news that leads me to the final section of this testimony.

IV. THE MEANING OF "CHINA'S EMERGENCE"

Mr. Chairman, barring internal systemic crisis such as might arise from a collapsing banking system or a catastrophic worsening of China's already serious rural and urban social dislocations or from a decisive degradation of China's corruption-ridden administrative structures, the China whose remarkable trajectory has been the object of world wonder and admiration over the past decade is here to stay. While specialists vary in their assessments of the fragility of China's economic and social stability, most view China's track record over the past twenty years, for all its potholes, as very impressive, and conclude that China is far from the brink of systemic failure. It would be a very risky bet to assume that China is headed back into the weakness and global insignificance that the older among us—and the parents of the younger among us—used to take for granted.

China's high-level politics, however opaque they might be to Western eyes, still appear demonstrate continuity and "normalcy." The transition to new Party and government leadership has been navigated to conclusion only in the past few hours. The regime has now passed a longer period free of wrenching internal political conflict than at any time since its founding. The deep-seated assumption, arising from Mao's time, that any leader of China must be a charismatic "mobilizational" figure is outmoded; China's leaders are educated, administratively experienced, technologically literate, and for the most part unspectacular. The era of "Great Man Rule" is over.

The regime's stalwarts, like our own still come to their posts from overwhelmingly domestic backgrounds. But China possesses a large pool of internationally competent talent, in government and increasingly in business. The contrast with the situation twenty years ago could not be more stark.

China's international relations are generally stable, especially on its borders. Its position in the Asia-Pacific regional economy is increasingly prominent and has not caused the economic disaster in the region that some observers had predicted; indeed, China's Asian neighbors are increasingly interested in building bilateral and regional cooperative links with China that might help to assure their place in a regional economy heavily influenced by China's trade behavior. China is an engaged, generally responsible player in most major world bodies.

The US-China dialogue of the past eighteen months, characterized by repeated meetings of the heads of government and near-routine consultations at the cabinet level—and, I'm happy to say, by expanded Congressional engagement with China—appears to be on a civil and respectful course, even when the two nations cannot fully agree. Human rights and labor issues continue to rankle, and should not be lightly dismissed, but the past year has seen a few hopeful moments, including the visit of representatives of the Dalai Lama to China and the release of Mr. Xu Wenli. Somewhat amazingly, after the tumult of the period from the Lee Teng-hui visit through the Taiwan Strait missile crisis, the missile technology brouhaha, and the successive controversies over campaign finance, the Cox Commission, Los Alamos, the Belgrade Embassy bombing, the Long Beach and Panama Canal questions, and the EP-3 Hainan Island incident, US-China relations are said by both sides to be "better than ever before."

China has, as the title of this hearing suggests, "emerged."

Yet the full implications of China's arrival among the ranks of the very significant nations of the world are still, somehow, unexplored. I hope the Subcommittee will excuse me for going beyond the narrow professional focus of the US-China Business Council for a moment to comment on this broader problem.

The recitation of our business and economic relations with the PRC above is a small facet of this larger picture. And there are a number of disquieting signs.

It is common to observe that with the collapse of the Soviet Union the "strategic rationale" for US-China relations evaporated, and that in its absence a plethora of individual issues has tossed US-China relations one way and then another.

Perhaps the "war on terror" has re-established that overarching commonality of interests needed to advance the bilateral relationship. Perhaps not.

An arms race is underway in the Taiwan Strait, identified by all observers as the point of greatest military volatility in US-Chinese relations. No matter where one chooses to identify first causes, the fact of that military race is undeniable.

To the alarm of American observers, some Chinese strategic analysts paint a portrait of a United States bent on "blocking" China's rise, constricting its economic opportunities, emasculating its strategic and regional military strength, compromising its sovereignty, and undermining its political system. The writings of such commentators often claim more attention in the United States than the writings of those who posit a more cordial US-China relationship as one of the core elements of Chinese foreign policy.

From time to time, American observers find in China a state determined to reassert ancient imperial pretensions to world power, a regime that takes the United States as China's "principal enemy" and bends its efforts to ensuring its ability to confound American economic and military power.

Some analysts in China view the United States with alarmed uncertainty. They find it difficult to conclude, for example, from the recently published National Security Strategy, whether China is the real intended target of the American pledge to prevent the emergence of any military challenges to U.S. power, or whether the China that the United States pledges to work with in a consortium of major powers dedicated to eradicating the threat of global terrorism is the Americans' "real" China.

Significant bodies of opinion in both countries see conflict between the American "status quo power" and the Chinese "rising power" as likely, if not unavoidable. The costs of such conflict are not addressed.

Some powerful voices within the United States see China's increasing ability to compete with the developed industrial nations, including the US, as a mortal threat to the US economy and thus to U.S. national security.

In spite of the resumption of cordial US-China engagement in the aftermath of September 11, with cooperation in the campaign against global terrorism as its centerpiece and rapidly growing economic engagement as its most visible manifestation, the two nations have yet to achieve—or perhaps event to seek—a durable set of understandings as to their intentions and their understandings of each others' national interests.

There is no sign of effective dialogue between the two countries as to what constitute the legitimate needs and aspirations of both, when the two bump against each other. Each side has its list of "non-negotiables," but there seems little results-oriented communication—official or otherwise—as to where and how to reach mutually satisfactory understandings in areas of latent conflict.

In the absence of such a consensus over basic goals and mutual interests, the "data" of this relationship—whether trade numbers or facts and figures about weapons deployments—are left to be interpreted by believers according to their preconceptions. The fascinating and disturbing thing about the entire strategic dialogue, to which our trade and economic engagement is from time to time a footnote, is that in the absence of US-China communication about the nature of this relationship, those who "know" out of conviction what the relationship is now and must become can all point to the facts and figures to prove their points of view. There seems to be little concern, moreover, for questions of how the United States and China might act purposefully to establish consensus, defuse frictions, and reduce the possibilities of major conflict.

Ironically, the conundrums that China poses for the United States today arise from China's growing ability to function in the world as a "normal" nation, and not as the grotesque and demonic state that Americans saw with such alarm in the 1950s and 1960s. Surely, with the emergence of a country this large, this significant to the future of the global commons, this invigorated by a sense of finally achieving the elusive breakthrough to prosperity and security, the United States and China should be trying with maximum energy to answer the riddle of their future relationship.

China's "emergence" is a fact. The world is a different place as a result. The United States Senate and all Americans should be asking: how are the interests of the United States best secured in this new and different world? Should we take China's emergence solely as an existential danger toward whose undoing we should bend every ounce of American strength? Would that be feasible? What would it cost? Would the world be with us? What would it mean to "prevail"?

Does China's emergence require that the United States examine its own definitions? Can the US and China do more to harmonize their interests and their engagements? Are the current fault lines in US-China relations fixed for all time? Is it even worth exploring these questions anew, and more effectively, with China than we have managed to do thus far? What might be the dangers in doing so? Is such an effort simply beyond the abilities of leaders in two such disparate societies to manage?

I hope that the Senate Foreign Relations Committee and this Subcommittee will not avert their eyes from big-picture questions like these, Mr. Chairman, for it is in the answers to these questions that the meaning of the economic and trade data, the micro-level experiences of Americans in business and other walks of life, will emerge to inform the thinking of our legislators and policy makers. The work needs to go forward in the absence of US-China crisis. I thank the Subcommittee for getting started.

V. A CONCRETE CONCERN: THE ONGOING PROBLEM OF VISA PROCESSING

Mr. Chairman, before concluding my testimony, I would like to raise one very practical and immediate issue, with which I believe the Subcommittee and perhaps the full Foreign Relations Committee ought to be concerned. The American business community engaged with China has, since the summer of 2002, encountered serious difficulties in regard to the travel to the United States of Chinese citizens in the employ of US firms, or at the invitation of US firms, for legitimate business purposes. Many visa applications for business travel have been delayed for four to six months, without explanation. Some visa applications have been denied, after lengthy delays, again without explanation.

The press has already reported on a series of cases in which US firms have been unable to bring to the United States Chinese citizens whose travel to the US is integral to the US companies' achievement of valuable sales, implementation of signed sales agreements with Chinese customers, training of Chinese personnel in the use of legitimately purchased US equipment, or planning of US company business development strategies in China.

The disruption of visa processing appears to be the result of two separate US policy thrusts. One aims at strengthening US border security by denying entry to dangerous individuals. The other is to tighten access to US-origin technology by augmenting existing export controls. The US business community strongly supports improvements in border security and understands the need for appropriate export controls.

At the same time, it is clear that any truly effective new visa procedures must eliminate, or minimize as fully as possible, the unnecessary "collateral damage" that the current procedures are causing to American companies attempting to function in today's global economy.

Whether the problem lies in the inadequacy of manpower and equipment resources for the prompt and predictable processing of visa applications, or in the policy definitions and administrative guidelines (not transparent to those outside of the relevant government agencies) that have occasioned these very counterproductive results, we sincerely hope that Members of this Subcommittee will turn their attention to the task of remedying these problems and restoring the maximum possible level of effectiveness in the visa evaluation process.

We have worked, as part of a larger coalition of concerned business associations and companies, for many months on this issue, with representatives of executive branch agencies and with members of Congressional staff in both Houses of Congress. The matter appears now to reside principally in the newly created Department of Homeland Security, with which we hope to establish productive working contact. We appreciate, in advance, your willingness to take an interest in this matter, and hope we can remain in close contact with you about it.

Thank you very much.

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THE US-CHINA BUSINESS COUNCIL

Letter from the President

(ROBERT A. KAPP, PRESIDENT, THE US-CHINA BUSINESS COUNCIL)

WTO: TOWARD "YEAR TWO"

The US-China Business Council recently joined other trade organizations in offering a detailed analysis to the US government of China's progress in adjusting to the demands of its World Trade Organization (WTO) membership since it joined the world trading body last December. The Council's presentation was part of a multi-agency US government process of information-gathering and evaluation that will result in an official administration report to the US Congress by December 11, the first anniversary of China's accession. (The Council's full presentation can be found on the Council's website, www.uschina.org.)

In a brief oral presentation accompanying the written submission, the Council summed up its overall estimation of China's WTO progress as follows:

In the starkest of "glass half full/glass half empty" terms, the Council considers the glass more than half full as the end of the first year approaches, thanks to the extensive and highly visible efforts China has made in many areas of WTO-mandated reform.

These efforts included

- Elimination of laws and regulations incompatible with WTO terms and issuance of new legislation and regulations designed to comport with WTO requirements;
- Reduction of China's tariffs to levels pledged in the terms of China's WTO accession;
- Widespread commitment to "capacity-building," or the development of WTO-trained personnel in central and sub-central government agencies, and efforts at public education on the WTO and its implications for Chinese economic and commercial life.

These developments, we felt, were appropriate "infrastructure" measures as China turned to building a new economic and commercial environment under the terms of its WTO membership. But we went on to offer a cautionary comment:

We perceive, however, a tone of impatience and uneasiness among some respected and experienced business observers within China over the PRC's accomplishments and intentions in some of the areas which have proven most problematic in Year One. Because we are still in "early days," American companies have not seen fit to issue, through the US-China Business Council, stark characterizations at this time, but the concerns registered in our written submission require close observation and may require additional action.

The full content of the Council's written analysis, produced by Council staff in Washington, Beijing, and Shanghai, mentions several examples of worrisome developments—or non-developments—in the post-accession PRC trade and investment environment. Widely acknowledged problems with agricultural tariff-rate quotas (TRQs) and other traded goods under quota; the appearance of new procedural obstacles, such as opaque registration processes or onerous standards or prudential requirements; and the persistence of massive intellectual property abuse were a few of the concerns mentioned in the Council's presentation. The Council also pointed to signs of an apparent inability or unwillingness of some government agencies to overcome other bodies' entrenched resistance to thorough WTO implementation.

In the question-and-answer session that followed, we were asked whether any particular year, in the nearly decade-long process of China's WTO implementation, was of special concern. We replied that Year Two was crucial.

We suggested that China had appropriately offered unique Year One responses to the challenges of the inaugural WTO year: updating its legal framework, cutting tariffs, moving toward the kind of consultative transparency that the Internet makes so technically feasible, and training WTO-competent administrators.

But as the United States and other WTO members track Chinese WTO adjustment in Year Two, they will increasingly raise questions appropriate to an ongoing implementation process:

- Will China remedy the acknowledged inefficiencies and confusions encountered in Year One? China itself has acknowledged that agricultural TRQs were inadequately determined and allocated in the first year. There are other significant examples. A second year of disappointment on TRQs and these other issues will not be attributable to start-up difficulties.

- Will measures that were to have been completed in Year One, but that were not, appear decisively in Year Two, and closer to the beginning of the year than to the end?
- Will Year Two phase-ins take place on time? Delays in effecting these crucial market-opening reforms will pile up in ensuing years; prompt delivery on phase-in commitments is essential.
- Will China find the necessary powers of persuasion to compel full WTO implementation by recalcitrant central and sub-central agencies?

The process of evaluating China's progress in adjusting to the requirements of WTO membership takes place, like everything else in international relations, in a broader context. Here are just some of the background factors that directly or indirectly relate to the WTO implementation process:

- US-China trade continues to expand vigorously, in spite of sluggish economic conditions in the United States, Europe, and many of the Asia-Pacific economies. First-half 2002 US exports to China were up more than 10 percent year-on-year, while Chinese exports to the United States in the same period were up nearly 15 percent. China is a critically important export market for many US firms struggling with deep declines in other markets.

- Foreign investment, perhaps buoyed by the terms of China's WTO entry is moving into China at a very high rate.

- China and the United States appear, superficially at least, to be getting along somewhat more civilly of late, thanks to the "War on Terror" and signs that the top leadership in both countries sees the value of cooperation. Signs of progress on Chinese control of missile and missile-technology exports, a series of releases of politically sensitive prisoners, and the recent visit to China by senior associates of the Dalai Lama are recent indications that progress can be made between the two countries. Diplomatic contacts are again in high gear, and the network of consultative arrangements between the two governments appears to be widening. The presidential meeting in Crawford, Texas, suggests a commitment at the top to continued US-China engagement.

- The United States is preoccupied with the possibility of major war in the Middle East; on top of the response to September 11, 2001, this preoccupation has deflected the energies of those earlier concerned with the likelihood of confrontation with China and has become the primary index by which the United States gauges every country's positive or negative relationship to the United States. Though many observers note that the underlying factors auguring for an ultimate clash of interests between the United States and China are basically unchanged, it would be hard to conclude today that the authoritative short-term American assessment of China is as gloomy as it seemed to be in 2001.

- And last but emphatically not least, China is on the brink of long-awaited changes in its political leadership. Within the Communist Party this fall and within the government next spring. While no one expects this leadership transition to result in wholesale and radical changes, hope appears much more widespread that new principal office-holders will at least permit forward motion to resume and gather speed on many policy issues currently perceived to be in suspended animation.

Energetic implementation of China's WTO commitments must be one of the vehicles moving forward at full speed after the transition in China's political leadership. That China's new leaders will face daunting domestic economic challenges is a given: rural-urban disparities of income and wealth, East-West disparities, unemployment associated with economic transition, looming troubles in the banking and securities sectors—each of the major economic challenges facing the regime can be portrayed as dangerously susceptible to the disrupting effects of WTO compliance. It will take concentrated attention by China's new leadership team, and reaffirmation that WTO compliance is in China's dear interests, for Year Two to yield decisive progress in uncertain areas.

Immediately after publishing the Council's written USTR presentation in mid-September, I heard from a number of knowledgeable friends in the Council business community in China. I close with portions of one such message.

If one asks what positive difference WTO membership has meant to foreign business, it would be difficult to point to anything that the Chinese would not have done on their own, except maybe for some tariff reductions; companies that were doing reasonably well prior to WTO accession continue to advance, while companies that faced daunting barriers continue to beat their heads against the wall.

. . . [China has] feverishly written new regulations and trained thousands of people, and hailed all that as progress toward transparency and rule of law. But in reality there has been little, if any, evidence of the structural

change that WTO was meant to trigger. Indeed, I would argue that thus far the Chinese have been busily hijacking WTO rulemaking to further obstruct foreign participation in key sectors, while maximizing the access of their own companies to more liberal foreign markets . . . [such as the United States]. I still think the top leadership embraces not only the letter, but the intent of WTO membership. But too many parts of the regime do not, and the leadership has not demonstrated a firm grip. Yes, there's a big transition taking place . . . [, but there are also] many entrenched interests that we knew opposed WTO. But they can't make excuses—or be excused—indeinitely.

[Though] I assume your “glass half full” characterization was intended to encourage the good guys, I don't think it is accurate.

It will be up to China, in Year Two, to show this writer and many others that my friend's concerns were off the mark American business—and many in American government—want to be constructive partners with China in WTO progress. But in the end, the laws, the regulations, the judicial rulings, and the changes in work style that the world is rooting for lie in the hands of the Chinese themselves.

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THE US-CHINA BUSINESS COUNCIL

Letter from the President

(ROBERT A. KAPP, PRESIDENT, THE US-CHINA BUSINESS COUNCIL)

MISSION IMPOSSIBLE: FINDING “THE BUSINESSPERSON'S VIEW OF CHINA”

I was asked to speak at a conference on the topic of “the businessperson's view of China.” I will be the only person on the program to address this topic. Others will deal with issues of morality, national security, media coverage, ideology—the familiar panoply of concerns with which Americans frame the US dialogue on China. My job is to “speak for business.”

Put yourself in my place. What would you do to get your hands around that topic?

1. It's always safe to start by defining terms

Who genuinely embodies “the businessperson's view of China”? The CEO of a multinational corporation, for whom China—no matter how important to the company's business—is but one of a million daily concerns? How about a Taiwan- or Singapore-born manager of a US wholly owned plant in some East China economic zone, working to keep a complex production operation running smoothly? Or the American general manager of a joint venture, sitting as a minority member on the venture's board of directors? Or perhaps a government affairs director in Beijing, working to improve the company's communications with Chinese government agencies? Or maybe a lawyer with a good American firm and years on the ground in China helping clients to do their homework before they sign their contracts? What about the head of a security firm responsible for digging up reliable, confidential information about the Chinese companies and individuals with whom the firm's clients are contemplating business relations? Or maybe a logistics person, struggling to get goods into China, out of customs, and on to their distributors and end-users countrywide? And what about the owner of a small US company pondering whether this, finally, is the moment when China looks promising enough for him to look for profitable opportunities in the PRC? Is there an archetypal “businessperson's view of China” to be found here?

2. Next, we might read the latest books in English on China's economic and commercial prospects

These books' message is brisk: China is China, either as it has been since imperial times or else as it has been since Mao took it over in the late 1940s. American businesspeople are “innocents abroad,” self-deluding dreamers at best, and cavalier fools at worst, suspending their normal tough-mindedness as they guzzle the seductive elixir of the limitless China market just as their predecessors did in nineteenth-century England and early twentieth-century America. Drunk on the “sheer numbers” of people in China, these merchants failed to notice the difficulties—poverty, barriers of language and culture, and logistics—that ultimately sent many of them home disappointed. Today, these books suggest, US businesspeople still fabricate a mythical cornucopia of commercial triumphs just over the horizon, willfully deaf and

blind to the evidence that China was, is, and will always be impenetrable and immune to their misdirected efforts.

Focused on China, the writers of these books maintain—if only by failing to look elsewhere—that China is unique as a graveyard for dashed business expectations.

They do not ask how overall returns on investment in other developing economies compare with those in China.

Focused on business aspirations, they forget about other Americans' dreams—some still very much alive today—of a China with new social, political or religious norms based on US or other foreign models.

Focused on business disappointments in China, they do not mention such domestic fiascos as the collapse of the American savings and loan sector or the more recent bursting of the dotcom bubble.

And they certainly do not spend their time on stories of business success or wise business planning by American firms.

We still haven't found the key to "the businessperson's view of China." We can—

3. *Look at the numbers*

China is awash in numbers and statistics. Maybe the numbers will speak for themselves, and a thorough search will lead to an inescapably convincing "businessperson's view of China?"

But which numbers? China's economic growth since the late 1970s, as reported by the National Bureau of Statistics or as measured by skeptical foreign economists? The ballooning foreign direct investment numbers since 1992 and especially in the past year? The figures showing China's foreign trade growth from practically nothing 25 years ago to hundreds of billions of dollars today? The statistics on the soaring number of mobile-phone and Internet users? The information on disposable income levels for China's emergent middle class? The data on exploding private ownership of dwellings and autos? There are plenty of numbers to suggest that this time around, China has achieved an economic takeoff that global business would be foolish not to notice and derelict *not* to factor into its own projections.

Others' quantifiers are less encouraging. No one outside of China, and few inside, who have looked at the financial system have written a persuasively rosy picture; many have seen darker visions. Though hundreds of millions of Chinese have left poverty behind in the last 20 years, millions more remain impoverished. The quantitative evidence of inequality in wealth and income between cities and rural areas, and coastal and interior regions, suggests the intractability of China's immense social, economic, and political challenges. Indices of environmental degradation can be daunting. The HIV/AIDS numbers are only now beginning to see the light of day. And doubts keep arising about the reliability of statistics in China.

So far we've looked at defining our terms, we've read the latest books, and we've pondered some of the quantitative signs that could help our hypothetical businessperson form "the businessperson's view of China." Still, we're not there. Of course, we can also—

4. *Take a look around*

It's hard to come away from a visit to many areas of China without the sense that the past 25 years amount to much more than a mirage.

Even as one sighs at the perpetual flow of media stories detailing investment bubbles, *guanxi*-driven real estate scams, or huge, white-elephant office blocks unrented, the movement and the economic energy in many Chinese cities and towns bombards the senses. And by the way: What is that huge billboard for life insurance doing above the main thoroughfare in remote Kashgar, at the western-most edge of China in Central Asia? And how did that sign reading "Love and Protect the Precious Fiber Optic Cable" wind up alongside the ribbon of asphalt running across the endless desert of western Gansu?

On the other hand, who are those people in tattered clothes camping out under bridges on the outskirts of this or that great city and scavenging through rubbish piles? Somehow, "the businessperson's view of China" needs to encompass the vitality and the suffering that are part of the China he or she is seeking to "view."

Still on the trail of "the businessperson's view of China," we certainly should—

5. *Listen to China businesspeople who have lived and worked in other developing countries*

Businesspeople with time on the ground elsewhere in Asia, Africa, the Middle East, or Latin America usually have interesting, and often balanced, perspectives on China as a business site. Employee productivity, human resources, localization issues, systems integration capacity, physical security, bureaucratic procedures, transportation challenges, intellectual property security, corruption, functionality of

telecommunications—take your pick. Ask Americans or businesspeople from other developed economies how China compares with other developing countries such as India and Brazil, which are closest to China in size, or South Korea, Taiwan, Indonesia, or Malaysia, among the major Asian developing economies. See what these veterans say.

It also makes sense to—

6. *Talk to Chinese friends, in-country and abroad*

What the Chinese think about their goals, their points of pride and longing, also provides insights for businesspeople about China, whether the “Chinese friends” are businesspeople, students, or employees.

We’ll hear exuberance at the electrifying discovery of opportunities to succeed in the “outside world?” We’ll hear fears of the overwhelming technical power of the advanced industrialized economies. We’ll hear bounding hope that China’s continued opening to international business will bring growth and jobs, exposing the dark and protected corners of the old society and economy (and even the old politics). We’ll hear grim conviction that foreigners’ high-tech productivity will throw millions of simple Chinese working people out on the street. We’ll hear familiar sounds about our investment dollars making money in China. We’ll hear pride in how much has been achieved in such a short time; we’ll hear sober assessments of how much remains to be done.

All right: we’ve done our due diligence. To find “the businessperson’s view of China,” we’ve defined our terms, read the books, waded through the numbers, walked around on the ground, talked to worldly-wise veteran business expatriates, talked to our Chinese friends and colleagues, and maybe even read a little history.

Can you, in my shoes, now come up with “the businessperson’s view of China?” If you can, I have a speaking engagement I’d love to have you fill.

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THE US-CHINA BUSINESS COUNCIL

Letter from the President

(ROBERT A. KAPP, PRESIDENT, THE US-CHINA BUSINESS COUNCIL)

IN THE HILLS

American businesspeople, journalists, and politicians accustomed to running up and down the East China coast, from glistening boardroom to humming twenty-first-century factory floor to the front end of the airplane, should take a deep breath now and then and go west, or inland—or even just get out of town. It is a refreshing experience, in many ways invigorating, and in some ways very sobering.

I was lucky to have had that chance recently. From a speaking engagement in Tianjin, whose famous Tianjin Economic and Technological Development Area houses advanced production facilities for some of the world’s most sophisticated companies, I headed to Sichuan, China’s most populous province, home to 130 million people.

In the provincial capital of Chengdu, I passed through a new airport that compared splendidly with the new airports of the coastal cities. I marveled at the extent of the urban development that has swept over this inland provincial capital since the days, 15 or 20 years ago, when Sichuan was a regular stop on my China itineraries. I visited a proud business owner whose brilliantly lit five-story emporium sold only high-end furniture and accessories made in Spain. Then I hit the road to see things I really hadn’t seen before.

And what a road. Heading north from Chengdu to Mianyang, “the road” was a gleaming, four-to-six-lane superhighway, perfectly graded and paved. When we hit 170 kilometers per hour, my eyes widened, not just out of fear, but out of a realization that, until a year or two ago, the Chengdu to Mianyang trip was a matter of endless hours and frustrations. Mianyang itself, with broad boulevards, beautifully tended public spaces, the massive Changhong Electric Co. television production facility rolling block after block through town, and a booming downtown commercial core, has been firmly “launched,” no matter how far from the coast it lies.

On the other side of Mianyang, the superhighway ended, and we exited onto another road—National Highway 108, to be exact—which connects the great southwest (as far as Yunnan) to the northwest and ultimately to Beijing itself. Kilometer posts showed numbers in the 2,000+ range, the distance to the national capital. Occasion-

ally the road could be called two-lane; most of the time it was “suck-in-your-gut” width.

Now the land heaved up; we entered the foothills of the Qinling, the great hill barrier that traditionally isolated the densely settled Sichuan Basin from the old imperial capital of Chang’an to the north (now the northwestern metropolis of Xi’an), and, indeed, from all of North China. We seemed to step back in time. The road was pitted and slow, overwhelmed with heavy trucks moving cargoes in and out of Sichuan on the only cargo route through the mountains. Country buses lurched and swayed, carrying peasants and traders from town to town, from county seat to outlying market villages, in this inaccessible region. Road maintenance was under way mile after mile—by hand. Sunburned men and women shoveled piles of river rock out onto the highway, sprinkled shovelful of asphalt over them, and waited for the passing traffic to pack the highway surface. When overloaded trucks ruptured their springs, dozens of vehicles waited—with a good-natured patience utterly unknown in Washington, DC, I might add—to inch by the impasse. I was reminded of the first thing that used to be said about Sichuan in the last century: “*Jiaotong bubian*”—“Transportation is difficult.”

The countryside was utterly gorgeous. Tiny fields of golden wheat alternated with rape or small plots of fruit trees. There were no large fields at all, no expanses of paddy, no plains of wheat, soybeans, or sorghum. The steeper mountainsides showed wild evergreen and deciduous growth. In market towns we passed warehouses where huge sacks of Chinese medicinal herbs from the mountainsides are collected and traded.

Roadside signs revealed that we had entered a region of poverty and announced programs for local government assistance to the impoverished. Aside from our highway, roads were scarce; the hills, bigger than the Appalachians but smaller than the Rockies, stretched out in layers to the horizon. People living in them walked to town. Yet children heading home from school were vividly clothed, their school bags ornamented with cartoon animals in bright colors. I wondered if there were other children for whom bright clothes—or school itself—were impossible.

We passed through the great Jianmenguan, a breathtaking narrow pass through towering vertical rock faces. We were on “The Road to Shu,” (as Sichuan was anciently called), formerly a stone track no wider than a single person, immortalized in Tang poetry as “more difficult than ascending to Heaven itself.” Steam poured from the engines of overheated trucks on their way up to the pass and out of Sichuan. Then we headed down, a racing river just below the side of the road. Now steam jetted from the hissing brakes of the heavily laden trucks struggling to navigate the twists and potholes on the steep descent.

By the end of the day, we had reached our destination: Guangyuan County Seat, essentially the last stop in Sichuan. The borders of Shaanxi Province, and of Gansu Province, gateway to Central Asia, lay a few miles further up the road.

In bustling Guangyuan, I learned from the mayor and his colleagues:

- Urban construction had recently blossomed, much of it funded by investors from the uniquely entrepreneurial city of Wenzhou in the East China province of Zhejiang.

- The military plants uprooted from East and Central China and flung into the inaccessible interior by Mao Zedong in anticipation of war with the Soviet Union 35 years ago had picked up and moved out, either back east or to more accessible locations.

- I was the second American visitor to Guangyuan in memory.

- There was now a new airport, with daily flights to key Chinese cities and connections through Xi’an and Chengdu to just about everywhere.

- Everyone was excited about China’s World Trade Organization (WTO) membership and hoped that it would bring opportunity to smaller and more distant communities like Guangyuan.

- Wahaha bottled water (the traveler’s friend in the scorching Chinese summer) had set up a bottling plant in none other than Guangyuan itself—living proof of a bright future!

But, most staggeringly, I learned that the superhighway that had taken me from Chengdu to Mianyang in an hour and a half would be completed all the way to Guangyuan by year’s end: by 2003, Chengdu would be three hours’ drive from Guangyuan County Seat. And the mountain communities through which we had labored would face a different future.

On the way back to the United States, I read intently about China’s rural economy and the problems it faces: declining crop prices; rising taxes and fees imposed on farmers by parasitic local-level government bodies filled with cousins and in-laws “eating imperial grain” (as they say about those paid with taxes and fees extracted from the peasants); rampant usurious lending to these peasants by bottom-rung cad-

res struggling to secure the money that must be sent up the administrative chain to meet tax and fee obligations; out-migration of millions of rural inhabitants unable to survive on the land and hoping for better times in the neon-lit cities and humming factories of the coastal enclaves; the difficulty of implementing centrally directed economic, political, and social reform in the face of entrenched holders of local privilege; and the potential power of modern exposé journalism. It was a reminder that much remains unsolved in this gigantic, fascinating, and sometimes incredibly lovely land.

For me, living in the world of favorite seats on 747s, busy business people, US and Chinese diplomats and government leaders, journalists and polemicists, congressional investigators, Washington trade diplomats, nongovernmental organizations, human rights campaigners, WTO trainers, and US and PRC think tanks, a couple of days on the road were more than a pleasant diversion. They were a reminder that all of us who engage with China are part of a human drama that we can only perceive in fragments, and that what we do in business and diplomacy connects to a big chunk of China's life in ways that we'll probably never fully grasp. Even so, I have a hunch we all ought to be thinking about what's happening outside of town.

Senator BROWNBAC. I hope, Dr. Kapp, you and your association can help us press the Chinese to move toward democracy.

That would be a thing to help us in establishing and moving this forward over a longer period of time. While they had a seamless transition in leadership, it was certainly not a democratic one that they went through. So, your help in that—you have got great relations there in the country. And I think for the relationship between the two countries to really maximize over a period of time, it needs to be one democracy to another.

Dr. KAPP. Sir, I know that we need to turn to our second witness. Just let me say that if we could have a private conversation, I would be happy to discuss some of the ways in which I, personally, have attempted to act in that manner.

Senator BROWNBAC. Good, thank you.

Ms. Rosen, thank you very much for appearing in front of the subcommittee. I have not seen you in a while. Good to see you again.

STATEMENT OF HILARY B. ROSEN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, RECORDING INDUSTRY ASSOCIATION OF AMERICA, WASHINGTON, DC

Ms. ROSEN. I like being before you in this committee very much.

Senator BROWNBAC. It is a better setting, is it not?

Ms. ROSEN. Much better setting.

And now I feel like the skunk at the picnic. I want to start by saying how humble it feels to be here testifying on an issue with such obvious self-interest when we are going through what we're going through in this country. So I am incredibly—I was moved by what you said about the relationship to the larger picture, and obviously grateful for your recognition, in particular, of the intellectual property issues as they relate to the larger picture.

My testimony will go on the record. I will just make a couple of points, because you have, for so long, demonstrated such good understanding of some of the issues that we are facing.

Obviously, I have been involved in issues related to China for some time, and during that time there have been good developments and bad developments. And I will start with the positive.

In the early 1990s, China was the largest pirate exporter of music in the world. There were over 25 domestic CD plants when

the legitimate market would have been served just fine with one plant. It was the will of the U.S. Government and the response of the Chinese Government that changed that situation dramatically. The Chinese Government instituted regulations and enforced laws to change the working nature of those plants. In some respects, they shut down more than half of them; and, in others, they forced them to go legitimate. That progress continues to this day. We do not see a pirate export market out of China. It has drifted to other parts in the region, like Taiwan, which we will talk about another day.

But the problem that we face in China now is a great problem and one that was left unresolved, I think, by the Chinese Government's will those years, and that is really the domestic piracy problem. What we have is, as you said Mr. Chairman, virtually a 90 percent pirate market for all intellectual property goods. That is for us—Mr. Freeman called it the \$64,000 question—I think we see it more like a \$2- or \$3-billion question, and that will not be resolved until the Chinese officials take more steps to meet their TRIPS obligations under the WTO.

Specifically, I will give you some of the things we think they have to do. They have to change the threshold laws for criminal prosecution. There are procedural hurdles in their laws that they need to change. And then once they change those laws, they need to appoint some high-ranking—perhaps a Vice Premier to be in charge of the anti-piracy long-term enforcement. They need an anti-piracy task force within the enforcement authorities that is given the resources to do the job they need to do. As you said, Mr. Chairman, they seem to find police officers to energize the things that they decide are important, and we think that they should do it here. Finally, looking forward, we think that they should ratify the WIPO treaties for the Internet, which would mean adopting laws domestically that would implement the WPPT and the WCT treaties.

So there is a lot that they can do. We think that it is something that they certainly could do if there was a significant will there.

There is one other issue that I think is worth mentioning here which really does affect the domestic piracy situation, and that is the market access issues. For our industry, there are very strict rules of how foreign record companies can access the Chinese market. They have to be done in minority stakes with the controlling elements of investment and production and distribution, even investment and talent, being done by Chinese companies. That obviously limits our abilities in several areas. It limits our abilities to work effectively with law enforcement on anti-piracy, and it restricts our capacity to grow businesses and return moneys for a favorable balance of trade, which we think could be somewhere over a half-a-billion dollars just for the U.S. record industry.

But there is a problem here, which is that the market access provisions directly are not a violation of their WTO obligations. It is simply the effect of them for some odd reasons.

Presumably, the market acts as provisions exist in China for the record industry because they want to maintain control over content. The Chinese Government has very strict rules for foreign sound recordings, and they are subject to significant censorship.

Any music that is regarded as unsuitable for public consumption is rejected. And the Chinese have very tough laws punishing offenders for releasing uncensored materials.

Obviously, this system of censorship would exist if we were permitted access to the market. I see the irony in your face, Mr. Chairman, as I am having this conversation.

Senator BROWNBACK. You are tempting me. You are tempting me.

Ms. ROSEN. But the problem here is that in China these provisions only affect a legitimate market, not the pirate market, which is such a dominant source of access for consumers that it makes no sense.

The Rolling Stones are about to go to China. It has been well publicized. They are touring in several major cities the first week of April. And they have been told not to play certain songs in their concert, and the Stones have agreed not to play certain songs in their concert.

The irony is that the pirate versions of all of those censored songs are available everywhere on the streets and will be sold by the thousands and thousands, maybe even millions, the week of the Stones concert. But the legitimate CDs, which have those songs deleted, are obviously not going to sell. And so they have effectively created the forbidden-fruit aspect of the pirate marketplace in a way that hurts U.S. economic interests dramatically and obviously puts complete holes in their decisions on market access.

So we are grateful for this committee's interest in these issues and hope that, as you convey your concerns about intellectual property to the Chinese Government, that market access restrictions, as you see them, will also be a part of that discussion. Again, while it is not a violation of their WTO obligations directly, we think that it significantly creates incentives in the pirate market that do prevent their ability to be in compliance on their enforcement promises.

Next month, China is going to host the World Intellectual Property Summit celebrating the importance of intellectual property for improvement of the condition of society and the betterment of man. We are supportive of this conference and grateful that China is interested in hosting it and welcoming so many foreign visitors. Let us hope that the recognition of these issues, though, are followed through in Chinese action.

And this committee, I think, knows better than most that the greatest breakthroughs that we have had in China have been when the U.S. Government has been most aggressive, most active, and the U.S. Congress as its partner with the administration in those times. We have seen it occur successfully in the late 1990s. We can see that again.

Thank you.

[The prepared statement of Ms. Rosen follows:]

PREPARED STATEMENT OF HILARY B. ROSEN, CHAIRMAN AND CEO, RECORDING
INDUSTRY ASSOCIATION OF AMERICA, WASHINGTON, DC

Thank you for holding this important oversight hearing. China's impact on the US economy is significant, and it is important that Congress stay involved along with the Administration to ensure that Chinese law and practices continue to evolve in ways that reflect its place in the international community, and its international obli-

gations. I have been personally involved in working on issues related to China for nearly two decades, and can state that there have been both good and bad developments over that time. I can also advise this Committee that the greatest breakthroughs in China have come during the times of the greatest engagement by the US Government. I therefore urge the Subcommittee to remain engaged, and to convey along with the Administration to the Government of China that it expects progress in areas where Chinese practices have lagged. We ought to be straightforward with our praise, and with our criticism, because only with transparency will we be able to effectively deal with the problems of today and tomorrow.

With that as my guide, let me offer my views on the successes and failures that we have witnessed in China over recent years. Let me start with the positive. In the early 1990's, China became home to the largest concentration of pirate CD plants the world had known. Largely financed and operated by Taiwanese syndicates, China amassed over 26 CD plants at a time when 1 plant would have had sufficient capacity to meet all of China's legitimate needs. These 26 plants produced pirate CD's around the clock, almost entirely for export. During these dark days, Chinese pirate exports decimated surrounding markets, and we witnessed significant declines in markets throughout Asia. In 1996, this came to a grinding halt. Faced with the imposition of US sanctions to the tune of approximately \$1 billion a year, the Chinese authorities took swift action, shutting down half of the plants, impounding the equipment, and introducing a new licensing regime for the remaining plants to create more of a deterrence for future piracy. This plan worked, and continues to work. To this day, we have not seen the resurrection of an export based pirate industry in China. Unfortunately, other countries have picked up where China left off, but we leave that story for another day.

This triumph is not to be underestimated—either with respect to the US commitment to address it, or with respect to the Chinese determination to resolve it. The fact that this success has lasted is a testament to the manifest will of both parties. It is now time, however, to turn our attention to the issues that were left unresolved, and which continue to be unresolved to this day.

Simply, and transparently, put, piracy in China for all categories of copyrighted materials exceeds 90%. In the music sector, piracy hovers at approximately 95%. This is, quite plainly, unacceptable. The Chinese Government has itself expressed dismay at these levels of piracy—levels that it does not challenge, but it has not organized itself, either from a legal or practical standpoint, to do anything meaningful about it. Many Chinese officials have undertaken sincere efforts to address this, particularly within the Ministry of Culture and within Customs, but they lack both the necessary manpower, and legal support, to get the job done. As a consequence, Chinese officials can, and have seized over two hundred million pirate CDs over the past two years—a truly staggering sum, but have not had any impact on piracy in China due to the fact that there are no criminal prosecutions. This failure is exacerbated by some legal impediments to bringing criminal copyright cases, but it is primarily the consequence of the lack of will on the part of relevant Chinese officials to pursue these cases criminally. USTR and other parts of the Administration have been discussing this lack of criminal prosecutions with China for some time, and continue to do so, but have yet to see any resolution or even any meaningful progress. This is unacceptable, and demands an immediate solution. If China does not quickly get a handle on the CD piracy issues, then all will be lost as we move to try to address internet issues, issues which are already beginning to heat up in China notwithstanding the Chinese control over other kinds of content on the net.

Rampant piracy led to an estimated loss of \$600 million for the recording industry alone last year, with losses for US repertoire amounting to about \$48 million per annum. The problem, of course, is that the profits are so high, and the deterrence is so low. Given the lack of criminal prosecutions, and the fact that enforcement manpower and resources devoted to combat piracy are clearly inadequate, the authorities are in reality, fighting a losing battle. Until China modifies its legal system to facilitate criminal copyright enforcement, and directs all parts of the enforcement structure to deal with copyright matters as a priority matter, China will not be in a position to meet its TRIPS obligations to provide effective enforcement. Criminal penalties in particular are required by TRIPS as an essential element of an effective enforcement regime, and these, as a practical matter, are simply lacking in China at the moment.

Aside from the resource and legal issues impeding China's anti-piracy performance, there are also the complications arising from the fact that foreign record companies are only permitted very limited access to the Chinese market. This not only limits our ability to partner with law enforcement in the battle against piracy, but also restricts our capacity to improve the infrastructure for the development of local talent, and for the manufacturing, distribution, promotion and sale of legitimate re-

cordings. China has determined, consistent with its WTO obligations I hasten, however sadly, to add, that it will only allow very limited forms of foreign participation in the development of the cultural industries.

This is a grave error that we hope the Government of China will reverse. Presumably, the idea behind limiting our access to the Chinese market is the desire to maintain control over the content that reaches the Chinese public. While we may or may not agree with this goal, the fact remains that it can be upheld while simultaneously permitting us much broader access to the Chinese market. All foreign sound recordings, whether licensed for local production or imported by a Chinese state firm for the Chinese mainland market, are subjected to strict censorship. Any sound recordings regarded as unsuitable for public consumption are rejected. The Chinese have very tough laws punishing offenders for releasing uncensored materials. This system of censorship offers more than sufficient safeguards concerning the content of cultural materials. Limiting our ability to do business in China is unnecessary, and destructive.

It is also highly instructive to note that if these market access provisions are indeed intended to guard against unwanted content, that such an objective is completely undermined by the total lack of control over piracy. The controls over content affect only US owners and their legitimate Chinese partners, but have no bearing on the pirates' activity whatsoever. Indeed, the inability to release materials EXCEPT in pirate form creates yet an additional competitive advantage for the bad guys. There is simply an enormous disconnect in China between the indifference and permissiveness shown towards the distribution of supposedly "undesirable content" on illegal carriers, and the great abundance of impediments placed in selling legitimate materials. This gap or double standard fuels the vast demand for piracy while ensuring that legitimate industry cannot compete. Present Chinese policy operates to effectively grant illegal enterprises far greater access to consumers than legitimate companies. This must be reversed through the significant liberalization of China's restrictive regime so that at a minimum, legitimate ventures can operate with at least with the same level of access to consumers as pirates.

At present, almost every aspect of operating a recording company is restricted. The basic business of a recording company is to release or publish recorded music, whether in physical format such as CDs or cassettes, or via transmissions. Chinese investment laws prohibit any foreign investment in this scope of business. Therefore our companies have to find a Chinese state owned publishing house or company to release or publish their recorded music in China, regardless of whether there is any company suitable as a partner.

Record companies need to sign artists, select suitable compositions, produce the recordings in a studio, manufacture physical products, and distribute these products to the public. Here we can see trade barriers erected at every stage in the process. Chinese law prohibits us from investing in a company to promote our own artists. Chinese authorities only issue permits to production houses wholly owned by locals, and allow only a minority stake in joint ventures or cooperative joint ventures for manufacture or distribution.

These trade barriers restrict us from doing business effectively or successfully in China, and contribute to the Chinese Government's inability to effectively address piracy. We hope that members of this Committee can convey to your Chinese counterparts your interest in extending the market access of US record companies, and in seeing China address its serious shortcomings in connection the enforcement of its copyright law through criminal measures. There have been encouraging recent statements from Chinese leaders about the need to address the overwhelming copyright piracy problem that affects US and Chinese creators alike, but these expressions of understanding alone will not solve the problem. To meet its WTO obligations, it is essential that China immediately commit to a course of action that will materially decrease the level of piracy in the Chinese market. In order to achieve this, China should closely consider expanding the market access it grants to foreign firms so that it will have powerful new allies in expanding the capacity to deliver legitimate materials to the Chinese public, and in confronting the scourge of piracy.

In just over one month, China will host the World IP Summit celebrating the importance of intellectual property for the improvement of the condition of society and the betterment of man. Let's hope, no, let's WORK, to translate this recognition of the value of copyright protection into meaningful action on the part of the Chinese Government to finally address this devastating problem.

Senator BROWNBACK. Thank you. You know, it just seems to me, that you just really have to press the Chinese on these issues to get anything going.

On the domestic cases, you positively noted the export piracy has been—much of that has been shut down, but the domestic situation is not. Do you know of any, or how many, cases the Chinese Government has brought domestically against domestic piracy?

Ms. ROSEN. Well, the problem is they have done a lot of seizures. Over the last couple of years, we think they have probably seized 2 million disks from the pirates, but they do not prosecute them because the will of the prosecutors is lacking. Also, their laws have very strange thresholds and strange provisions that simply guarantee that the prosecutors are not going to have the ability to give criminal jail time, which is really, as we know with piracy, the largest deterrent.

Senator BROWNBACK. So you do not know of any cases brought against domestic piracy or domestic selling of these pirated products in China?

Ms. ROSEN. We do not know of a single case where there is—one case, perhaps, where there was some conviction, but it was short-term.

Senator BROWNBACK. Out of 2 million disks that have been confiscated, one case?

Ms. ROSEN. Yes.

Senator BROWNBACK. Have you brought this issue up either to the Chinese Government or the U.S. Government for a response, why have there not been more domestic cases, why have you not changed the law so you can prosecute these cases?

Ms. ROSEN. Yes, weekly.

Senator BROWNBACK. And their response?

Ms. ROSEN. Well, as I think you know, the Chinese Government is only so responsive to business. Maybe Dr. Kapp has some ideas there. But the domestic Chinese music industry obviously has an incentive, as we do, to see more prosecutions, and there is just not a response.

I think USTR has been terrific in pressing these issues, and I think they are as frustrated as we are with the lack of action on the Chinese Government's part.

Senator BROWNBACK. So, you bring it up, but there is just no response. Does the Chinese Government—

Ms. ROSEN. It is the mother-in-law test. That is my new—I love that analogy.

Senator BROWNBACK. Well, do not tell my mother-in-law. I am in trouble, then.

Ms. ROSEN. Good thing this is not on C-SPAN.

Senator BROWNBACK. What is the Chinese Government response to you when you raise this with them?

Ms. ROSEN. Well, the good news is that they acknowledge that there is a problem. The bad news is that they are not doing anything about it. So I think that we feel like we are being “yessed,” but we are not being responded to.

Senator BROWNBACK. My guess is, too, that when you represent the entire intellectual property industry here at this hearing, but software, movies are as bad, if not worse than what the recording industry—

Ms. ROSEN. Absolutely. And in fact I think, for the U.S. music industry, we may be the smallest victim on a daily basis in terms

of overall dollars. Software, video games, films are extremely significant. You know, software, I think, is a billion dollars of the \$2 billion total that we think we are all losing.

Senator BROWNBACK. Mr. Kapp, do you have any thoughts on this? I mean, this has been a well-known problem for some period of time—of how we should address this?

Dr. KAPP. Senator, it has. As I start to answer, I should say, in case I did not make it clear earlier, that since Charles Freeman enunciated the series of serious issues, that by the end of China's first year in the WTO, had emerged as requiring improvement—agricultural TRQs, intellectual property, transparency, capital requirements and so forth—one of the reasons that I did not recite those myself was that Charles had already done them, and, in a sense, had laid out the major list of blocks of concern that USTR and the business sector feel very strongly about. So any omission of that list from earlier remarks was not intended to de-emphasize those, but rather simply not to repeat them.

You know, the problem in China is that the place is evolving in the direction of adherence to universally applied laws, but the process is sometimes very slow. We have just done a compilation of basic information on all the provinces and cities. Even it's with all the little different colored blocks, is sort of a symbolic representation of the fact that the PRC today has left Stalinism behind to a very significant degree; is really not totalitarian by most people's definitions anymore; and has given a wider range of latitude of behavior to people in their lives in their ordinary communities, much wider than was the case 10 years ago, but, at the same time, has a problem making its writ stick. It has trouble collecting taxes. It has trouble, even when it wishes to, in pushing down on local society to do what Beijing says.

So people like our friends at USTR and people in the association, they know. Beijing generally gets it. The people in Beijing, the ones who signed the WTO deals, they understand the terms, they understand the concepts, they understand the benefits. The minute you get, metaphorically speaking, a hundred miles out of town, you are into a world where local interests play a much, much bigger role. I think Hilary Rosen knows this well. If a local party secretary, who has to report on whether or not he is keeping unemployment under control ultimately to the boss up in Beijing somewhere, if he has got a factory turning out pirated materials that keep 250 people on the job, he has got a conflict. The law says eliminate piracy, and he says, "I have got to show my boss that I am keeping unemployment low." I am not apologizing for—it needs to be ended.

The pressure does need to begin with the central authorities, I believe, and to be expressed both legally and educationally downward throughout the society. We all have a role to play in that. I think many American trade associations now are contributing positively to a fuller understanding of key concepts and of the value of adherence to those concepts at the local level than used to be the case. But it is not fast enough for any of us, and I do not disassociate myself from anything that Ms. Rosen said on behalf of the recording industry, or the software and the other creative industries. It is a large structural problem.

Now, years ago, when I was still out in Seattle working in a very small organization, one of my friends at a software firm in Seattle told me that in those days, and that was before China became as big as it was today, the biggest single intellectual property abuser that they faced, by value, was Germany. And the reason it was Germany was that even though the incidence of abuse was lower, the pervasiveness of the computer and of the use of software was so great that, in dollar terms, Germany looked even worse than China. That was, however, before China really took off into the massive electronification and digitalization of the economy.

Senator BROWNBACK. Ms. Rosen.

Ms. ROSEN. I think that that answer, with all due respect to Mr. Kapp, was extremely kind, but really too indulgent.

Dr. KAPP. The whole answer, or just the German part?

Ms. ROSEN. The German part is history, I think. Germany enforces extremely well, as far as I can tell.

Too indulgent for a couple of reasons, because this is not a capacity-to-succeed issue in China. We see, before every important state visit, that the streets are cleaned up. We see that, in 1997, when the Chinese Government thought that the future of their bilateral relationship with the United States in other issues was at risk, they cleaned it up. They have the ability to do this. I fully subscribe to what you said earlier, Mr. Chairman, that if we left some of these issues to the resolution of the global geopolitical future of China, though democracy is an important and laudable goal, that there would always be an excuse not to do the thing right before them, the problem right before them. Unless all of the issues of the relationship were addressed, then why should we bother addressing this one? Our experience in this country has shown, particularly on issues like trade within bilateral agreements, that the more specific we are, the more insistent we are on action on specific issues, the better our results are.

Senator BROWNBACK. Thank you, and I want to thank the panel. And I just would mention, Dr. Kapp, as you leave, I work with a number of companies that are working in China. Now, that is a good thing. And I have seen enormous progress taking place in China since the first time I went there in 1984-85. Beautiful. Great for the individual life that is there. I am very concerned that if they do not continue to—if they do not move forward positively on a broad-based agenda, that a number of businesses from the West, from the United States, that invest there are going to be in a difficult situation if we get in a confrontational situation. EP-3, I was glad it got resolved. It also sowed a worrying note to a number of people that this is not the alliance or partnership that some had hoped for. This is still an adversarial relationship, and a number did not think that it was. And that's very troubling, because we have a number of businesses in the United States, a number of businesses in China, that have heavy investment there, they have heavy economic relations back and forth, and if the progress does not continue to be made on democracy, human rights, and the basic, opening up the society, on a free press, on military issues, we could really be—we would be doing two things that could be very bad. One, we could have a lot of investment that is going to be in difficult circumstances down the road. Two, we could actually

be paying for the modernization of a potential adversary in the future. And I just really hope that with all the relations that our business community has, which are very positive, and that is the strength of the relationship now to the United States and China, is the business and the economic relationship, that it helps move it forward on these other fronts that are lagging, that are not moving as aggressively as they need to, and they sow very worrisome notes for a lot of people.

Dr. KAPP. Senator, when you have a minute to look at the written testimony, I think you will discover that, in a way, you have said better and certainly more briefly what I tried to say myself and what I opened with today.

I do think the business and commercial relationship has grown beautifully for many people. It has got a lot of problems. There are some businesses who are very unhappy. But, by and large, it is become a very, very big enterprise for both sides. But it cannot survive in a vacuum, and I think that is what you're saying. If the other dimensions of this large relationship are not carefully managed with a view toward a long-term, you might even say strategic emerging and improving of both sides' interest, it will be to the detriment of our economic engagement with China, no matter how large today's trade volume. You are saying, if these other dimensions are not properly—I hate to use that old word, but it requires “engagement.” And I think, again, that you, yourself, from what you have said today on this subcommittee by having this hearing at the beginning of a new Congress in a period of great international tension, are laying the groundwork for the effort that needs to be made within our country and bilaterally. I hope we can proceed with it.

Senator BROWNBACK. Thank you very much for joining us.

Dr. KAPP. Thanks.

Senator BROWNBACK. The third panel will be Dr. Larry Wortzel—he is with The Heritage Foundation in Washington, DC—and Dr. David M. Lampton, director, Chinese Studies at The Nixon Center, Washington, DC.

Dr. Wortzel, delighted to have you joining us. We will take your written statement into the record, and you can summarize if you would like.

I will set the clock at 7 minutes to give you some warning about what is going on.

STATEMENT OF LARRY M. WORTZEL, PH.D., VICE PRESIDENT AND DIRECTOR, THE KATHRYN AND SHELBY CULLOM DAVIS INSTITUTE FOR INTERNATIONAL STUDIES, THE HERITAGE FOUNDATION, WASHINGTON, DC

Dr. WORTZEL. Mr. Chairman, I appreciate the opportunity to submit a statement for the written record. I also want to thank you for inviting me.

China is rising as both an economic and a strategic power in Asia, and it has great influence over what happens on the Korean Peninsula, so it is an important country that cannot be ignored.

It is also important that you hold this hearing, because a lot of Americans have been critical that the United States is incapable of conducting a war on terrorism around the world; of managing dis-

arming Iraq, if necessary, and I think it will be necessary; of supporting the democracy on Taiwan; and addressing the North Korean nuclear program. The fact that this committee is holding this hearing demonstrates the really powerful capacity of our democracy to manage a lot of strategic challenges in a decisive way.

China is involved in all these things in one way or another. It is a permanent member of the U.N. Security Council. It supported—I would say it half-heartedly supported—the war on al-Qaeda. It did it for its own interests because it wanted to be able to face, I think, a credible internal terrorist threat. Beijing supported U.N. Resolution 1441. Since then, they have made it clear that they did not support the use of force in Iraq. But thanks to French intransigence on the Security Council, Beijing did not really have to take a position there. They kind of got away with it.

I think we have very serious disagreements with China over the question of Taiwan, the island republic's sovereignty, and about American arms sales under the Taiwan Relations Act. But I think that there is a common agreement that neither China nor the United States right now wants to see that problem resolved by force. And I do not think either China or the United States wants to see a war on the Korean Peninsula. I think China wants to see a divided Korean Peninsula. It does not want to see it unified democratically.

With respect to Korea, senior generals in the People's Liberation Army made it clear to me when I was a military attache in China that Beijing will not permit the collapse of North Korea, and any American attempt to act in North Korea in a military way that is not coordinated with China, they say, could well result in the situation that we saw in 1950, with the involvement of the Chinese military.

China provides 70 to 88 percent of North Korea's fuel needs and roughly 40 percent of North Korea's food needs. There is no country in the world that is more capable of putting pressure on North Korea than the People's Republic of China. The result of that is, I think that Beijing finds itself in a diplomatic position that it enjoys because it has got diplomats and legislators from Tokyo, Seoul, Washington rushing over to Beijing to seek their assistance with the North Korean nuclear program. That parade of visitors really puts China at the center of a regional issue, and I think the politburo welcomes that. At the same time, China's worst fear is probably a re-militarized and nuclear-armed Japan.

So this is not as simple a matter as China ignoring their proliferation agreements and giving nuclear weapons and missiles to Pakistan. They have got a higher stake here. I can tell you that there is a debate going on in Beijing about what to do, but the people that are calling Americans hegemonists are winning this debate. Beijing is not moving decisively on what they could do.

I think that we must continue to attempt to resolve the North Korean problem in a multilateral forum. Beijing is essentially carrying Pyongyang's water, trying to encourage the United States to negotiate bilaterally with North Korea. I think to do that would isolate South Korea and would be a serious mistake.

Now, let me talk for a minute—Mr. Chairman, you have covered the broad trade statistics. They are in my paper. I am not going

to cover those again. But I think it is fair to say that free trade builds wealth and prosperity for the United States and all involved in the fair exchange of goods, and China has benefited from turning away from a Stalinist system to a market economy. Economic freedom in China has created a body of entrepreneurs and of ordinary citizens who have a variety of choice about where they live, where they invest, and what they buy. At least in the economic sphere, that gives the Chinese Communist Party less control over individual lives.

It is a dictatorship. It is a Leninist dictatorship. I think that the Chinese people are quite capable today of realizing that if you can pick where you live, if you can pick the car you buy, if you can pick where you invest and make wise choices in the marketplace, you can figure out who is going to be the best elected leader. It is the People's Liberation Army and the security forces that prevent that from happening. I hope someday we see that change.

World foreign direct investment flows into China between 1995 and 2000 were \$245 billion, but China did not attract the most FDI out of the United States. It went to Hong Kong and Singapore. What that tells us is that the rule of law, abiding by international rules, are what affects the investor community, and I think that is what China realizes.

I want to emphasize that I support free trade and I think we need prudent national security controls on exports. There are some areas where the United States maintains a significant advantage in technology that has direct military application. We should do nothing to make the People's Liberation Army a greater threat or to make it more effective at suppressing the Chinese people.

I think that the biggest area where we could come into conflict in China is not Taiwan and is not North Korea, but it is China's excessive territorial claims and its unwillingness to allow the free passage in international airspace and waters. The EP-3 incident was an example of that. I find that very dangerous. I think we need to work on it.

I will close with a comment on capital markets. I think that Chinese participation in our capital markets is a positive thing. Mr. Chairman, anybody that gives you a straight-line prediction about where China will be in 20 years is making it up. The United States policy is about right. We ought to encourage reform, and we ought to anticipate a China that has an educated populace, a productive work force, and a nation that operates in a world of rules. But we have got to handicap the potential outcomes, and I would give that outcome about a two or three in five. We could see a collapsed China with a floating labor population tearing the country apart, or we could see an emerged Chinese state that will have a powerful coercive military that threatens its neighbors and the United States. So while we embrace the possibilities that lead toward that first outcome, we have got to maintain our military edge and the ability to defend American interests in the event of the latter outcome.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Wortzel follows:]

PREPARED STATEMENT OF LARRY M. WORTZEL, PH.D., VICE PRESIDENT AND DIRECTOR, THE KATHRYN AND SHELBY CULLOM DAVIS INSTITUTE FOR INTERNATIONAL STUDIES, THE HERITAGE FOUNDATION

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Mr. Chairman and distinguished members of the Committee, thank you for inviting me to address the regional factors related to China's rise as an economic and strategic power in East Asia. With respect to the security problems on the Korean Peninsula, China is a prime actor. More broadly, China's economic growth, its military capacity, its industrial strength, and its entry into world economic markets challenge its regional neighbors and the United States.

Today's hearing comes at a critical time for the American people as well as America's friends and allies. Some Americans have opined that the United States cannot keep its focus while it conducts a war on terrorist organizations, stands ready to disarm Iraq, continues to support the democracy on Taiwan, and addresses the problem of the North Korean nuclear program. The very fact that the Senate Foreign Relations Committee is holding this hearing demonstrates the powerful capacity of this democracy to manage multiple complex strategic challenges in a mature and deliberative, yet timely and decisive way.

China is involved in all of these issues in one way or another. As a permanent member of the United Nations Security Council, Beijing gave half-hearted support to the war against al-Qaeda and the Taliban in Afghanistan. Beijing also professes support for the long-term war on terrorism, believing that it faces its own internal Islamic separatist terrorist threat. With respect to Iraq, while Beijing supported United Nations Resolution 1441, the Chinese leadership made it clear that it did not support the use of force in Iraq, but French intransigence permitted Beijing to avoid taking a position in any subsequent vote. Over Taiwan, the United States and China disagree about the question of that island republic's sovereignty and about American arms sales under the Taiwan Relations Act; but it is fair to say that neither Beijing nor Washington wants to see the question of Taiwan's relationship to the communist government of China resolved by force. Neither the United States nor China wants to see a war on the Korean Peninsula. I believe that China would prefer to see the Peninsula divided and loathes the idea of a unified and democratic Korea.

Let me address Korea first and then turn to economic and other regional security factors.

THE KOREAN PENINSULA

Developments on the Korean Peninsula have worked to increase Beijing's political influence in the region. During the years I worked as a military attaché in China, the senior generals of the People's Liberation Army made it clear that China would not let North Korea collapse. I was consistently told that in the event of a major crisis, war, or collapse in North Korea, China must be consulted on any military action to be taken. Three senior generals who fought against the United States in the Korean War stated that if U.S. forces had to stabilize a collapsed North Korea or move into North Korea to fight there again, and those forces approached the Chinese border without consulting with Beijing, it could force the Chinese military to enter into Korea as the PLA did in 1950.

China provides somewhere between 70 percent and 88 percent of North Korea's fuel needs and between 30 percent and 40 percent of North Korea's food needs. Secretary of State Powell has given a range of figures for China's support for North Korea, as have other U.S. officials. The figures I cite are from the former defense minister of South Korea. It is clear that the statements of Chinese generals that Beijing will not permit North Korea to collapse are correct. Moreover, the magnitude of this aid means that the People's Republic of China is probably the country with the most influence over North Korea. Unfortunately, Beijing seems unwilling to pressure North Korea to end its nuclear program.

I believe that the leadership of China finds itself in a position that it enjoys. Diplomats and legislators from Tokyo, Seoul, and Washington are rushing to Beijing to seek assistance in ending the North Korean nuclear program. This parade of visitors puts Beijing into a central position on regional issues that the Chinese Communist Political Bureau must relish. Moreover, the fact that China's nuclear proliferation to Pakistan has been more or less accepted by the United States means that Beijing has managed to undermine a major pillar of American foreign policy—the non-proliferation regime. The situation with North Korea is more delicate than that in Pakistan, however, because Beijing fears that a nuclear-armed North Korea could drive Japan to abandon its peace constitution and even to consider expanding its military capabilities to include nuclear weapons and delivery systems. Centuries of animosity and war between Japan and China have left deep clefs between the two countries. The last thing Beijing wants to see is a re-militarized Japan. United States diplomacy must emphasize to Beijing the potential consequences of failing to stop North Korea's nuclear program, and of China's proliferation behavior.

The senior leaders of the Chinese Communist Party continue to support the negotiating position of North Korea in dealings with the United States. Both Pyongyang and Beijing insist that the only way to resolve the diplomatic and security dilemma is direct negotiations between the United States and North Korea. Seoul also prefers to see direct U.S.-North Korean talks. I believe such an approach would be a mistake. Any solution to the nuclear program in North Korea must be multilateral. The same is true for North Korea's economic problems.

The 37,000 U.S. troops in Korea are part of a United Nations Command. The U.S. fought in the Korean War and negotiated the armistice ending the fighting on the Peninsula on behalf of the United Nations. The International Atomic Energy Agency, the body charged with monitoring the North Korean nuclear program, is a United Nations agency. Russia, Japan, South Korea, China, and the United States all have a stake in any outcome in Northeast Asia. The Korean Energy Development Organization, or KEDO, which provided heavy crude oil to North Korea under the 1994 Agreed Framework, is a multilateral organization. Finally, bilateral United States talks with North Korea only serve to isolate South Korea and freeze Seoul out of the settlement of the security threat it faces.

An interesting facet of the 1953 Armistice ending the fighting on the Korean Peninsula is that South Korea refused to sign and has not signed to this day. Instead of arguing for the United States to negotiate bilaterally with the North, Seoul should begin its own talks to finalize that armistice. Ending the state of war on the Peninsula would open the way for a wider round of regional talks about trade and economic development for North Korea if it verifiably ends its nuclear program.

All of the nations involved on the Korean Peninsula recognize that North Korea must resolve its food and energy needs, as well as its economic problems. Pyongyang must do this by reforming its Stalinist, command economy; changing its military-first policies; and ending the use of blackmail to gain concessions from its neighbors and the world. There should be no help for North Korea, however, until Kim Jong-il meets the obligations he has to South Korea and end the nuclear program.

FREE TRADE AND NATIONAL SECURITY

Free trade builds wealth and prosperity for the United States and all involved in the fair exchange of goods. China has benefited from turning from a Stalinist, centrally planned system toward a market economy, as have the Chinese people. The increase in economic freedom in China has created a body of entrepreneurs and ordinary citizens who have a variety of choices of where they live, how they invest, and what they buy. This means that the state and the Communist Party have less control over major aspects of the lives of China's citizens.

China's turn to a market economy has produced consistent economic growth for the country. Its economic standing in Asia has given Beijing political influence in the region, and China's trade with its neighbors has grown rapidly. According to recent estimates, China's gross domestic product today is \$1.1 trillion. The future growth rate for China's gross domestic product is expected to be between 7 percent

and 9 percent, according to the *Economist Intelligence Unit*. Regionally, only Vietnam is expected to have that potential with a future growth rate of 7 percent. Japan is projected to have a future GDP growth rate of only 0.7 percent. The Taiwan Institute of Economic Research (TIER), a major private think tank on the island, on November 7, 2002, revised its 2002 economic growth forecast for Taiwan slightly downward to 3.05 percent from 3.09 percent. Singapore's economic growth is expected to reach 3.1 percent in 2003 and accelerate to 5.1 percent in 2004, according to the February 10, 2003, issue of *The Economist*.

China's merchandise exports grew 301 percent between 1990 and 2000, greater than the rest of Asia except the Philippines, where exports grew at a rate of 391 percent for the same period. China is attracting needed capital and export markets away from its neighbors. World foreign direct investment (FDI) flows into China between 1995 and 2000 were about \$245.1 billion. For Hong Kong and China combined, investment flows reached \$377 billion. By comparison, for the same period South Korea only attracted \$33.1 billion in FDI, Singapore \$52.1 billion, and Malaysia \$31.3 billion, according to the July 2002 *Report to Congress by the U.S.-China Security Review Commission*. However, China did not attract the most U.S. FDI for the same period. China received \$6.8 billion while Japan attracted \$21.4 billion, Hong Kong \$13.7 billion, and Singapore \$13.4 billion.

The lesson for Beijing here should be clear: American capital—Western capital in general—flows to nations with stable legal systems, the rule of law, strong property rights, and transparent banking and financial systems. That is the lesson of *The Index of Economic Freedom*, published annually by The Heritage Foundation and the *Wall Street Journal*. It is an outcome that supports United States policy goals in trading with China: the creation of a market economy, increased rule of law, and a China that functions in the world abiding by rules-based behavior.

I believe that American trade with China benefits the United States. Such trade creates and supports American jobs. At the time that trucking unions demonstrated against permanent normal trade relations with China, in 2000, about 40 percent of the shipping containers that passed through the port of Seattle, Washington, contained goods bound for or being imported from China. Those containers translate into American jobs.

Competition in the marketplace creates an environment in which industries must innovate and transform themselves or face obsolescence. Corporations and whole sectors of industry revitalize themselves in the face of fair competition. That said, there are prudent reasons for national security controls on certain exports where some goods are withheld from the marketplace. If a nation poses a direct threat to the United States or its allies, or if its security policies pose a latent threat, it is prudent to restrict the sale of military goods to that country. This is the case with China, especially because of China's explicit threats against Taiwan. Also, given the history of the use of the Chinese People's Liberation Army to suppress the democratic movement in the 1989 Tiananmen Massacre, there is no reason to make the Chinese military a more effective force.

With respect to dual-use items—those with both military and civilian application—I would encourage a careful examination of licenses with increased end-user verification as well as pre- and post-license checks. Where the United States is the world's unique possessor of technological and manufacturing capabilities with clear military application, there are prudent reasons to control the licensing of such technologies or capabilities.

REGIONAL SECURITY

The United States and the People's Republic of China share a number of common national interests. Both nations seek a peaceful and non-nuclear Korean Peninsula; both seek to stop international terrorist organizations from disrupting commerce and their respective ways of life; both work to end international trade in drugs and persons; and both want to see a stable environment where trade flourishes, creating economic growth. However, there are still a number of areas of serious disagreement between China and the U.S. The resolution of how the democratic Republic of China on Taiwan and the Communist government of the People's Republic work out their differences on Taiwan's sovereignty is a major area where Washington and Beijing disagree. China refuses to renounce the use of force to bring Taiwan under its control.

I do not believe that is the most volatile policy difference between the U.S. and China, however. In my view, it is Beijing's expansive interpretation of its own territory that can lead to conflict, as demonstrated by the confrontation over how China handled the peaceful passage through international airspace by a United States EP-3 reconnaissance aircraft in April 2001. China's insistence in its own territorial laws

that it controls airspace and the sea out to 200 miles, the Exclusive Economic Zone, is an interpretation of the Law of the Sea that the United States cannot allow to stand, or the right of free passage of vessels and aircraft for free trade will be impeded. Moreover, China's expansive claims in the East and South China Sea compete with those of Japan, Indonesia, Malaysia, the Philippines, Brunei, and Vietnam. China is building the type of military to back up those claims with credible force and to deny the United States the flexibility to operate its own forces in these areas.

China's military buildup is not a challenge to American military superiority, but it is worrisome because of Beijing's history of using the military to reinforce its expansive territorial claims. Japan's air and naval capabilities are purely defensive, but the Japanese Self-Defense Force's technological and equipment capabilities far outstrip those of China. The single exception to this is in the area of ballistic and cruise missiles. China has developed a strong ballistic missile force and is modernizing its long-range missiles to be mobile and armed with multiple warheads. Today, both the United States and its allies, especially Japan, are without ballistic missile defenses. Because of China's modernization, and the threat from North Korea, the early development and deployment of ballistic missile defenses is critical to security in the Asia-Pacific region. Beijing is also building (and buying from Russia) a dangerous force of land attack and anti-ship cruise missiles. Cruise missile defense requires improved radar, but the basic defensive systems are already in the American and Japanese military inventories.

CHINA'S PRESENCE IN U.S. CAPITAL MARKETS

Chinese state-owned companies and the Chinese government have raised an estimated \$20 billion over the past decade from international bond offerings, according to the 2003 *Report of the U.S.-China Security Review Commission*. They have raised more than \$40 billion in international equity markets over the past decade, with over \$14 billion coming from initial public offerings in U.S. capital markets in the three years preceding the publication of the commission report. Some argue that such actions by China raise capital that supports Beijing's military expansion. Indeed, it is very difficult to tell which Chinese entities are related to or wholly owned by the People's Liberation Army. It is prudent to deny known Chinese entities that engage in proliferation access to the U.S. markets. The Securities and Exchange Commission should require foreign companies to file registration statements electronically, should review such filings to see whether the companies are subject to U.S. sanctions, should seek information from filing companies about their business with U.S.-sanctioned countries, and should share such information with the Treasury Department.

In general, I would argue that China's investment in the United States, like the trade between China and the U.S., represents a tool of influence in the economic relationship between the two countries. However, the United States should not close its capital markets and must exercise caution in denying Chinese firms access to the markets. One discussion in which I participated with those who proposed to keep Chinese companies from trading with the United States suggested that any Chinese entity that produces goods for military use should be kept from doing business in the United States. Such an approach is foolish in my view and would lead to a response against American companies, hurting U.S. economic interests. Chinese industries are increasingly producing goods for both civilian and military markets. They function like major American conglomerates. Should a U.S. company be penalized because it produces both toasters and military radar? I think not. In the case of China, if it is a clandestinely owned PLA company, that may not be the case. But Chinese firms, even state-owned firms, ought to get equitable treatment if they operate in the marketplace according to SEC rules.

CHINA'S FUTURE ECONOMIC GROWTH

China could turn into the second largest trading nation in the world by the year 2020 with a per capita income equal to that of the Republic of Korea or Portugal today, according to the World Bank's *China 2020* report published in 1997. Should China focus on being a trading nation rather than a major military power, and reform its legal and financial institutions, this outcome is feasible. However, China faces huge problems that will only be exacerbated when it finally complies with its obligations as a member of the World Trade Organization. Today, about half of its state-owned companies are not making a profit. No one knows how many of the loans out from Chinese banks are non-performing, but the rate may be around 46 percent. There are some 140 million agricultural workers who are unemployed or underemployed and floating around the country looking for work. The World Bank

expects that to grow to 200 million people. The Chinese state is failing to deliver health care and education to its people, demonstrating the bankruptcy of the Communist Party and undermining its legitimacy.

Anyone who gives a straight-line prediction about where China will be in 20 years is making it up. United States policy is about right—to encourage reform and to anticipate a China that has an educated populace, a productive work force, and a nation that operates in a world of rules-based behavior. However, we must “handicap” the potential outcomes. This particular one may get a two or three in five. It is also possible that we will see a China in chaos, with the legitimacy of the ruling party collapsed and the floating labor population tearing the country apart. And it is possible that the emerged Chinese state will have a powerful, coercive military that threatens not only its neighbors, but the United States as well. Thus, while the United States embraces policies that encourage the first outcome, it must maintain its military edge and the ability to defend American interests in the event of the last outcome.

Senator BROWNBACK. Thank you, Dr. Wortzel.

Dr. Lampton, you started all of this with The Nixon Center and Richard Nixon’s trips.

Dr. LAMPTON. I cannot claim all the credit or the blame, either way.

Senator BROWNBACK. Well, it was a bold stroke, and here we are, what, nearly 25 years later—well, no, we are over 35 years later—and moving forward.

Dr. LAMPTON. Well, I think President Nixon would not have envisioned the world that we are in, in many respects, and certainly not with China, both in some of the problems we have and some of the successes.

STATEMENT OF DR. DAVID M. LAMPTON, GEORGE AND SADIE HYMAN PROFESSOR OF CHINA STUDIES, JOHNS HOPKINS SCHOOL OF ADVANCED INTERNATIONAL STUDIES AND DIRECTOR OF CHINESE STUDIES, THE NIXON CENTER, WASHINGTON, DC

Dr. LAMPTON. Let me say it is a great honor to be with you this afternoon and this subcommittee. I think we are all aware of and thinking about our forces in the Middle East and Central Asia. But I do think this problem that we are talking about today is going to be one of the most enduring, long-range problems we face. As a great country, we have to be able to walk and chew gum at the same time, and I am very pleased that your subcommittee and you, Mr. chairman, are interested in this topic at this time.

I have a bottom line in my testimony and in my view, and that is that America’s strategy with China ought to be to reinforce the generally positive trends associated with China’s rise, create as benign an external environment as possible in East Asia, but, as Mr. Wortzel just said, maintain the capacity to respond if things go awry.

I think there are five things that undergird that general proposition, that general bottom line. The first one is that it is most prudent to assume that China will enjoy—I think it will be variable, but, nonetheless, generally rapid economic growth for the next decade or two. China’s economic influence and military power, therefore, will likely become increasingly formidable. Though it is possible, it is unwise, in my view, to bet that China will have a sudden regime change, that there will be widespread instability, or that its economic growth will stall for a prolonged period of time.

My second assumption is that we cannot be certain how Beijing will use its growing power. And I would agree, anybody who has certainty about how China will use its future power in any long timeframe is probably not as wise as they ought to be. I think it is unknowable what the internal conditions that will shape future Chinese policy will be. It is going to be impossible for us to know the environment that China's leaders are going to be responding to. Indeed, it is going to be impossible to know who those leaders are going to be in the future.

Our strategy, therefore, ought to be to try to reduce some of these uncertainties, and there are a couple of things that we can do. One is to try to connect to new Chinese leaders. Literally hundreds of people that the United States doesn't understand, or have much connection to are rising to the fore. And we ought to have a national strategy of trying to connect to this new generation and do what we can to understand it. In the aggregate, there is no reason to believe we cannot work with the generation of leaders that is moving up in China, but that is a proposition to be tested, and we ought to do so seriously.

My third assumption is that the foundation for U.S.-China relations now is sounder than it has been since 1989, notwithstanding the frustrations and, I would say, mutual strategic apprehension that both countries have of each other. Beijing has been reasonably cooperative in the war on terror. I think Larry had a somewhat more modest estimate of how useful China has been, and I am not trying to exaggerate it, but I think everybody in the administration would say we have been better off with China's degree of cooperation than certainly some of those others that have been traditionally our allies.

Turning to economics, the foundation of economic ties has been strengthened. I met with the Minister of Finance of China not too long ago, and I have done some research with our own Treasury Department. Beijing now holds 8.4 percent of all U.S. Treasury notes held by foreigners, second only to Japan. And in addition, holds about \$50 billion in U.S. State, local, and corporate debt instruments. If you look at the total debt instruments of the United States that China holds as of the end of last year, it is about \$150 billion. If you look in Mr. Wortzel's testimony you will find that the United States has invested considerably less in China than they have invested here. So I just think that's interesting, just a little factoid that shows you how deep this relationship is when you really begin to get into it.

Having said that the relationship is stronger than it has been since 1989, I have to say a couple of things. One is that China has very grave apprehensions about the national security strategy of the United States issued in September of last year. It is true, as I think Secretary Schriver said earlier, China is proud—and I think “proud” is a well-chosen word—to be considered a great power. That is the one part they like of the document.

But Senator Corzine asked the very key question: Are the Chinese not also apprehensive about our national security strategy? And I believe the answer is yes, they are. It has to do with preemption, as he suggested. It has to do with the U.S. commitment to stay on top of the power heap; period; forever. And it has to do with

a number of other aspects of this; in particular, the commitment to political system change. I am not saying all the Chinese criticisms are correct, but I do want to say they are apprehensive about what they perceive to be our national security strategy. So while the relationship is sound, or sounder, it is in relative, not absolute, terms.

My fourth assumption is that there is a reasonable chance, and I would say actually a pretty good chance, that Chinese nationalism will be directed mainly, for the next two decades, toward internal modernization rather than, let us say, external expansion, with the important exception of Taiwan, which the Chinese would consider internal affairs and we would consider in some other way perhaps. But in any case, I am not too worried about Chinese expansion, at least in a territorial sense. The economic leverage of China is increasing enormously, and we could be perhaps concerned about that.

Let me just tick off some policy implications. I do not want to leave the impression that I think it is only the United States that has things to do in this relationship in order to make it stronger. China has a lot of things to do, too. But let me tick off several things we can do and a couple of things that China could do.

One of the things I am most worried about is the development of an arms race in East Asia. The administration, frankly, could do several things to reduce either the intensity of it or the occurrence of it. First, the administration should be exploring how the United States can build and deploy an ABM system that least threatens China's minimal deterrent and elicits the most restrained response from Beijing possible. Washington needs to talk to the Chinese about strategic nuclear and missile defenses, which the administration seems loath to do.

My second suggestion is that the administration should be developing a strategy for dealing with North Korea that China, Japan, and South Korea can agree with and support. We have not done so. This almost inevitably means, in my view, that Washington will end up talking directly to Pyongyang, whether we like it or not or trust them or not—of course, we do not trust them. But I think it is not just China that is opposed to the U.S. current approach; it is, indeed, our other friends in the region, most notably, the Republic of Korea. They all, as far as I can see, want us to talk to North Korea, however distasteful we may find that.

The third thing is, the administration should be encouraging a trilateral security dialog among China, Japan, and the United States so as to stabilize that three-way relationship. I agree with one of the implications of Larry's testimony—Sino-Japanese ties are one of the more volatile relationships for the long-term. And if that relationship goes haywire, we are all in trouble. To manage problems in East Asia, you need China, the United States, and Japan, if not to be singing the same notes, be at least on the same page of music. And frankly, we are not, and we ought to be trying to get us on somewhat the same page.

And fourthly, the administration should be exploring with Beijing what former President Jiang Zemin meant by his suggestion in October and November of last year that China might remove some of its missiles from their threatening positions near Taiwan

were the United States to show parallel restraint in its military links with Taipei. So far, the administration's silence on this issue has been deafening.

So, we should look at some of the problems that are fueling an arms race and address them.

Now, in the spirit of acknowledging that China needs to do some things here, I'd just tick off a couple that I would suggest. First of all, if you just look at not only the public relations of it, but the humanity of it, China ought to be supporting a way in which Taiwan can participate in the World Health Organization. And we see the latest example of the problem with this flu, this upper respiratory stress syndrome. The fact of the matter is, the WHO isn't dealing with Taiwan because Beijing objects, and that's the fact of the matter. There ought to be a way to get the 22 million people of Taiwan involved—and they're not participating in a life-and-death organization. I think they should.

Also, China has made, as Mr. Wortzel said and was mentioned earlier, I guess by Secretary Schriver, progress on proliferation. I think you have to admit that. But, on the other hand, we need a lot more progress, and the Chinese have to tighten up that export control and their proliferation policy beyond what it is. So there's a lot we can do.

The relationship's better than it's been in a long time, but there's plenty of room for improvement.

[The prepared statement of Dr. Lampton follows:]

PREPARED STATEMENT OF DAVID M. LAMPTON¹, GEORGE AND SADIE HYMAN PROFESSOR OF CHINA STUDIES AT THE JOHNS HOPKINS SCHOOL OF ADVANCED INTERNATIONAL STUDIES AND DIRECTOR OF CHINESE STUDIES AT THE NIXON CENTER

THINKING ABOUT THE SECURITY IMPLICATIONS OF CHINA'S RISE

Mr. Chairman and Members of this distinguished subcommittee, I am pleased to have this opportunity to be with you.

I have been asked to address the issue of what China's rise means for East Asia and the interests of the United States, particularly in the security realm. I want to commend this subcommittee for taking time to address this centrally important long-term issue even as we all are preoccupied with the welfare of our forces in the Middle East and Central Asia. It says a lot that an administration that came into office skeptical about what China's rise may mean for America now is cooperating meaningfully with China in the war against terror and that President Bush as recently as March 18th (Beijing time) called China's new president, Hu Jintao, to express the desire for closer U.S.-China relations.² In the last thirteen months President Bush met four times with Jiang Zemin (who just stepped down from the presidency, but may well remain the "core" of the leadership³) and once (last spring) with just-named President Hu Jintao.

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²"Hu Jintao yu Bushi tung dianhua: Zhongguo xiwang heping buyao zhanzheng"[Hu Jintao and Bush Talk by Phone: China Wants Peace, Not War], Renmin Wang, <http://www.peopledaily.com.cn/Gbshizheng/16/20030319/946767.html> (accessed, March 17, 2003).

³See http://news.xinhuanet.com/newscenter/2003-03/18/content_786235.htm

⁴David M. Lampton, "U.S.-China Relations—'Normalized' At Last?", (March 2003), forthcoming, now in manuscript. Data from: "Foreign Exchange Reserves," Financial Times Information, Global News Wire, *The Korean Herald*, February 19, 2003, <http://web.lexis-nexis.com/univ>

Here is my bottom line—America’s strategy should be to reinforce the generally positive trends associated with China’s rise, create as benign an external environment as possible in East Asia, and maintain the capacity to respond if developments go awry.

Five propositions capture the thinking that leads me to this conclusion:

- In assessing the future impact of China’s rise, it is most prudent to assume that China will enjoy variable, though generally rapid economic growth for the next ten to twenty years. Consequently, China’s economic influence and military power likely will become increasingly formidable. Though possible, it is unwise to bet that China will have sudden regime change, widespread instability, and that its economic growth will stall for a prolonged period. Nonetheless, China’s modernization process will be tumultuous and full of uncertainties, one of which concerns the incomplete transition of power in China that has just occurred, another rising inequality, and a third the unhealthy financial system. Were China to fall into disorder and revert to its pre-reform-era posture of a dissatisfied power, this would be very inimical to U.S. interests. The likely scenario upon which we should base policy is that of continued growth, protracted political liberalization, and non-trivial social disturbances.
- We cannot be certain how Beijing will use its growing power. Unknowable internal considerations will shape future policy and we cannot now discern the external environment to which China’s leaders will be responding. To shape and reduce these uncertainties, however, the United States needs to do two things: connect to leaders of Chinese society at all levels and work with Beijing and its neighbors to construct as benign an external environment as possible. A principal uncertainty for the future concerns ties between China and Japan. With respect to leadership, China’s November 16th Party Congress and the just-completed 10th National People’s Congress have brought to power hundreds of new leaders at all system levels. Moreover, society outside the state is growing. In the aggregate, there is no reason that we ought not be able to work with China’s leaders and emerging middle class and there should be a concerted national effort to do so.
- The foundation for U.S.-China relations now is sounder than it has been since 1989, notwithstanding current frustrations in the UN Security Council and elsewhere and the mutual strategic apprehension each still has about the other. Beijing has been reasonably cooperative (and certainly not obstructionist) in the war on terror. Witness, for example, that while Beijing is not in favor of a war in Iraq at this time, there was never a serious danger of a Chinese veto of a second UN resolution and that, indeed, Beijing voted for UN Resolution 1441 on November 8, 2002. Although we have ongoing and legitimate worries about Beijing’s proliferation behavior, China appears to be strengthening its export control regime (e.g., the August 2002 issuance of missile, chemical, and biological technology and agent control regulations and lists) and seems to see increasingly clearly the dangers that proliferation represents to its own interests (e.g. South Asia and North Korea). Nonetheless, there is room for further improvement in China’s anti-proliferation work. The foundation for bilateral ties also has been strengthened through increasing U.S.-China economic linkages. For example, Beijing now holds 8.4% of U.S. Treasury notes (held by foreigners), second only to Japan, and holds about \$50 billion in U.S. state, local, and corporate debt instruments.⁴ In short, in this globalized world, a solid foundation for ties requires both positive security and economic links, and these are now more robust than at any time in the last fourteen years. Having said this, China has substantial apprehensions about the September 2002 *National Security Strategy of the United States of America*.
- There is a reasonable chance that Chinese nationalism will be directed toward internal modernization for at least a decade or two, and not onto the road of militarization. Chinese leaders believe they cannot remain in power if they fail to meet popular material demands. A widely shared analysis in China ascribes the collapse of the Soviet Union to its excessive military expenditures and the Kremlin’s inadequate attention to economic needs. In this light, the recent single digit (9.6%) military budget increase announced at the just-concluded NPC may be suggestive (the previous 13 years saw double digit increases). I hasten to caution that other military-related expenditures may have been larded else-

³See http://news.xinhuanet.com/newscenter/2003-03/18/content_786235.htm

where in the national budget.⁵ More broadly, because about one-third of its exports go to the United States and employment in China is significantly affected by economic ties to America, China's leaders see a linkage between the capacity to effectively address their own internal problems and continued productive relations with America—this doesn't assure harmony, but it increases the odds of it.

- The Chinese realize that power has different faces—military, economic, and normative (ideological) power. Right now, China is finding that in the era of globalization, economic power (and potential economic power) is the form of power it has in greatest abundance and which it can use most effectively. As long as economic influence continues to be effective for Beijing, as it now seems to be in dealing with Taiwan, for example, China is unlikely to resort to military intimidation as its chief foreign policy instrument. Further, there is no doubt that Beijing recognizes the military superiority of the United States and consequently is cautious. Indeed, this is one reason why China is placing increasing emphasis on using multilateral organizations (such as the UN Security Council) as a means to restrain the unilateral exercise of American power.

These views add up to a perspective on China's rise and its implications that is much different from that of the University of Chicago's John Mearsheimer. In his book *The Tragedy of Great Power Politics*, Mearsheimer asserts that it doesn't matter whether China becomes democratic or not; the mere fact that it is growing rapidly puts it on a collision course with America (p.4). This is so because the international system is a jungle; in the jungle force is most useful; and all states will convert economic power into growing coercive power to achieve dominance in that jungle. In contrast, I believe that China now defines its security principally in terms of internal economic welfare and social stability, that it is not striving for external dominance (with the important exception of Taiwan), and that if America helps create a moderately benign regional security environment there is no reason China and America cannot cooperate to their mutual advantage for a considerable period. In short, China is rising the "right way", not the wrong way, from the perspective of American interests, with the principal uncertainty being Taiwan. Those who see an inevitable conflict on the horizon propose adopting measures that assure the outcome they profess to wish to avoid.

The following issues merit specific consideration in light of China's increasing power and influence:

First, China is modernizing its military in terms of projection capability, a secure nuclear deterrent, and internal management. For the last eighteen years China has been trying to transform its military into a more professional force able to fight the next regional conflict offshore, not on its own territory as Mao Zedong contemplated. This reflects the desire to protect China's increasingly valuable coastal assets and to deter Taiwan from making possible independence moves. The PLA has made steady progress, though it remains far behind U.S. technological and organizational levels. As its national economy grows Beijing will have more wherewithal to continue making progress.

Second, as the United States develops its missile defenses, and possibly transfers these capabilities to regional allies, China will increase its missile and warhead numbers and diversify its delivery modes in order to assure a second strike capability. Indeed, China has been modernizing its strategic forces gradually because its deterrent capability already is problematic. If one combines this "vertical" proliferation in China with "horizontal" proliferation in North Korea, the Republic of Korea, Japan, and Taiwan will come under increasing pressure to develop offensive forces themselves, perhaps nuclear capabilities. In short, there is no way that China can modernize its military without creating some anxiety among neighbors, thereby generating pressures for regional arms expansion. Conversely, proliferation around China may push Beijing along an upward trajectory as well. What Japan does will be particularly important in this respect.

SOME SPECIFIC POLICY RECOMMENDATIONS

In an effort to minimize the action-reaction arms race cycle, the administration should do several things: A) It should be exploring how the United States can build and deploy an ABM system that least threatens China's minimal deterrent and elicits the most restrained response from Beijing in terms of increasing warhead numbers. Washington needs to talk to the Chinese about strategic nuclear weapons and

⁵Xing Zhigang, "Military budget rise lowest in 14 years," *China Daily*, Friday, March 7, 2003, p. 3; as to possibility that defense items may be elsewhere in the budget, this information comes from a recent interview with a Chinese citizen by David M. Lampton.

missile defenses, which the Administration seems loath to do, particularly the Department of Defense. B) The Administration should be developing a strategy for dealing with North Korea that China, Japan, and South Korea can agree upon—we have not yet done so. This almost inevitably means Washington will have to speak directly with Pyongyang. The sooner we build this consensus and proceed with its logic, the better off we all will be. C) The Administration should be encouraging trilateral security dialogue among China, Japan, and the United States to stabilize that three-way relationship to the greatest extent possible. And D), the Administration should be exploring with Beijing what former President Jiang Zemin meant by his suggestion in October and November of 2002 that China might remove some of its missiles from threatening positions near Taiwan were the United States to show parallel restraint in its military links with Taipei. Without endorsing this rather vague proposal, it does provide an opening for dialogue that might help retard militarization in the Taiwan Strait, a militarization that Taiwan can ill-afford. So far, the Administration's response has been deafening silence.

Senator BROWNBACK. Dr. Lampton, is China moving toward a democracy at the national level, or not?

Dr. LAMPTON. I would put it a little differently. I would say China is, as a society, developing the preconditions that make a democracy, or, let us say, more humane, lawful, and pluralistic government possible. But I think, frankly, we're talking about a process of decades. There isn't going to be a solid basis for democracy until China really has a middle class that demands rule of law. It's going to take a tremendous amount of time to build the institutions to regulate a market economy.

So the way I would put it is, they're headed in the right direction. The slope is up, toward what we would concede to be a more desirable form of government. But I think it's going to take a long time. I'd just observe that, of course, we would have said the same thing about the Soviet Union in 1985, perhaps, and by 1991, we were in a radically different situation. So analysts can be wrong. I can be wrong, for sure. And almost everything of significance that has happened in China in the last 30 years has been unpredicted by the experts. So I guess I will say I hope this becomes one more example of experts being wrong.

But they're moving in the right direction. I think the U.S. business community and our engagement with China, and invitation to students and scholars to study here, has been an enormously successful foreign policy that we've conducted.

I know many people think our policy with China has been unsuccessful. I respectfully disagree. I think it has been one of the most successful policies of the last 60 years that we have had with a major country that you can enumerate.

Senator BROWNBACK. Is China doing all it can to stop the nuclear proliferation by North Korea?

Dr. LAMPTON. I think largely so. Of course, I am not privy to classified information. And also one could question their behavior in the past—I am not absolutely sure that they have not done things that were helpful to North Korea in the past. I am reasonably sure that they are not doing anything now to assist in the North Korean nuclear effort.

And indeed, I just went, in November, with former Secretary Perry and Mr. Scowcroft and others, to China and talked to the top four leaders as they relate to this issue. Without presuming to speak for Secretary Perry or Mr. Scowcroft, I, personally, concluded from those discussions that the Chinese are increasingly alarmed

at the phenomenon of proliferation. I mean, now they have Pakistan—which they unfortunately, from our point of view, helped create as a nuclear problem. India, a very volatile situation is to their south. They are worried about Taiwan eventually, and the United States has played a role in damping down Taiwan's efforts a couple of times in the past. They are very worried about North Korea. And, as one of my friends has said, "You know, with friends like the North Koreans, who needs enemies?" So they're very worried about that. They, of course, still have Russia, with thousands of nuclear warheads. And so I think they're worried about the environment that they're in, and in particular the stability of the North Koreans and the decisionmaking structure that they have. So I take the Chinese at their word that they do not want the Korean Peninsula with nuclear weapons.

The problem is—and I think Mr. Wortzel captured the Chinese priority. For the United States, the first, second, and third priority is no nuclear weapons on the Korean Peninsula. Those are our top priorities. I think the first priority for the Chinese is no instability in North Korea. And then nuclear weapons are important, but I think it's not the first priority. And so I think the Chinese are ultimately afraid that the means the United States would use to stop the North Koreans from getting nuclear weapons will jeopardize their first security priority, which is stability in North Korea.

The Chinese are concerned that we would use means that would jeopardize their, meaning the Chinese, first security priority, which is no instability.

Dr. WORTZEL. Mr. Chairman.

Senator BROWNBAC. Dr. Wortzel.

Dr. WORTZEL. If I could. The history of strategic thinking about nuclear weapons in China is that proliferation is a good thing, because it breaks what they term the superpower monopoly on those weapons. I think that they have—the history of them recently proliferating weapons of mass destruction and missiles is that they have stiff-armed us at every turn and lied and cheated and proliferated. And as recently as today, or was it yesterday, Bill Gertz, in the Washington Times, has another example of that, of perhaps more materials going into North Korea that would lead to proliferation.

Senator BROWNBAC. What countries would those be, Dr. Wortzel? I mean, Pakistan has been mentioned.

Dr. WORTZEL. Pakistan has been mentioned, certainly Iran, Syria, perhaps back earlier to Iraq, we know of North Korea. So the real dilemma for China now is the second and third order effects of what might happen in Japan, and I think that's where our diplomacy has to focus.

They are happy, I think, that they're at the center of diplomatic crossroads. I think they're quite happy that the United States is pretty well extended militarily in a lot of other parts of the world and can't focus on Taiwan or on them or even on North Korea.

But I think we need robust ballistic missile defense deployed in East Asia. I think we need to work with the Japanese to get ballistic missile defenses out there, and I think we need to press the Chinese to remind them that the worst consequences of their behavior would be a remilitarized Japan.

Senator BROWNBACK. Where all would you place ballistic missile defenses throughout East Asia? What countries do we need to do that?

Dr. WORTZEL. I think that we have to work very closely with the Japanese. I think we need sea-based defenses, and I think we can get ground-based defenses here and there.

South Korea is less interested in ballistic missile defenses, quite frankly, because they could be obliterated by artillery. So they're not terribly interested.

Taiwan is a place that has great need for shorter-range ballistic missile defenses, primarily sea-base, but ground-based would do them very well.

Our relationship with Japan and the interpretation of the Japanese constitution makes it extremely sensitive to begin to talk about architecture. In 1998, Strom Thurmond, Defense Authorization Act, asked for the study of a theater architecture involving Japan, Korea, and Taiwan. I think that's a great goal. But I think that if we really want to move forward with Japan and we want to work with the Japanese on moving into development and deployment, any system with Taiwan that eventually the Taiwan legislature may fund because they've been very slow to do that, not just for economic problems, but also because they don't want to anger them, some elements in Taiwan, don't want to anger the mainland. But I think it needs to be an architecture in and of itself, perhaps an architecture that's readily linked to the United States. But talking about a theater architecture involving the United States, Japan, and Taiwan will drive the Japanese public, in my opinion, away from a decision that Japan needs to make, and that is to move forward on a ballistic missile defense.

Senator BROWNBACK. What's the likelihood of Japan becoming a nuclear power if North Korea continues its track and develops nuclear weapons?

Dr. WORTZEL. Well, as you know, at the Heritage Foundation, we've had a very close relationship with some of the conservative faction in the Japanese Diet. It's a multiparty faction. It's about 25 Diet members. For 8 years, they've been coming to Heritage to talk. I go to Japan twice a year and meet with them. Five former Defense Ministers, or the JDA heads, and the current JDA head, are part of the group.

I think it's fair to say that there are some people that very, very seriously believe that if Japan faces that sort of threat, it needs to develop the capability to respond. And it is only their belief in the American nuclear umbrella that inhibits that.

Dr. LAMPTON. I just might say a couple of things, one on Taiwan—their missile defense. I think it would be very important not to, at least initially, transfer ABM technology beyond the Patriots, which we already are, to Taiwan. First of all, I just made a proposal that we at least explore with the Chinese their offer to reduce some of the missiles near the Taiwan Strait and at least plumb other strategies to reduce tension there. We might end up failing at that and then come back the ABM option. But I think there are some things to do before we get there.

Also, even if we decided that missile defense was needed in that area, I would hope we could go to ship-borne ABM that would re-

main under U.S. control for a number of reasons, one of which includes technology leakage.

So let's explore the diplomatic possibilities in finding a way to de-escalate tension in the Taiwan Strait first. If that fails, think about alternative strategies. But I think giving the technology directly to Taiwan would be way down my priority list for two reasons. First, it would jeopardize Taiwan's security. You would not be able to predict Beijing's reaction and then we'd have to cope with that. And, second, it's going to be very expensive. And Taiwan needs to use its investment to increase its economic competitiveness. The biggest threat to the island is that it's not doing what it needs to do for its own economic development. And there are many reasons for that, and we could go into it.

But the long and the short of it is that the strategy of encouraging Taiwan to spend enormous amounts on technology trying to achieve security when the biggest threat to its security is its own economy is not wise. Not what I would perceive to be Taiwan's interests, our interests, or anybody else's.

Senator BROWNBAC. Dr. Lampton, too, I hope your institute, you'd look some to it, the Chinese treatment of North Korean refugees, which I think is just an absolutely deplorable violation. I mean, it's deplorable human rights, but it's a huge violation of their agreement under the U.N.—their agreement with the U.N. High Commission on Refugees. I mean, and this is—I suppose you could say, if it were a couple of hundred people, it's not a huge issue to arise, although I think we should look at every person uniquely. But you're now in—a third of the population of North Korea is being fed by international food donations, and literally thousands have walked into China, and a number are being caught and repatriated—into a horrible situation. I would hope that would also cross your radar screen on the relationship.

Dr. LAMPTON. Well, Senator, I certainly agree that forcing people back across the border so that they can meet an uncertain but almost certainly violent consequence is not anything I would endorse and I think we all feel enormously badly about that. I think we ought to be doing what we can as a government to find an orderly process by which people can get into China, get out of China, and go somewhere. But I think the problem doesn't just stop at China's doorstep.

You have to ask who will take people in that volume today? And you can start, I think, asking the question with respect to the Republic of Korea. As I would understand the Republic of Korea's policy, it is to take people if they can get there, but they're not encouraging the Chinese to have large numbers of people go to South Korea. And of course we would like to find other countries that would be willing to take these individuals, as well. So I think the Chinese—

Senator BROWNBAC. I think we did that. In Indochina in the 1970s, where there was a couple of million people that moved out and various places around the world when they faced such horrific conditions.

Dr. LAMPTON. Yes.

Senator BROWNBACk. I would hope we could do something similarly here. And I think it would be viable and possible, but China is the door. They have to be the door to this.

Dr. LAMPTON. Right.

Senator BROWNBACk. And so far, they've indicated no willingness whatsoever to do anything but send the North Korean refugees back.

Dr. LAMPTON. I think that's right, and I'm the last one to carry the water for the Chinese on anything, and including this. All I would say is, I think the Chinese occasionally—you hear various numbers, but there may be up to 200,000 or more people from North Korea in China in the border areas. And my sense is that Beijing often turns a blind eye to those people. It's when they start moving into the cities—

Senator BROWNBACk. You used to. But after some of the high-level embassies were hit they've gone—and I went to that area in December, and after the high-level incidents took place, the Chinese went in and really started sweeping, even through the northern areas, to capture North Korean refugees and send them back.

Dr. LAMPTON. That's true.

Senator BROWNBACk. That's really bad—

Dr. LAMPTON. I had a graduate student go there who is of Korean nationality, and her 40-some-page report is an eye-opener. Let me put it that way.

Senator BROWNBACk. It has opened my eyes.

Thank you both very much. This has been a very interesting panel. It's been a very interesting overall hearing, but you provide a lot of food for thought. And you've been at this work for a long period of time, and I appreciate your willingness both to share your expertise.

Dr. LAMPTON. Thank you.

Senator BROWNBACk. The record will remain open for the requisite number of days. The hearing is adjourned.

[Whereupon, at 4:50 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

RESPONSES TO ADDITIONAL QUESTIONS SUBMITTED FOR THE RECORD

RESPONSES OF CHARLES FREEMAN, DEPUTY ASSISTANT U.S. TRADE REPRESENTATIVE, TO ADDITIONAL QUESTIONS FOR THE RECORD SUBMITTED BY SENATOR GEORGE ALLEN

Question. Procurement Issue: The Wall Street Journal recently reported (March 7, 2003) that an interagency task force in charge of the central government's information-technology planning efforts proposed procurement guidelines that may limit market access and open competition for procurement of software products by the Chinese government.

This is a cause for great concern since it would violate the spirit of free trade commitments within the WTO and send the wrong message that China is not open to free trade and utilizing the best software and security technology available.

Are you aware of these guidelines? If so, what is your assessment of its applicability to software makers in the U.S.? What do you think is the best way for China to achieve its goals of developing a local high tech industry while staying true to its free trade commitments within the WTO?

Answer. We have encouraged China to practice fair and open procurement policies and to allow market conditions to be the primary determinant in government pro-

curement. However, China is not a signatory to the WTO Agreement on Government Procurement, and has no trade commitments to ensure equal access to government contracts for foreign suppliers.

China is clearly a growing market for American software. Many American software companies have made sales to the Chinese government and are expanding operations in China to better market their products to Chinese purchasers. While the Chinese government has not signed the WTO Government Procurement Agreement, we do expect China to honor all of its WTO commitments, including those related to national treatment for products regardless of national origin.

Question. Software Piracy Problem in China: In 2001, the business software piracy rate in China was 92%, the second highest level in the world. Losses due to software piracy in China in 2001 amounted to a staggering \$1.66 billion. The biggest problem facing the software industry is enterprise end user piracy, when businesses and government institutions use unauthorized copies of software.

The high piracy rate not only curtails China's ability to attract foreign investment but also hinders the development of its own high tech industry.

As a WTO member, what can China do to decrease the piracy rate? What type of legislative reforms and enforcement resources would be required and what is your sense of China's commitment to IPR issues.

Answer. China's protection of intellectual property rights continues to be one of our greatest concerns. While China has made great strides over the past decade and improved its legal regime significantly prior to its accession to the WTO, the level of piracy remains disturbingly high. We are actively engaged with the Chinese government on this issue, and are pressing them to enforce the laws on their books.

The Chinese government appears to understand that piracy is not simply a matter of concern to foreign companies, but also poses a dramatic threat to China's domestic economic development. While the government still has much to do to provide adequate protection for IPR, there have already been many positive changes in China's IPR protection regime, and we believe the Chinese government is committed to fixing the problem areas that remain.

China's WTO commitments include a promise to attain a "deterrent" level of enforcement against IPR piracy. We expect China to fully honor this commitment and are working with the Chinese government to ensure that this is the case.

RESPONSES OF RANDALL G. SCHRIVER, DEPUTY ASSISTANT SECRETARY OF STATE FOR EAST ASIAN AND PACIFIC AFFAIRS, TO ADDITIONAL QUESTIONS FOR THE RECORD SUBMITTED BY SENATOR JOSEPH R. BIDEN, JR.

Question 1. Did Secretary Powell discuss the situation of North Korean refugees in China during his recent trip to Beijing, and will this issue be on the agenda for Vice President Cheney's planned trip to China next month? What specific recommendations is State making to the Chinese to address the problem from the perspective of humanitarian concerns and China's international refugee protection obligations?

Answer. Substantial number of North Koreans, who have entered the PRC seeking food or work or fleeing persecution in the DPRK, live in Northeast China. The PRC considers all North Koreans in China to be economic migrants, while we believe there are bona fide refugees among them. Their situation in China is of great concern to this Administration, and we are troubled by reports that China continues to forcibly repatriate some of these people back to the DPRK where they may face severe mistreatment upon return. As a signatory to the 1951 Convention on Refugees and the 1967 Protocol Relating to the Status of Refugees, China has an obligation to allow the UNHCR access to this population in order to assess their status. We have repeatedly pressed China to live up to this obligation, to treat the North Korean population in China in a humanitarian spirit, to stop all deportations back to the DPRK, and to allow North Koreans who wish to leave for the ROK to do so.

The U.S. Government has also expanded its support for humanitarian assistance programs run through the UNDP which target the North Korean population in China, providing North Koreans with food, medicine, shelter, and other humanitarian services.

Question 2. The UN Commission on Human Rights opened this week in Geneva, and today the EU foreign ministers left the door open to supporting a resolution on China, though the EU won't take the lead. Why has the administration hesitated to sponsor a resolution this year on China's human rights record? Does it intend to do so, and if so, when?

Answer. After careful consideration, the Administration decided not to sponsor a resolution on China's human rights practices at the 2003 session of the Commission on Human Rights (CHR). The decision on a resolution followed a year of limited, but unprecedented, progress on human rights issues in 2002 and was based on what we believed would best advance human rights in China with the new government in Beijing. This progress included China's decision to allow special representatives of the Dalai Lama to visit Beijing and Lhasa and the release of a significant number of political prisoners, including democracy activist Xu Wenli and Tibetans Jigme Sangpo and Ngawang Sangdrol.

Unfortunately, the progress on human rights that we saw in 2002 has not been sustained in 2003. In recent months, we have seen significant backsliding, including the arrests of democracy activists and those posting information on the Internet, continued denial of due process for those accused of political crimes, as well as the execution of a Tibetan without due process. We are also concerned by China's failure to take steps to live up to the commitments it made during the December 2002 human rights dialogue, including cooperation with UN human rights mechanisms and the release of political prisoners. We have conveyed our concern and disappointment over these negative developments at the highest levels in Beijing and Washington. In the months ahead, we will continue to press China's government to improve its human rights record and to implement the commitments it undertook as part of our human rights dialogue.

In consultation with like-minded governments, we will decide whether to sponsor a resolution on China at the 2004 session of the CHR based on China's human rights progress over the course of the year. We have made it clear to the Chinese government that progress will be necessary to avert a resolution.

RESPONSES OF RANDALL G. SCHRIVER, DEPUTY ASSISTANT SECRETARY OF STATE FOR EAST ASIAN AND PACIFIC AFFAIRS, TO ADDITIONAL QUESTIONS FOR THE RECORD SUBMITTED BY SENATOR RUSSELL D. FEINGOLD

Question. The title of this afternoon's hearing is "emerging China," which seems to assume that China's recent impressive economic growth performance will continue. Yet China has a number of emerging problems that it could have a difficult time emerging from. These include an insolvent banking system, widespread official corruption, labor unrest, urban-rural and regional inequality, an HIV/AIDS epidemic, a worsening water shortage and severe environmental degradation. How likely do you think any one or combination of these factors is to disrupt China's economic future?

Answer. The complexity of development challenges facing China is significant. China is not unique in this regard, as many nations in the developing world face similar challenges. Thus far, China has had comparative success, despite these difficulties, in promoting growth and raising income levels. It is difficult to quantify the extent to which any one, or a combination of the problems cited in the question will curtail the continued growth of China's economy, although we recognize it as a serious concern. It is clear that the Chinese government's overriding goal is to promote growth and that it increasingly recognizes and is taking concrete steps to address these problems, albeit in mixed fashion.

After recording the largest economic expansion in history between the late 1970's and the year 2000, China still relies on a state-run banking system which is weighed down by a high-level of non-performing loans. Capital markets are immature and the inefficient state-owned enterprises are a drag on growth. Added to these very real structural problems are problems resulting from reductions in public health services, diseases like HIV/AIDS, water scarcity, labor unrest over corruption and unemployment, and other issues generate serious dissatisfaction and will no doubt create frictions in China. China is working both domestically—putting greater emphasis on environmental protection, and establishing social safety net measures in recent years—and with many of its international partners to address these challenges but they are not subject to a quick fix. For example, China engages in dialogue with international financial institutions, whose assistance strategies are designed to improve the institutional underpinnings, efficient functioning, and sustained growth of the Chinese economy.

We discuss these problems and possible approaches to resolving them with the Chinese, using the opportunities to promote better economic governance and encourage political reform in China. China's success at resolving these problems will have important implications for stability in the region as a whole; China's neighbors, no less than China itself, need a China that has clean and sustainable development,

a healthy population, an economy that acts as a positive engine of trade and growth for the region, and a productive Chinese workforce.

Question. Labor protests, some of them quite large in scale, have been sweeping parts of China for more than a year now. How do you rate the significance of this movement, and can we use it as an opening to encourage China's leaders to respect their obligations as a member of the International Labor Organization?

Answer. Labor protests over the past year in China have increased in number but remain mostly uncoordinated and most are relatively small scale. Public anger at corruption and layoffs caused by the downsizing of the state-owned sector are the principle driving force behind recent protests.

Chinese labor law allows "strikes," but in practice there has been to date no national, coordinated movement that affects China's economic health or results in major social disruptions. While Chinese leadership is increasingly concerned over the number of protests, without a significant growth in scope and coordination, they are not in themselves likely to provide sufficient incentives to implement internationally recognized labor practices. The ILO is active in working with China to implement international labor standards that are not yet in place in China.

The U.S. government is engaged in a number of programs to improve the conditions for workers in China. We have funded, either through State Department or the Department of Labor, advocacy and mediation of labor disputes, programs on labor law reform, work safety and health, mine safety, corporate social responsibility and protection of women and children in the workplace.

Question. There has been some recent reporting in the press speculating that Hu Jintao and Wen Jiabao, who will take over as President and Premier this week, since they have both served in some of China's poorer regions, will take a somewhat "kinder and gentler" approach than their predecessors to managing China's economy and dealing with its myriad of social problems. Are there grounds for optimism that this will be the case?

Answer. It is too early to tell exactly what policies the new Chinese leaders will implement, but both President Hu Jintao and Premier Wen Jiabao have given some early indications that they may focus more attention on improving conditions in China's rural and poorer regions.

In his first press meeting after being confirmed as Premier, Wen noted that addressing rural economic stagnation and creating more jobs are among his main challenges. He also confirmed that "only through continued reform and opening" can China develop. So, although no new policy details have been announced yet, we do believe that the new leaders will continue and deepen the reforms started by their predecessors.

Question. There is a report in Monday's Washington Post that Chinese journalists have been forbidden to report on a potentially serious new disease outbreak in Guangdong Province until after the meeting in Beijing of the National People's Congress. What does this imply about China's ability to live up to its trade and other commitments that require transparency and disclosure?

Answer. The outbreak of Sudden Acute Respiratory Syndrome (SARS) was first reported in China's Guangdong Province in late November. Starting in mid-February, some information on the disease was shared with World Health Organization and U.S. Centers for Disease Control and Prevention (CDC) specialists, although they were not allowed to travel to the sites in question.

Chinese media were reportedly not allowed to cover this outbreak at the time due to a ban on reporting "bad news" during the National People's Congress. China has shared data on SARS at the technical level with the U.S. CDC and the WHO and continues to do so.

In recent years, Chinese authorities have banned public reporting on social issues such as health problems during politically sensitive periods. We cannot assume, however, a linkage between these acts and China's sharing of information under other agreements they have signed.

