

CHINA'S GROWTH AS A REGIONAL ECONOMIC POWER: IMPACTS AND IMPLICATIONS

HEARING BEFORE THE U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION ONE HUNDRED EIGHTH CONGRESS FIRST SESSION

DECEMBER 4, 2003

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The Commission's Statutory Mandate begins on page 186.

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

DECEMBER 23, 2003

The Honorable TED STEVENS,
President Pro Tempore of the U.S. Senate, Washington, D.C. 20510
The Honorable J. DENNIS HASTERT,
Speaker of the House, Washington, D.C. 20515

DEAR SENATOR STEVENS AND SPEAKER HASTERT:

On behalf of the U.S.-China Economic and Security Review Commission, we are pleased to transmit the record of our hearing held December 4, 2003, on "China's Growth as a Regional Economic Power: Impacts and Implications."

As you know, the Commission is mandated by law (P.L. 108-7, Division P) to assess, among other areas, "the extent of China's 'hollowing out' of Asian manufacturing economies, and the impact on United States economic and security interests in the region; [and] review the triangular economic and security relationship among the United States, Taipei and Beijing." Our hearing was focused on exploring trends in these areas and in the broader spectrum of China's regional relations.

The December 4th hearing examined from several perspectives the regional impacts of China's rapid growth as an economic power. Asian governments, the international media, and academic experts have increasingly noted China's growing importance to trade and investment patterns in Asia. They also note China's more assertive regional economic diplomacy, including proposals to enter into liberalized trading arrangements with members of the Association of Southeast Asian Nations (ASEAN) and the Shanghai Cooperation Organization (SCO) as well as the countries of Northeast Asia. We asked expert panelists to provide their perspectives on these dynamics and on appropriate U.S. policy responses.

Based on the hearing, we present the following preliminary findings:

- In recent years, China has adopted a softer yet more confident and proactive posture in its relations with its Asian neighbors. China's various bilateral "partnership" relationships—that once seemed largely symbolic—have gradually taken on greater substance.
- In contrast to fairly passive advocacy in the past, China is now actively promoting the establishment or strengthening of regional multilateral institutions, such as the Shanghai Cooperation Organization in Central Asia and the ASEAN "Plus One" (China) and "Plus Three" (China, Japan, South Korea) partnership fora.
- Some observers conclude that China is filling a void in the region left by U.S. preoccupation with Iraq and the global war on terrorism. China touts its policy of "non-interference" in the internal affairs of other states and contrasts its hands-off approach to that of the U.S., which actively pursues an agenda to combat terrorism and to promote human rights and democratic governance. Aside from reiterating the importance of partners accepting its "One China principle," China makes few political demands on its Asian neighbors. China does not push human rights, labor or environmental standards in its diplomacy.
- China's regional strategy appears to be subordinate to its global economic strategy, which is to maintain access to the open multilateral trading system on which its rapid export-driven growth now depends.
- China's regional strategies are in part driven by its energy security needs, a topic the Commission explored during a hearing on October 30, 2003. For example, major pipeline projects are being planned to connect China to oil and gas fields in Central Asia and the Russian Far East and to establish liquefied natural gas terminals to receive shipments from Australia and Indonesia.
- China's export-driven economic boom has been fueled by a high volume of inward Foreign Direct Investment (FDI), particularly in the wake of China's entry into the World Trade Organization (WTO). In the view of one witness, China's membership in the WTO has sharply reduced the perceived "risk premium" for FDI in China and intensified the trend. This has implications for all regional economies, but especially for the countries of Southeast Asia, which have already experienced a relative decline in FDI flows and could lag behind China in technological progress.
- One panelist noted that "hollowing out" of some industrial sectors in the region was taking place due to China's export drive, attraction of FDI, and development as a major manufacturing power. This was particularly true in Taiwan, which of all the Asian industrial economies has the heaviest "trade dependence"

on China, but it also has affected Northeast and Southeast Asian nations. At the same time, panelists acknowledged that for now the high growth in exports from the rest of Asia to “feed” China’s manufacturing sector was taking some of the sting out of “hollowing out.” The question is whether China will move up the technology ladder to such an extent that its current imports from the rest of Asia will slow or change in composition. Several of our panelists concluded that Japan, South Korea, Taiwan and the ASEAN nations have no choice but to rise to China’s challenge by advancing their own technological base, if they want to remain competitive and improve their standards of living.

- In the region there is a disquieting perception that the U.S. was largely indifferent to Asia’s fate during the 1997–98 regional financial crisis and has ignored a number of Asia’s developmental concerns in its preoccupation with the global war on terrorism and the North Korean nuclear threat.

Some of these dynamics were apparent at the recent APEC meeting in Bangkok where China projected itself as a more attentive and profitable alternative to the U.S., depicting the latter as preoccupied with terrorism and security relations. Many Asian leaders left Bangkok praising Chinese President Hu’s economic initiatives and wondering why President Bush seemingly downplayed economic concerns. Likewise, after visits by Presidents Bush and Hu to Australia, the Asian press reviewed Hu’s performance more favorably. Such perceptions can limit the U.S. Government’s ability to secure the cooperation of Asian nations in achieving our priority objectives.

The implications of China’s economic rise vis-à-vis the U.S. are significant. Chinese economic and political practices represent a troublesome alternative to U.S. norms. International labor standards are essentially ignored in the rush for production, transparency is clouded by corruption and insider deals, environmental protection takes a back seat, and democratic principles are suppressed by authoritarian “realism.” Yet, the “success” of China’s model is no doubt making a strong impression on its Asian neighbors. An important multilateral vehicle that the U.S. could use to reassure Asian partners is APEC—the Asia-Pacific Economic Cooperation forum. APEC should be strengthened by more active American participation, innovation, and high-level political support for its regional economic agenda. Our long-term economic and security interests in Asia are too important to fall victim to a distracted America.

As the Congress deliberates on issues concerning U.S. interests in Asia and considers how to strengthen American diplomacy in the region, the economic rise of China is a key factor to assess. Through its economic success, China is exercising a more effective and assertive regional diplomacy and exercising enhanced political influence in Asia.

Yours truly,



Roger W. Robinson, Jr.
Chairman



C. Richard D'Amato
Vice Chairman

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CHINA'S GROWTH AS A REGIONAL ECONOMIC POWER: IMPACTS AND IMPLICATIONS

THURSDAY, DECEMBER 4, 2003

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

The Commission met in Room 124, Dirksen Senate Office Building, Washington, D.C. at 10:45 a.m., Commissioners June Teufel Dreyer and Carolyn Bartholomew (Hearing Co-Chairs), presiding.

OPENING REMARKS OF CHAIRMAN ROGER W. ROBINSON, JR.

Chairman ROBINSON. We'd like to bring the hearing to order. I know that folks are just filtering in from this unexpected evacuation of the building for a fire drill. I can confirm that it was a no-notice event for us, and we apologize to all of our witnesses that have had to roll with the punches on this. We also know that there are some non-trivial time constraints for two of our witnesses, and we're going to try to accommodate those concerns as well.

June, are you ready?

Co-Chair DREYER. Yes.

Chairman ROBINSON. So I would like at this juncture to postpone my opening statement as well as that of Vice Chairman Dick D'Amato. Our Co-Chairs for the hearing, Commissioners Dreyer and Bartholomew, have likewise kindly agreed in the interest of time to postpone until the afternoon session their opening statements. With that, I would like to turn the proceedings over to Commissioner Dreyer, Co-Chair Dreyer, who is going to be administering the first half of our interesting day. Thank you.

PANEL I: OVERVIEW: CHINA'S REGIONAL STRATEGY

OPENING REMARKS OF COMMISSIONER JUNE TEUFEL DREYER HEARING CO-CHAIR

Co-Chair DREYER. First of all, welcome all, and thank you for agreeing to this rearrangement of the schedule and without further ado, I would like to start. Dr. Gill, could you take this first?

STATEMENT OF BATES GILL, Ph.D. FREEMAN CHAIR IN CHINA STUDIES CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES

Dr. GILL. Of course, Commissioner Dreyer. Thank you very much for that opportunity. I was going to say maybe I should postpone my opening statement as well in the interests of time.

But I do appreciate this opportunity. I want to thank you, Chairman Robinson, also Vice Chairman D'Amato, and Commissioners Dreyer and Bartholomew, for the opportunity to speak today. I've

been asked to set the stage for today's hearing along with my co-panelists by providing a kind of overview of China's regional strategy. I'm going to be emphasizing mostly issues related to diplomatic, political and security concerns. They're not directly economically related; however, I think we'll agree that these broader aspects certainly do have an impact on the questions which the Commission is interested in hearing about, and I do congratulate you on holding this very timely and I think important hearing on the implications of China's growing economic influence in the region.

I'll try to keep my remarks very brief simply by emphasizing what I see as three important identifiable and increasingly important, increasingly more powerful trends, which define, I would say, China's regional strategy and its growing influence there.

Let me make two remarks to begin. First, before I get into the trends, I think we should recognize that these trends are embedded in what I would characterize as a broader degree of confidence. I think we can identify a move from a greater concern on China's part. I think John Tkacik's remarks make this point as well, moving from a kind of reactive and concerned approach in the mid to late '90s to one that's more confident.

And secondly, I think we have to characterize this regional strategy of China's over the past three to five years, and especially in the last two to three years, as successful. I think they are making significant inroads, politically, diplomatically, economically certainly, and even militarily throughout the region, and these ought to be issues of concern and interest to all of us here in the United States.

Let me get to the three major trends. First, I speak about a more proactive regional approach. What do I mean by "more proactive regional approach"? China, historically, at least in the region, had been slow to be an active player, tended to let others take the lead first, eschewed even bilateral commitments, and certainly tried to avoid multilateral commitments.

This is changing and we can see it across the board, beginning in the mid-1990s, but really accelerating in this decade. I identify the 15 so-called strategic partnerships, which China initiated with a range of its partners, most of them in the Asia Pacific region, symbolism perhaps, but I think you can point to some of these strategic partnerships as having moved in recent years to something much deeper and sustained and institutionalized.

For example, I would point to the China-Russia 25-article friendship treaty, which was signed in the summer of 2001, which was a direct follow-on from the so-called strategic partnership, which China established with Moscow in the mid-1990s.

China-ASEAN relations have moved forward quite rapidly beyond the China-ASEAN Free Trade Agreement to a full range of non-traditional security issues. The China-ASEAN relationship is another one of those so-called strategic partnerships, which we dubbed symbolic back in the mid-1990s, and now we see some real meat beginning to develop on those bones.

Another one that we're not paying a lot of attention to, I think, is the China-Europe connection, another strategic partnership established in the late 1990s, now getting quite deeply institutionalized, and I would recommend all of you to have a look at the re-

sults of the sixth EU-China summit, which was held in October of 2003, concluding two major agreements on satellite navigation cooperation and tourism facilitation, and also the establishment of a new mechanism on industrial policy dialogue. EU-China relations are moving ahead very quickly and very substantially.

Another interesting example of China's proactive approach is related to the Shanghai Five, now known as the Shanghai Cooperation Organization, extending Chinese influence I think quite effectively into central Asia, beginning on security issues, but moving now more into economic-related questions. I know some of your speakers later today will be discussing those, so I do not want to get into that.

A couple other examples, though. China reached out to NATO for a dialogue which I think was held for the first time in January of this year, and maybe the best example of all is China's more proactive role on the Korean peninsula, agreeing to host the three-party talks in April, six-party talks in August, and agreeing once again to hold talks in this month. Much more proactive, that's my point, going from a reactive position, waiting, biding its time, to something that's a little bit more active on China's part.

Second major trend: increased support for and participation in regional security mechanisms. I mentioned before that China tended to avoid and eschew involvement in either bilateral and especially multilateral security mechanisms and confidence-building measures dating from the '80s and into the mid-1990s.

China saw them as something which was designed by the United States often or other major countries, as a way of containing, drawing China in and tying it down is the way Gerald Siegel referred to these multilateral institutions, and China knew it and tried to avoid them. Not so anymore. China is an extremely active player in a range of multilateral security mechanisms in Asia and outside of Asia around the globe. I've mentioned already the Shanghai Cooperation Organization. You can take a look in the paper about a range of things in Southeast Asia that China has undertaken. I think one of the more interesting things, for example, was the June 2003 suggestion by China that the ARF institute a so-called "security policy conference," which would engage defense leaders rather than simply the ministers of state or—I'm sorry—the foreign policy leaders of the region. This is something the United States talked about many, many years ago, but has sort of let slide. Now, China is moving ahead to try to initiate it, and it's very interesting.

In another area of multilateral security interest for China is its participation in foreign military exercises. I'm sure you're all aware that China has been an observer at Cobra Gold, for example, our major exercise with Thailand and Singapore. Even more interestingly, though, is China itself has allowed foreign visitors to come to its own military exercises. I would point to the August 2003 exercises in Inner Mongolia at its tactical training base where China invited observers from 15 countries, including the United States, United Kingdom, and an a range of others to come and observe. I hope you've all had a chance to talk with American observers at that exercise and try to find out just what it is they saw and what it is they think about China's military capacity at an exercise level.

Also, interestingly, a range of port visits. China circumnavigated the globe a couple years ago with its Navy for the first time. It just finished a major 37-day set of port visits in October and November to Guam, Brunei and Singapore. China is all over the place in Southeast Asia in terms of its multilateral military presence as well.

Increase in United Nations peacekeeping. China has now its largest international presence of peacekeepers since 1994, so across a broad range of multilateral and bilateral security mechanisms, China is certainly much, much more active. Just one more point, the July 2003 agreement by China to join in the United States Container Security Initiative is another good example of China's willingness to jump in on multilateral security mechanisms. So that's the second point, much more active participation, and I think concrete. It's not just symbolic. Much more concrete and it's making a difference, especially in Southeast Asia and in central Asia in terms of Chinese influence.

Third, emphasizing economic and political influence vis military influence. Again, John talks about this in his presentation. You can look at the 1990s, in the late 1990s, is a period which China thought it was maybe smarter to flex its military muscle as a way to try to get what it wanted in parts around its periphery such as vis-à-vis Taiwan or in the South China Sea.

I'm not saying China is abandoning that, far from it. We know that China is continuing its military modernization program across a range of aspects, but importantly it's seeking to downplay it and give greater emphasis to what it recognizes is a more favorable approach for its interest of economic and political influence. And I think it's doing it quite effectively.

In Southeast Asia, we see that China has reached the Declaration of Conduct for Parties in the South China Sea, setting that issue aside and I think reassuring its Southeast Asian neighbors of its benign intentions in that part of the world.

North Korea is another good example, I think, not that China would exercise military force against North Korea, but it is seeing the benefit of trying to exercise economic and political levers with its neighbor to try to seek some kind of solution.

I think the best example of this trend is Taiwan. Again, China has not given up obviously its military threat against Taiwan, but it's certainly stepped up and accelerated and I think become more nuanced in its political and economic efforts vis-à-vis Taiwan to bring about the kind of solution that it would like to see there. So those three trends, I think, are very important in looking at—more proactive regional approach, increased support for participation in multilateral security, and emphasizing economic and political influence.

One last word, Madam Chairman. This obviously has major implications for us here in the United States. I think China is having a successful effort, and we need to watch this much more carefully. Thank you very much.

[The statement follows:]

**Statement of Bates Gill, Ph.D.
Freeman Chair in China Studies
Center for Strategic and International Studies**

Introduction

Allow me to begin by thanking Chairman Robinson, Vice Chairman D'Amato, as well as the Co-Chairs for today's session, Commissioners Bartholomew and Dreyer, for the invitation to speak before the Commission today. I congratulate the Commission on holding this timely and important discussion of China growing economic influence in Asia and its implications for the region and the United States.

I have been asked to help set the stage for today's hearing by providing an overview of China's regional strategy, with a particular emphasis on the broad diplomatic, political, and security aspects of that strategy. With this in mind, my brief remarks will begin by identifying and discussing three key trends which increasingly define China's growing regional influence, and will conclude by noting some of the principal implications to be drawn from of these developments.

Three Key Trends

China's evolving regional strategy can be captured with reference to three key trends. A closer look at these three trends shows that the tactics which Beijing employs to achieve its interests have become more subtle, nuanced, flexible and sophisticated, and, increasingly, successful.

Overall, these trends are embedded in an increased "confidence" evident in China foreign and security policy, particularly with regard to regional strategy. This marks an important change. From the mid-1990s and into 2000, China's regional strategy was less a reflection of its strength than its self-perceived weakness and frustration with an increasingly troubled global and regional security environment. These views derived primarily, though not entirely, from Beijing's negative perceptions of U.S. policies in the Asian region and elsewhere around the globe.

However, more recently, and especially over the past two to three years, China's regional political, diplomatic and security strategy has become less stridently reactive and concerned, and steadily more proactive and confident. This trend predated the global shifts brought on by the September 11, 2001 terrorist attacks, but were accelerated by them, as the new strategic concern of terrorism overtook and side-tracked overt contentiousness between the United States and China. China's entry into the WTO in December 2001 and the smooth transition of power to the new "Fourth Generation" leadership in Beijing further strengthened China's more confident approach toward the international and regional security situation.

Across the spectrum of China's foreign policy elite are found new calls for a more "mature," "constructive," and "responsible" great power diplomacy for China. Such appeals call for abandoning China's long-held and reactive "victimhood" complex, putting memories of the country's "century of shame" to one side, and identifying more closely with a "great power mentality" befitting China's larger and more secure position in regional and global affairs. This broad policy approach is both cause and effect of China's more confident perception of its regional and global situation. A look at three key trends helps sharpen our understanding of China's emergent confidence.

More proactive regional approach. A first identifiable trend in China's regional strategy is its more proactive nature. Beijing has increasingly taken the initiative in trying to foster a security environment consistent with its interests, but which aims to engage its neighbors more openly and beneficially. For example, since the mid-1990s, Beijing has reached out and established more than 15 "strategic partnerships" with major bilateral and multilateral partners, with more than half of them in Asia-Pacific region. These "partnerships" may in some cases be largely political symbolism, but the important point is that China sees their importance as a means to expand its regional influence.

In some cases, these arrangements have moved beyond symbolism to deeper, sustained, and institutionalized relationships. For example, at Beijing's urging, having established a strategic partnership, China and Russia signed a 25-article "friendship treaty" during the Jiang-Putin summit of June 2001. China-ASEAN relations have moved forward with the establishment of efforts to achieve a China-ASEAN Free Trade Agreement, and agreement to cooperate on a full range of non-traditional security issues. The establishment of European Union-China summitry in the mid-1990s has led to deeply institutionalized dialogue channels across a range of issues; the sixth EU-China summit, held in October 2003, concluded two major agreements on satellite navigation cooperation and tourism facilitation, as well as the establishment of a new mechanism for industrial policy dialogue.

China also took the lead in establishing and expanding the “Shanghai Five” process as a way to manage security matters with its Central Asian neighbors, and in seeing to its institutionalization as the Shanghai Cooperation Organization (SCO) in 2001. China also had a leading role in establishing the importance of the annual ASEAN+3 consultations, which includes security-related discussions amongst China and its East Asian neighbors Japan, South Korea, and the ten states of the Association of Southeast Asian Nations. In the spring 2002, Beijing quietly approached the North Atlantic Treaty Organization (NATO) to explore the possibilities of initiating a security dialogue, which was later announced in October that year and held in January 2003. Beginning in 2002–03, China has been a far more active player in efforts to resolve differences between the United States and North Korea, initiating three-party consultations in April 2003, hosting six-party discussions (United States, North Korea, China, South Korea, Japan, Russia) in August 2003 (with plans to hold another round in December 2003), and orchestrating an active diplomatic effort with the key parties to keep the channels of dialogue open and moving toward resolution.

Increased support for and participation in regional security mechanisms.

A second important trend defining China’s evolving regional strategy concerns increased participation in and appreciation of regional security and confidence-building mechanisms.

Two of the best examples of this increased activity involve the SCO and the ASEAN Regional Forum (ARF). Beijing has also actively seen to the institutionalization of the SCO as a regional, multilateral security and confidence-building mechanism. Under SCO auspices, China and its Central Asian neighbors Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan engage in range of multilateral discussion and exchanges, from annual head-of-state and head-of-government summits, to regular meetings amongst senior counterparts in the fields of security, economics and trade, to the establishment of the SCO counterterrorism center in Bishkek, to the formal establishment of an SCO secretariat, based in Beijing, which will open its doors in January 2004. China and its SCO neighbors have participated in at least two joint military training exercises, the first in October 2002 between China and Kyrgyzstan, and the second in August 2003 involving China, Russia, Kazakhstan, Kyrgyzstan, and Tajikistan.

In Southeast Asia, China has deepened its interest and participation in the ARF since the mid- to late-1990s across a range of activities, confidence-building measures, hosting of meetings and conferences, and submission of data and information on security issues to the ARF. At the July 2002 meeting of the ARF, Beijing for the first time submitted a formal “position paper” which provided a detailed explanation of the new security concept. China proposed in 2001 that ARF members report on and send observers to multilateral joint military exercises. In another example, Foreign Minister Li Zhaoxing proposed to the June 2003 ARF meeting that the organization establish a new “Security Policy Conference,” to be attended largely by senior military personnel from ARF participating governments.

Beijing also moved in the late 1990s and early 2000s to initiate dialogue channels with ASEAN outside of the ARF process. In 2002, China and ASEAN established the “Cooperative Operations in Response to Dangerous Drugs,” which has included ministry-level meetings amongst China, Laos, Myanmar, and Thailand to deal with the challenge of drug smuggling in their shared border regions. During the China-ASEAN meeting of November 2002, the parties reached a “Declaration on the Conduct of Parties in the South China Sea” to govern the activities of claimants to various parts of the South China Sea, and reduce the potential for tension and conflict in the disputed areas.

China has also been increasingly more open to participating as an observer of foreign military exercises in East Asia, including those run by the United States, such as Cobra Gold. In an unprecedented step, China in August 2003 allowed foreign military personnel from 15 countries—including the United States, the United Kingdom, France, Russia, Germany, Canada, Tanzania, Thailand, and Turkey—to observe Chinese military exercises involving 5,000 Chinese troops at the country’s large tactical training base in Inner Mongolia. China has also become far more active in dispatching naval vessels abroad for friendly port visits: the country’s first naval crossing of the Pacific took place in early 1997 with visits to the United States, Mexico, Chile, Peru, the Philippines, Malaysia, and Thailand; in 1998–99, Chinese naval vessels made friendly port calls to New Zealand, Australia, the Philippines, Malaysia, Tanzania and South Africa; in a major first, the Chinese navy completed a circumnavigation of the world in 2002, visiting 10 countries along the way; in October and November 2003, a Chinese missile destroyer and naval supply ship undertook a 37-day voyage paying port visits to Guam, Brunei, and Singapore.

It is worth mentioning that China has also demonstrated its support for regional mechanisms and multilateralism in other parts of the world. These measures have included its political and financial support for regime change in and rebuilding of Afghanistan and increased personnel contributions to United Nations peacekeeping activities in Africa, Asia, the Middle East, and Europe. The December 2003 trip by Premier Wen Jiabao, which includes a stop in the United States, will also include his trip to Ethiopia to take part in the second China-Africa summit. Beginning in the late 1990s and significantly increasing in 2003, China ramped up its contributions to United Nations peacekeeping: China has nearly 300 observers, troops and police serving in eight U.N. missions, the highest number of Chinese personnel since the early 1990s.

China has also stepped up its support for a range of post-September 11, 2001 counterterrorism initiatives, including the establishment of counterterrorism dialogues with the United States, Russia, France, the United Kingdom, Pakistan and India, submission of a report to the Security Council Anti-Terrorism Commission on the implementation of Security Council resolution 1373, and accession to 10 of the 12 international counterterrorism conventions. China has also reached a number of cooperative counterterror agreements with the United States, including China's participation in the Container Security Initiative announced in July 2003.

Emphasizing economic and political influence. An increased emphasis on economic and political influence—while downplaying (though certainly not abandoning) its growing military strength—is a third key trend shaping Beijing's growing regional influence and increased emphasis on economic and political influence. In a prominent example of this tendency, China's role as host for the 2001 Asia Pacific Economic Cooperation (APEC) leaders summit in 2001 not only demonstrated its "arrival" as a major regional economic and political power, but also showcased its diplomatic adeptness in facilitating the meeting's joint counterterrorism statement.

In Northeast Asia, China is trying to flex its political and economic influence—such as putting a squeeze on economic assistance—to cajole North Korea toward a more agreeable posture, not only in terms of differences between Washington and Pyongyang, but also in terms of promoting political and economic reform and opening in the North. In Central Asia, China envisions an increasing role for economic and political ties, especially with countries such as Kazakhstan and Kyrgyzstan, to build upon and solidify gains made in the security sphere over the late-1990s. In Southeast Asia, Beijing has been adept in more confidently exercising its increasing economic and political influence in Southeast Asia to assuage the security concerns of its neighbors. The "Declaration on the Conduct of Parties in the South China Sea" with ASEAN in November 2003, and China's signing of the ASEAN Treaty of Amity and Friendship during the ASEAN-China summit in October 2003, were security-related political moves welcomed by Southeast Asia.

The increased Chinese emphasis on economic and political levers of regional power is best illustrated by the more nuanced, multifaceted, but still tough Chinese approach toward Taiwan. In the late 1990s and into 2000, Beijing openly threatened Taiwan with military action, such as the missile tests of 1995 and 1996, and the bellicose rhetoric suggesting a timetable for forcible reunification in the run-up to the 2000 Taiwan Presidential election. It appears Chinese leaders may be more willing to exercise economic and political levers—without abandoning the steady military buildup—to entice and co-opt different Taiwan-based constituencies into sharing a vision of cross-Strait relations that is closer to Beijing. While considerable tension, uncertainty, and potential instability and conflict still weigh heavily in the cross-Strait dynamic, Beijing's approach in recent years appears to be part of a more confident regional strategy overall.

Implications

Looking ahead, two key points may help us assess and gauge the prospects for what has been a relatively successful regional strategy for China. First, depending on the direction of the global war on terror and developments in other hotspots, the world may become an increasingly dangerous, uncertain and unstable place for Chinese interests, forcing Beijing to reassess its security position and make some very difficult decisions. For example, Beijing was not supportive of American intervention in Iraq, and would be extremely apprehensive about further American expansion of military action, not only for the disruptions it might bring to the international and regional security situation, but also for what it might mean in terms of American "hegemony" and military predominance. Indeed, many developments related to the counterterrorism effort exacerbate, rather than alleviate, long-standing Chinese concerns about the U.S.-led regional and global security order.

Likewise, a deterioration of the security situation on China's immediate periphery—up to and including war on the Korean peninsula or in the Taiwan Strait—would profoundly shake China's new confidence and, especially with regard to Taiwan, possibly bring it into conflict with the United States and its allies. Difficult choices lie ahead for Beijing regarding North Korea and Taiwan, and, if anything, these choices are likely to become all the more thorny.

Second, significant question marks continue to define the longer-term U.S.-China relationship in Asia. For example, at what point does China's successful cultivation of and influence in its regional neighbors significantly encroach upon spheres of influence enjoyed for decades by the United States? In many respects, Beijing's successful diplomacy and its promotion of a "new security concept" can be seen as Beijing's effort to offer an alternative security system in the region in contrast to Washington's framework of U.S. leadership, military alliances and a forward-based presence. Many in the United States and China harbor long-term concerns about one another. These understandings on both sides of the U.S.-China relationship point to potentially contentious times ahead as China emerges as a more prominent player in Asia.

But whether China's regional security trajectory smoothly continues on its currently successful trajectory or meets setbacks, one point seems certain: for better or worse, China is likely to become all the more capable at effectively pursuing its national goals and strategies, both within the region and among larger external powers with interests in the region such as the United States. That in itself is a relatively new and exceptional situation demanding far greater attention. I hope this hearing can make a useful contribution to that process.

Thank you.

Co-Chair DREYER. Thank you very much. By the way, I should have said for those few of you who may not know Dr. Gill holds the Freeman Chair at the Center for Strategic and International Studies, and I'd like to follow Dr. Gill's testimony up with that of Mr. John Tkacik, who is Senior Far East Specialist at the Heritage Foundation. Welcome.

**STATEMENT OF JOHN J. TKACIK, JR.
RESEARCH FELLOW IN CHINA POLICY, THE HERITAGE FOUNDATION**

Mr. TKACIK. Thank you, Madam Co-Chairman. I appreciate having the invitation to speak to you today. My take on what's going on in not just in Asia but around the world follows pretty much what Dr. Gill has outlined, but I'm going to focus on the economic side of it, and I will also perhaps give you sort of the mirror image of what I think the influence is on U.S. interest in the region.

China's growing economic clout in the Asia Pacific region, and I think even further abroad—now you can see China's economic clout in Russia and in central Asia and in the Middle East and even in the European Union—is also translating into growing influence on the national security considerations of China's neighbors and its major trading partners.

As China's economy continues to expand, it's over seven percent this coming year, and maybe 13 percent, I think we can straight-line China's growth the same way we could have straight lined it if we had projected out in 1991 to 2003. We can expect China to be the second-largest economy in the world, overtaking Japan's economy certainly in purchasing power parity power within the decade, within the next decade, and I think this is, of course, particularly true if Japan's growth remains in the doldrums.

Foreign direct investment in China, which is in galactic proportions, has turned the mainland into the workshop to the world. It has an inexhaustible reservoir of cheap labor, a unified commercial structure and a burgeoning domestic demand, which makes China's export-oriented manufacturing sector dominate in Asia.

But more ominously, China's internal fiscal and taxation regimes have encouraged foreign direct investment to move away from the labor intensive and into the capital intensive, heavy industries, advanced technologies, at an alarming pace. Not only is China now the workshop to the world, it is fast becoming the workshop of the world. China now produces aluminum engine blocks for automobiles assembled in the United States. It produces raw plastic resins for midstream production lines in the United States.

It produces glass substrate for flat panel video displays. It is the world's largest consumer of steel, copper and zinc. It's the larger producer in the world of steel, aluminum and zinc. China this year surpassed Japan as the world's second-largest consumer of petroleum after the United States.

What this means is China is now on the verge of developing a world class—I could also say that China is now on the verge of developing a world-class semi-conductor manufacturing industry complete with a world-class semi-conductor design infrastructure. In short, China is becoming a global economic power. And this is a development that is unsettling, even alarming, to China's neighbors in Asia, but it's now becoming a fact of life in the strategic and economic calculus of China's major trading partners outside the Asia Pacific Region.

Now, as Bates mentioned, there has been a subtle change in China's strategy from before, I think, I would mark it from before September 11 to after September 11, and the reason I say this is because I think before September 11, I saw sort of—my impression was that there was sort of a heavy-handed Chinese approach to the Chinese-Russian treaty in July, and then the new Shanghai Five, now Shanghai Six, Shanghai Cooperation Organization treaty in the summer before 9/11.

I also noticed that before 9/11, the Chinese were much more unsubtle, much more sort of direct about their throwing around their geopolitical weight in Southeast Asia, but I think since September 11, China has changed its approach, or at least I've noticed a change in approach. I think rather than intimidating its neighbors, it has assiduously pursued a strategy of transforming its economic clout into political influence.

In November 2001, China made what is I think a bold proposal to the Association of Southeast Asian Nations, ASEAN, to begin negotiations over this continuing decade toward forming the largest free trade zone in the world with a population of about 1.7 billion.

The agreement with China to form a free trade area by 2010 with four weaker Southeast Asian countries given till 2015 to meet the targets, this is a pact that would take effect within say three years from the former launch last July. Now, at the time, in November of 2001, several ASEAN nations were alarmed by this. I think ASEAN's Secretary General Rodolfo Severino warned that ASEAN itself was not yet a new unified market and implied that it was too soon to make the leap into a big trade pact with the Chinese, but ASEAN acquiesced out of fear, I think, that if it balked, it would alienate China.

And China's strategy in this was very sophisticated, I think. In a bid to weaken sort of resistance, China offered an early harvest proposal that would give ASEAN agricultural products duty free

access to the China market for three years before China would demand duty-free access to ASEAN markets.

What this meant was that the ASEAN members without a strong agricultural export sector would lose out while those that did export farm goods and secondary products like Malaysia, Thailand, and Indonesia would begin to move ahead full speed.

The effect of this was a divide and conquer strategy, and I think it has worked. I think one Japanese analyst concluded that, quote, "China hopes to form at some point a counter power comparable to the United States and Europe by unifying Asian countries under its leadership."

I can also look at the June 2003 Strategic Partnership proposal that China made following the ASEAN free trade proposal. A senior ASEAN official described it as a, quote, "ambitious document whose subtext is to keep the Americans and the Japanese at arm's length from ASEAN or at least to give China a special relationship with ASEAN."

Other ASEAN diplomats wondered how the United States would react to this challenge. In July 2001, China signed on to ASEAN's Treaty of Amity and as this is the code of conduct in the South China Sea which committed itself to using peaceful means to resolve territorial conflicts, and I think in adopting the treaty, China agreed not to participate in any activity, quote, "which shall constitute a threat to the political and economic stability, sovereignty or territorial integrity" of the other signatory states.

Now, the intent was to ease ASEAN fears that China has territorial designs in the South China Sea, but a few ASEAN states, particularly the Philippines, continue to be highly suspicious of China's intentions, and last month we find China subtly pressuring Manila by continuing a persistent oceanographic research campaign in Philippine waters in violation of those security commitments.

Still, China's strategy is paying off. China's total trade with ASEAN grew at 60 percent in the first four months this year. China's exports grew 30 percent in the same period. But what does this trade constitute or what constitutes this trade?

I think what we're seeing is, according to one Thai official who was quoted in *The Wall Street Journal*, "China is dumping more of its exports into ASEAN and it is worrisome." The net result is predictable. The ASEAN-China free trade pact will mean that Chinese manufacturers will break into the Southeast Asian manufactured goods markets and ASEAN will be reduced to providing a stable supply of commodities and raw materials to China's economy.

In the end, one can foresee that manufacturing in ASEAN will be swamped by duty-free competition from China, and the ASEAN industrial investment will be relocated to China. FDI trade flows to economies in the Asia Pacific region have already declined 24 percent from 2000 to 2001, and I think trade suffered similarly.

But what we're seeing even now this year is a loss of jobs in ASEAN. I'm going to skip over the rest of this, but I'll say that you have the same phenomenon in Japan, you have the same phenomenon in Taiwan, you have the same phenomenon in Mexico,

and you have the same phenomenon in the United States. We are now exporting our jobs to China.

I don't want to make too much of this. There's certainly very good economic reasons for this to take place, but it's something that we have to be aware of. Not only is it, well, I think the major threat to the United States here is the migration of our advanced technology and our heavy industry from, particularly in semi-conductors, and I outline that in my paper.

In conclusion, let me just say that I've seen China's economic clout in Saudi Arabia, in Australia, and in the European Union yielding a much more conciliatory position of those countries and unions toward China. The European Union this week is even reassessing its view of its arms sales embargoes to China.

Now, when the European Union starts to reconsider selling advanced weaponry to China, I have to start worrying. The reason feels it can go this route is because of China's economic clout. Now, of course, this is hardly a comprehensive review of China's political and economic influence in the Asia Pacific region, but it has to raise the alarm in Washington, and I think while Washington is preoccupied with the war on terror, the occupation of Iraq, the North Korean nuclear crisis and dozens of lesser brush fires, China is patiently and systematically amassing a geopolitical presence of superpower proportions in Asia.

I think Washington must start to take China seriously as a potential great power competitor in the region. Thank you very much.

[The statement follows:]

**Statement of John J. Tkacik, Jr.
Research Fellow in China Policy, The Heritage Foundation**

Strategic Risks for East Asia in Economic Integration with China

Introduction

China's growing economic clout in the Asia Pacific Region, and even farther abroad, in Russia, Central Asia and the Middle East, even in the European Union, is already translating into growing influence on the national security considerations of China's neighbors and major trading partners.

As China's economy continues to expand at 7% to 13% annually, we can expect China's to be the second largest in the world, overtaking Japan's economy in purchasing power parity terms well within the next decade—particularly if Japan growth remains in the doldrums.

Foreign direct investment in China—in galactic proportions—has turned the mainland into the “Workshop to the World.” An inexhaustible reservoir of cheap labor, a unified commercial structure, an burgeoning domestic demand makes China's export-oriented manufacturing sector dominant in Asia. But more ominously, China's internal fiscal and taxation regimes have encouraged foreign direct investment to move into capital-intensive, heavy industry and advanced technology at an alarming pace. Not only is China now the “Workshop to the World,” it is fast becoming “Workshop of the World.” China now produces aluminum engine blocks for automobiles assembled in the United States, it produces raw plastic resins for mid-stream production lines in the U.S. It produces glass substrate for flat-panel video displays. It is the world's largest consumer of steel, copper and zinc, and the largest producer of steel, aluminum and zinc. China this year surpassed Japan as the world's second largest petroleum user after the U.S.

China is now on the verge of developing a world-class semiconductor manufacturing industry, complete with a world-class semiconductor design infrastructure.

In short, China is a growing global economic power. And this is a development that is unsettling, even alarming, to China's neighbors in Asia, as well as a fact of life in the strategic and economic calculus of China's major trading partners outside the Asia-Pacific Region.

China's Strategy before September 11 ... and after

Throughout the 1990s, China's leadership tended to confront its neighbors in the Asia-Pacific region with its military power. In 1995, Chinese missile tests in the Taiwan Strait halted commercial shipping in the Strait for over one week, and in 1996 China shot at least three short-range ballistic missiles into Taiwanese waters cutting off all maritime traffic in the Taiwan Strait for two weeks. In the mid-1990s China's navy aggressively expanded its presence in the South China Sea building permanent structures on submerged coral banks—as is allowed by the UN Convention on the Law of the Sea (UNCLOS) in economic exclusion zones—in waters also claimed by the Philippines. China's harassment of U.S. reconnaissance aircraft and ships in international waters also became increasingly aggressive.

Central Asia

In Central Asia, China strong-armed three of its neighbors, Kazakhstan, Kyrgyzstan and Tajikistan into border talks, then into border demilitarization talks, and finally into negotiations on a formal security treaty which included Russia. Later Uzbekistan joined the new alliance, called the "Shanghai Cooperation Organization," but it was clear that none of early three Central Asian states felt free to rebuff China's "invitation."

ASEAN

ASEAN states seemed intimidated by China's military and economic presence, and especially by the ability of China to attract foreign direct investment away from Southeast Asia to China.

Since September 11, 2001, however, China has changed its approach. Rather than intimidate its neighbors, it has assiduously pursued a strategy of transforming its economic clout into political influence. In November 2001, China made a bold proposal to the Association of South East Asian Nations (ASEAN) to begin negotiations over following decade towards forming the largest free trade zone in the world with a population of around 1.7 billion. The agreement with China form a free-trade area in goods, services and investment by 2010, with four weaker Southeast Asian countries given until 2015 to meet targets, and the pact would take effect within a target of three years from the formal launch of the pact on July 1, 2003.

At the time several ASEAN nations were alarmed and even the normally sedate ASEAN Secretary General Rodolfo Severino warned that ASEAN itself was not yet a unified market, and implied that it was too soon to leap into a trade pact with China. But ASEAN acquiesced out of fear that to balk might alienate China. China's strategy was sophisticated. It encouraged manufacturing investment to flee ASEAN to locate nearer the larger China market.

In a bid to weaken ASEAN resistance, China offered an "early harvest" proposal that would give ASEAN agricultural products duty-free access to the China market for three years, before China would require free-trade access for all goods with ASEAN. The result was that ASEAN members without a strong agricultural export sector would lose out, while those that did export farm goods and secondary products, like Malaysia, Thailand and Indonesia, would be inclined to move ahead. In effect, China's divide-and-conquer strategy with ASEAN has worked. One Japanese analyst concluded that "China ... hopes to form at some point a counter power comparable to the U.S. and Europe by unifying Asian countries" under its leadership.

At the ASEAN foreign ministers' meeting in Phnom Penh in June 2003, China followed-up this trade initiative with a proposal for a broad-ranging "Strategic Partnership" with ASEAN that included political cooperation. A Senior ASEAN official described the proposal as "an ambitious document whose sub-text is to keep the Americans and the Japanese at arm's length from ASEAN, or at least to give China a special relationship with ASEAN." Other ASEAN diplomats wondered how the United States would react, but as far as I can see, Washington has greeted the prospect with equanimity. In July 2001, China signed on to ASEAN's "Treaty of Amity," a disputes procedure established by the Association of Southeast Asian Nations (ASEAN) in 1976, which commits Beijing to use peaceful means to resolve territorial conflicts. In adopting the treaty, China has agreed not to "participate in any activity which shall constitute a threat to the political and economic stability, sovereignty, or territorial integrity" of other signatory states. The intent was to ease ASEAN fears that China has territorial designs on the South China Sea claims of littoral ASEAN members. But a few ASEAN states, particularly the Philippines, continue to be highly suspicious of China's intentions, and Beijing is subtly pressuring Manila by continuing its persistent "oceanographic research" in Philippine waters in violation of its security commitments.

China's strategy is paying off. China's total trade with ASEAN in 2002 was about \$55 billion, or about half the value of China's trade with the U.S., and Chinese im-

ports from ASEAN grew 60% in the first four months of 2003. China's exports to ASEAN grew 29% in the same period, but since then, according to a Thai official quoted in the *Wall Street Journal*, "China is dumping more of its exports into ASEAN and it is worrisome." The net result is quite predictable. The ASEAN-China free trade pact will mean that Chinese manufacturers will break into Southeast Asian manufactured goods markets and ASEAN will be reduced to providing a stable supply of commodities and raw materials to China's economy.

In the end, one can foresee that manufacturing in ASEAN will be swamped by duty-free competition from China, and Southeast Asian industrial investment will be relocated to China. FDI flows to economies in the Asia-Pacific region declined 24 percent from 2000 to 2001. Trade suffered similarly, with growth in merchandise trade falling to an estimated 2 percent in 2001 from 12 percent in 2000. But in 2001 and 2002, China took in \$100 billion in foreign direct investment, making it the number one Asian destination for all FDI—with investment levels up 16.89 percent in the first six months of 2002 alone. An example of the social and labor impact in Southeast Asia can be seen in Malaysia where Unico, a Malaysian firm that had been providing computer motherboards to chip giant Intel Corp., lost its Intel business when a Chinese rival grabbed the contract by offering to do the job for about half the price. At a stroke, half of Unico's 1,600 workforce was laid off. It is a story repeated weekly in the Malaysian press.

In the "zero-sum game" of FDI, China is sucking the oxygen out of the markets in Asia, and elsewhere for that matter. The result, in the words of one Hong Kong analyst, is that competition from China will reduce Southeast Asia's economic growth rate.

Even the *New York Times* sees China's economic presence "chipping away at the United States' position as the region's economic engine," beginning "an inescapable process of China replacing the United States as the dominant power in Asia" and becoming "already an economic and political threat to Japan." The *Times* quotes one analyst as explaining that "the export story for South Korea and Taiwan may not be so good because the components and parts factories will shift to China. ... [A]nything with volume is likely to end up in China." And there is a pervasive fear that Southeast Asian countries will be relegated to the role of supplier of food and raw materials to China in exchange for cheap manufactured goods that will, in turn, harm their own businesses.

The Affect of China's Trade and Investment Growth on Asia

These broader trends are already having their affect on labor patterns and standards of living conditions, not only in Southeast Asia, but in Japan, Taiwan, and in the Western Hemisphere as well. Taiwan government officials warn of the "hollowing out" of Taiwan's core industries as a result of an across-the-board migration of Taiwan's production lines to China. Trade patterns indicate that this same phenomenon has been a major factor in the persistent economic stagnation in Japan.

As late as July 2002, several major Japanese firms announced they would close production lines in Southeast Asia to cut costs and consolidate their assembly operations in China. NEC Corp. will close a personal computer line in Malaysia and move it to China. Seiko Epson Corp. will close a scanner production line in Singapore and transfer some production to China. Minolta will close a camera assembly plant in Malaysia and move the equipment to a factory in Shanghai. And the world's largest miniature ball bearing maker, Minebea Ltd., will relocate a measuring equipment line from Singapore to China. New statistics from Singapore show that the country lost more than 42,000 jobs in the past five years, most of them to China.

Some see China's economic power as the beginning of "an inescapable process of China replacing the United States as the dominant power in Asia." Others call China "already an economic and political threat to Japan." Indonesia is seeking a \$9 billion Chinese government liquid natural gas contract to power the industries of southern China. As the *New York Times* put it, "China—a hungry importer, a siphon of other nations' foreign investment and a surging exporter of cheap manufactured goods—is forcing its Asian neighbors to adjust."

Advanced Technology Investment and Trade

Ironically, the three countries with the most direct concerns about China's military modernization—Taiwan, the United States, and Japan—also have extensive direct FDI exposure in China's advanced technology industries which support modernization of China's People's Liberation Army.

By the end of 2001, Taiwan economic ministry officials say, Taiwan firms had invested an estimated cumulative US\$70 billion in China, while Taiwan's Central

Bank of China believes over US\$100 billion in Taiwan-controlled assets are in China. Chinese figures are a bit more modest, showing a total of US\$29.134 billion. Chinese government figures reflect that 2001 was the biggest year for Taiwan investments since 1995, with US\$2.979 billion in Taiwan direct investment.

But there has been a major change in Taiwan's investment patterns. No longer is the bulk of Taiwan money coming from small and mid-sized manufacturing operations in the low-tech sector. Instead, it is coming from Taiwan's largest firms. In the first seven months of 2002, Taiwan firms invested US\$1.94 billion in China, and 51.9 percent of that was new investment in the electronics sector alone.

The United States is a somewhat smaller investor in China than is Taiwan, but of higher quality. By 2000, American firms had invested a total of US\$9.58 billion in China, with over a third in high-tech manufacturing. In 2000 alone, U.S. direct investment outflow to China and Hong Kong hit a record high of US\$4.4 billion. In 2003, according to Assistant Secretary of State James Kelly, U.S. direct investment in China was up to \$5 billion.

Japan investment in China is also quite substantial, with over US\$1.5 billion in FDI estimated in the first half of 2001, 50 percent over the 2000 figure of US\$995 million, which itself was 32.5 percent over the previous year. Although the textile industry in China had attracted the bulk of Japanese FDI in the 1990s, since 1998 a third to a half of Japan's China-bound FDI was in the high-tech sector, particularly in electrical machinery and electronics. By the end of 2002, Japanese unemployment was at an all time high of 5.5%, and even advanced production facilities like Minolta's and Olympus's camera factories near Tokyo were moving Japanese plants to China, leaving their small and medium sized suppliers in Japan high and dry.

This phenomenon is even starker for Taiwan companies, which fill between 21 percent and 24 percent of all export orders from production lines in China. Indeed, Taiwan exports to China have risen from 18 percent of total exports in 1999 to nearly 23 percent of total exports in 2002, with 31 percent of exports to China being "electrical equipment and components." Over 70 percent of the exports appear to be destined for export processing. Earlier statistics indicate that Taiwan firms also account for 73 percent of China's entire information technology (IT) product output.

The significance of these trade patterns is that China's advanced-technology (AT) infrastructure is being built largely with foreign direct investment. Although FIE production lines heretofore had been designed to assemble imported AT components into electronic and IT hardware and appliances for subsequent export, foreign suppliers are now setting up the actual component production lines in China to be closer to their assembly lines and the assembly plants of other AT product customers.

Semiconductor technology is a prime example of this phenomenon. Already, Motorola manufactures mobile-phone specific integrated circuits—particularly global positioning ICs—at its MOS-17 waferfab in Tianjin. The MOS-17 facility includes full-up R&D, design, and manufacturing centers and will employ a total of 2,400 workers by the time it begins operation in 2002. By 2001, Motorola had 10,000 employees in China, including 1,500 researchers at the company's 18 labs. With the MOS-17 fab, Motorola's total investment in China was about \$3.4 billion in 2002, making it the largest foreign investor in China. But Motorola is now in the process of shedding all its production facilities, and has been obliged to sell off its Tianjin plant to a Chinese-owned chip fab for 20% of its value.

NEC Corp. of Japan has begun to produce 128-Mbit DRAMs at 0.25-micron linewidths (the industry standard) at its NEC Shanghai Huahong fab.

The Motorola and NEC investments have prompted Taiwan's top waferfabs—Taiwan Semiconductor (TSMC) and United Microelectronics (UMC)—to petition the Taipei government to permit them to transfer existing waferfabs to China. While Taipei has agreed in principle to the TSMC and UMC requests, it has conditioned its approval on the assurances that the Taiwan waferfabs will be replaced in Taiwan by more advanced facilities. As yet, the Taipei government has not issued formal rules governing the transfer of semiconductor facilities to China.

A migration of Taiwan's "crown jewel" technologies to China via Taiwan entrepreneurial exiles has alarmed Taipei's government. In a top secret report entitled, "An Analysis on how the Chinese Communist Party Attracts Taiwanese High Tech Investment for the Suzhou Industrial Park," Taiwan's intelligence agency reported in July 2001, that the Chinese authorities have a blueprint to actively develop semiconductor and high-tech industry "clusters" which include the entire spectrum of each industry. The result, the report said, was that China has effectively attracted the key sectors of Taiwan's computer industry, from downstream component makers like computer motherboard and monitor producers to PC cases and mouse makers. The report suggested that the Taiwan-invested high-tech sector would be a virtual "puppet" of Beijing, and recommended that the Taiwan government adopt policies

to curb high-tech investment in China. Indeed, the one high-tech area in China in which Taiwan's government still prohibits local investors from investing is semiconductor fabrication, but that ban, too, appears to be eroding.

Again, the impact of the loss of Taiwan manufacturing jobs to China is having a profound effect on labor and social stability in Taiwan. Unemployment is down from the all time highs in 2002 of over 6%, but it cannot seem to get below 5.5% despite the resurgence of economic growth in 2003. Thousands of white collar jobs at Taiwan companies are being relocated to China, and one estimate has over 300,000 Taiwan passport holders residing in China with over a million in China at any one time.

Russia

There are mirror phenomena in Central Asia and Russia, which I have read about only anecdotally. Kazakhstan's largest city, Almaty, reportedly has a Chinese suburb of nearly 100,000. In 2002, Russian Defense Minister Ivanov said he had no concerns about the number of Chinese workers in the Russian Far East, which "numbered between 200,000 and 5 million." Since there are only 8 million Russians living in the Russian Far East, Minister Ivanov probably protested too little to avoid a diplomatic row with China, his ministry's biggest customer for advanced weaponry. China has successfully leveraged its large population presence into geopolitical influence. In May 2002, Beijing successfully pressured the Kazakh government to withdraw an offer of basing support to U.S. forces supporting the Afghanistan campaign.

South Korea

South Korea is also a major investor in China, with over 56% of all ROK outbound direct investment going to China. Seoul also sees China as a potential brake on North Korean aggressiveness, and this makes the South Korean government solicitous of Chinese sensitivities across the board, from how the ROK handles the North Korean nuclear crisis, to Taiwan.

Petroleum, Natural Gas and Arms

China's appetite for petroleum and natural gas has also made it an important customer for Saudi Arabian oil and Australian natural gas. It is in a position to leverage its political influence on Central Asian and Russian energy decisions. Last year, China chose Australia over Qatar and Indonesia to supply it with 25 billion Australian dollars worth of gas over 25 years. And last month, the state-owned China National Offshore Oil Company signed an agreement outlining plans to sell Australian natural gas in China and to take an unspecified stake in the Northwest Shelf project. Chinese President Hu Jintao's October 2003 visit to Australia highlighted the growing Australia-China trade relationship and even had political commentators in Canberra pondering how Australia would react if some crisis in the region obliged it to choose between the United States and China.

The European Union is even reassessing its view of China. Just this week, EU Trade Commissioner Pascal Lamy said he was willing to "reconsider" the European Union's embargo on arms sales to China. His statement backs up comments this week by German Chancellor Gerhard Schroeder to Chinese Premier Wen Jiabao that China would be an excellent market for European military equipment. The EU's embargo was imposed after Beijing's crackdown on pro-democracy protesters in Tiananmen Square in 1989, and China told the EU in October that it wants the ban lifted.

Conclusion

This is hardly a comprehensive review of China's politico-economic influence in the Asia Pacific region, but it is enough to raise alarms. While Washington is preoccupied with the War on Terror, the occupation of Iraq, the North Korean nuclear crisis, and dozens of lesser brushfires, China is patiently and systematically amassing a geopolitical presence of superpower proportions in Asia. Washington must start to take China seriously as a potential great power competitor in the region.

Co-Chair DREYER. Thank you, Mr. Tkacik. I'd like to introduce Dr. Wing Thye Woo, who is Professor of Economics at the University of California at Davis, who will give us the mathematic/economic take on this issue.

**STATEMENT OF WING THYE WOO, Ph.D., PROFESSOR
ECONOMICS DEPARTMENT, UNIVERSITY OF CALIFORNIA AT DAVIS
AND DIRECTOR, EAST ASIA PROGRAM
CENTER FOR GLOBALIZATION AND SUSTAINABLE DEVELOPMENT
COLUMBIA UNIVERSITY**

Dr. Woo. Thank you, Madam Chairman and Members of the Commission. I'm most honored to be here to share with you my analysis of the economic consequences of China's integration into the international economy. The little distraction that we had before the hearing begun and what my two co-panelists have said have certainly convinced me that we're on to a burning issue of the day.

I will do my best to convince you that this burning issue is unlikely to end up with the U.S. economy being burnt. Under certain circumstances, some other economies could be made less well off by China's emergence. However, even then, with appropriate economic management, these countries could transform the outcome into a win-win situation for both sides. If we chooses to use the term "China's global economic strategy" to describe the kind of international economic system that would be in China's best interest, then China's global strategy is the preservation of the open multilateral trading system.

So any Chinese regional strategy is subordinate to the preservation of the open multilateral trading system. In short, if and when China becomes the leader of an Asian economic bloc, it is unlikely to make it a protectionist bloc. It is easy to see the basis for this global strategy. China wants to get rich by following the same export-led growth policies that propelled Japan, Korea, Taiwan, Singapore, and Hong Kong into the ranks of the developed world.

China cannot get rich by exporting only to its neighbors. China needs access to all the markets of the world to get rich. This is the key to understanding the forthcoming establishment of a free trade area between China and Southeast Asia, and it is also the key to understanding why China is not rushing into free trade area agreements with South Korea and Japan.

A free trade area with Southeast Asia will enhance the economic security of China by partly sheltering China from possible large price shocks from oil and other raw materials. A free trade agreement with Southeast Asia will make it easier for China to invest and co-own, Southeast Asian oil fields, palm oil plantations, rubber plantations, and tin mines and bauxite deposits.

Partial ownership of these plantations and minds in Southeast Asia means that China's vertically-integrated industrial groups will suffer less if the prices of raw materials were to ever spike upwards.

My interpretation of the forthcoming free trade area as a rush by China to secure its access to raw materials is confirmed by its recent attempts to build an oil pipe from central Asia to China, purchase an oil field in Russia, convert of the Shanghai Group from mainly a security grouping to an economic grouping.

The free trade area with China is welcome by Southeast Asia because Chinese foreign direct investment is offsetting the decline of foreign direct investment from other countries. What has happened is when China joined WTO and hence gained secure access to the U.S. markets, multinational firms have no longer the need to diversify its production locations across Asia in the worry that China

would not get MFN status in any year. And so multinational firms are consolidating their production locations in China.

To sum up, on the plus side, Southeast Asians are receiving FDI from China that is flowing into the raw materials sector. On the negative side, there is less FDI from other countries into the industrial sectors of the Southeast Asian countries because these other countries are now investing in China instead.

What's the net result of these pluses and minuses? Well, the inflow of FDI into the raw materials of Southeast Asia does not translate into much (if any) transfer of technology to make the production of raw materials more efficient. But the fall in FDI into Southeast Asia has meant a reduction in technological diffusion into Southeast Asia.

Southeast Asia is at higher technology level than China, and this is only because Southeast Asia has been able to persuade the rest of the developed world to bring the latest industrial technology to Southeast Asia. So if you were to look at the consequences on Southeast Asia of China's integration into the international economy, I would like to ask you to turn to page five at the very back of my paper which shows the change in the income of the world from the diversion of FDI into China.

Please not a confusion in the page numbering. The numbering repeats itself once we get to the graphs, after the text. It is not my overwhelming desire to be inscrutable that led to this misnumbering—the computer did it and I do not know how to override this glitch.

So it's called Figure 5, Change in Real GDP in Other Economies.

Co-Chair DREYER. Figure 5—not Table—

Dr. WOO. It is Figure 5. What we do see is that the Southeast Asian countries could end up having much lower growth than if China were not a member of WTO. Specifically, Thailand in 2020 could have a GDP that is seven percent lower than it otherwise would have been. The GDP of Malaysia and the Philippines would be five percent lower in 2020 and Indonesia would be three percent lower. Figure 5 is the case where the Southeast Asian nations are unable to offset the negative effects of the reduced transfer of technology into their countries, coming from the reduced FDI inflow.

If these countries were to be able to offset this drop in the flow of technology through various methods, such as increasing the interaction of the local universities with the scientific community in the West—the outcome would indeed be that shown in Figure No. 3. In the case where the reduced FDI inflow into Southeast Asia does not lower the rate of technological diffusion into Southeast Asia, the emergence of China would lower the GDP of Southeast Asia by less than half of one percentage point in 2020, an impact that is totally insignificant.

It is hence possible that the internationalization of China's economy would not render the Southeast Asian countries worse off—but this outcome requires an activist policy response by Southeast Asia. Simply put, the awakening of the Chinese dragon does not mean that the fates of the Southeast Asian economies are no longer in their hands.

Two final observations. The first is that the economic interest of China is converging to the economic interests of other developed

countries that are concerned with their vulnerability to the price shocks of raw commodities—to the disruption of the international communication system, and to the collapse of the open multilateral trading system. I therefore think that any Chinese regional economic strategy is subordinate to these three concerns with economic security.

My second concluding observation is that the international distribution of labor at the end of the last millennium was a very unnatural one. One-fifth of the world's population was prevented by its government from participating in the international division of labor.

Today, China is assuming the position abandoned 50 years ago when the People's Republic was founded. The right economic policy response by China's trading partners is to institute measures that would strengthen their ability to innovate technologically, and speed up the re-deployment of workers displaced by imports.

That's my statement. Thank you.

[The statement follows:]

**Statement of Wing Thyee Woo, Ph.D., Professor
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The Economic Impact of China's Emergence as a Major Trading Nation

Introduction

The key to understanding the international impact of China's emergence as a major economic power, as marked by its accession to the World Trade Organization (WTO), is that the global division of labor at the end of the last millennium was a highly unnatural one. It was unnatural because the self-imposed isolation of China in the 1949–1979 period and its slow integration into the international economy in the 1980–1991 period kept over one fifth of the human race from meaningful participation in the world trade and investment systems. This is why China's accelerated integration into the world economy beginning in the mid-1990s has led to significant relocation of labor-intensive industries to China. In mid-2003, the electronic and electrical firms in Penang, Malaysia, employed 17 percent fewer workers than in 2000. On the other side of the Pacific, 500 of Mexico's 3,700 *maquiladoras* (foreign owned export-oriented firms) have closed since 2001, and the surviving *maquiladoras* have reduced their employment by almost a third.

Foreign direct investment (FDI) into China increased from US\$44.2 billion in 1997 to US\$52.7 billion in 2002. This caused China's share of total FDI into the developing world during this period to rise from 22.9 percent to 32.5 percent, and its share of total FDI into Asia to soar from 40.6 percent to 55.5 percent.

The Gorilla Awakes

Developments like the above are the reason why the Prime Minister of Singapore, Mr. Goh Chok Tong, informed his fellow citizens during his National Day address in 2001 that:

“... China poses a big economic challenge. Some economists describe China as an *800-pound trading gorilla*. A Hong Kong newspaper added that this gorilla was *very hungry* ...

“Even India is being flooded with cheap but good quality Chinese goods. Some Indian manufacturers are finding it hard to compete. So they have done the next best thing. They stick ‘Made in China’ labels on their products to boost sales ...

Statement prepared for the Hearing of the *U.S.-China Economic and Security Review Commission on China's Growth as a Regional Economic Power: Impacts and Implications*, December 4, 2003, Room 124, Dirksen Senate Office Building. The empirical work presented in this statement is from joint research conducted with Professor Warwick McKibbin of Australian National University as part of the ongoing project on Economic Growth in China conducted by the East Asia Program of the Center for Globalization and Sustainable Development at Columbia University.

“Our biggest challenge is therefore to secure a niche for ourselves as China swamps the world with her high quality but cheaper products. China’s economy is potentially ten times the size of Japan’s. Just ask yourself: how does Singapore compete against ten post-war Japans, all industrializing and exporting to the world at the same time?”

“I do not mean that China will overpower every other economy, and grow at the expense of everybody else. As China develops and exports more, its imports will grow too. There will be many opportunities to invest in China. We must grasp those opportunities.”

Mr. Goh is certainly correct in pointing out that China cannot just be an exporter without also being an importer too. But the crucial issue is whether the composition of goods that China would import would require a complete overhaul of the production structures of East and Southeast Asia. Would China’s WTO accession cause Indonesia, Malaysia, Philippines and Thailand (the ASEAN-4) to de-industrialize and return to their roles in the 1950s and 1960s as primary commodity exporters? Or would there be sufficient lucrative niches within the manufacturing production chains that the ASEAN-4 could specialize in?

The second scenario is certainly a possibility, particularly for Singapore, Taiwan, and South Korea. In the opinion of Stanley Fischer, the former deputy managing director of the IMF:

... there is little cause for fear ... a big dynamic economy in the neighborhood is a benefit, not a curse, for those around it—look at Canada or Mexico ... Or, one might add, look at Asia after Japan emerged as an economic power from the 1970s onward. (“Don’t fear China threat,” *The Straits Times*, 4 September 2001.)

Boom or doom? And for whom? These are the two questions that I would like to address in this statement. In order to answer the above two questions about the international impact of China’s rise as a major economic power, we have to first understand why China has been so arduous in its pursuit of WTO membership. Since WTO membership for China mainly requires it to implement drastic reductions in its trade barriers across-the-board in a relatively short period of time, it can therefore appear puzzling why WTO membership is necessary when China can achieve the same results by undertaking unilateral cuts in effective tariff rates by the amount that it chooses and within a time period that it determines. Why did China pursue protracted negotiations to get an arrangement where the lowering of trade barriers is externally supervised, and leaves China open to international sanctions if the trade liberalisation does not meet the externally imposed criteria, when unilateral trade deregulation is an option?

The answer to this riddle is that the fundamental reason for China’s enthusiasm for WTO membership is that WTO membership will greatly enhance China’s economic security. The United States had enacted the Permanent Normal Trade Relations (PNTR) Act on 10 October 2000, and the PNTR ended the annual approval from the U.S. Congress for most-favored-nation (MFN) status in order for its exports to compete in the U.S. markets on equal terms against the exports from WTO countries. However, the important point to note is not the passage of PNTR, but the realistic situation that whatever laws passed by Congress can also be repealed by Congress later without violating any international law. So, until China is a WTO member, which gives China unconditional, *permanent*, multilateral rights to trade with other WTO members, the threat of PNTR being repealed renders China’s exports vulnerable to passing passions in the U.S. political arena. Examples of recent passing passions would include accidents like military airplane collisions in the South China Sea, and the Chinese burning of the U.S. consulate in Chengdu following the unintended U.S. bombing of the Chinese embassy in Belgrade. The importance to China of maintaining high export growth and of maintaining the competitiveness of its exports to the U.S. market is hard to overstate.

The United States is China’s biggest export market. The United States, until the recent restrictions on steel imports, had been perceived as ideologically committed to free trade and consequently less prone to protectionism than Europe and Japan. Clearly, in order for exports to be a sustainable growth engine, China must secure assured access to its biggest market. And, only WTO membership can prevent the United States from the impulsive unilateral action of switching off one of China’s most important growth engines by simply suspending the PNTR Act, and raising tariffs on China’s exports. (The reader interested in the legal protocol under which China joined WTO should consult Qin (2003).)

China’s Economic Linkages to the World

China’s enhanced economy security has important implications for its neighbors because the international movement of goods is only one of China’s two economic

links to the world. The international movement of capital is the other. The important but oft-neglected point in analysing China's WTO membership is that the removal of the uncertainty about China's market access to the U.S. market increases China's reliability as a supplier. This means that producers of labor-intensive goods destined for sale in the high-income economies can now reduce management cost by reducing the geographical diversification of its production facilities. More of the production can now be carried out in China because its labor costs are lower than in the ASEAN-4.

Analytically, the removal of the MFN threat when China officially became a WTO member at the end of 2001 is equivalent to a reduction in the risk premium demanded by investors in China's export-oriented industries. The complete picture of China's WTO membership is more than a reduction in China's effective tariffs; it also includes a reduction in the risk premium for investment in export-oriented production inside China. The effect of the tariff reduction is to reallocate the composition of China's output from importables to exportables and non-tradeables; and the effect of the risk premium is to reconfigure the global distribution of FDI in China's favor.

There is indeed evidence of the FDI diversion effect created by China's WTO membership. The Japan Bank for International Cooperation (JBIC) conducts an annual survey of Japanese trans-national corporations (TNCs) to find out which are the top 10 locations for manufacturing FDI over the next three years. Table 1 contains the results from the surveys undertaken in 1996, 2000 and 2001. 68 percent of Japanese TNCs listed China as one of the top 10 locations in 1996, and 65 percent did so in 2000. These responses made China the most frequently identified promising location for FDI in both years, i.e. China was ranked first in the list of 10 locations.

The evidence in favor of our FDI diversion hypothesis is captured in the 2001 survey. It became clear to the international community at the end of 2000 that China's accession to WTO was imminent. The upshot was that the proportion of Japanese TNCs in 2001 that identified China as one of the 10 most promising locations for manufacturing FDI jumped to 82 percent from 65 percent in 2000. Most telling of all, the "identification gap" between China and the United States, which were ranked first and second respectively in 2000 and 2001, widened from 24 percentage points in 2000 to 50 percentage points in 2001.

The frequency that the ASEAN-4 economies were identified as top 10 locations for FDI dropped between 1996 and 2000, and the most important reason for this change in TNC's perception could be the Asian financial crisis. The frequency that Thailand was identified fell from 36 percent to 24 percent, Indonesia from 34 percent to 15 percent, Malaysia from 20 percent to 12 percent, and Philippines from 13 percent to 8 percent. In terms of ranking within the 10 most cited locations, Thailand slipped from 2 to 3, Indonesia from 3 to 4 and Philippines from 8 to 10, while Malaysia improved from 6 to 5.

As the Asian financial crisis was over by early 2000, the changes in the frequency of identification and ranking of the ASEAN-4 economies on the list of profitable FDI locations between 2000 and 2001 could therefore justifiably be attributed to the WTO-created improvement in China's reliability as an international supplier. The frequencies that Thailand and Indonesia were identified as desirable FDI locations are practically identical in 2000 and 2001, but the identification gaps between them and China increased significantly. The China-Thailand gap went up from 41 percentage points to 57 percentage points, and the China-Indonesia gap from 50 percentage points to 68 percentage points. The frequency that Malaysia was cited declined from 12 percent to 8 percent, and the Philippines dropped out of the top 10 list. Malaysia's rank moved from 5 to 9, and the China-Malaysian identification gap soared from 53 percentage points to 74 percentage points. These differences in the survey results of 2000 and 2001 are certainly consistent with our hypothesis of WTO-induced diversion of FDI to China.

A recent news report makes clear that the drop in inward FDI in Malaysia has been substantial in 2002, and that the Malaysia government has no doubt that much of the drop is due to FDI diversion to China:

"Malaysia attracted approved manufacturing FDI of only RM 2.16 billion ... for the first six months of this year [2002]. This is a sharp drop from the RM 18.82 billion it pulled in for the whole of last year.

... 'Everybody is feeling the pinch because the amount of FDIs has shrunk and then, a lot of that is going to China,' Dr. Mahatir [Prime Malaysia] told a news conference later." ("Malaysia turns inward for growth," *The Straits Times*, 21 September, 2002).

To fully appreciate the importance of this diversion of FDI, we should be cognizant of the possibility that FDI diversion could be more than just a simple relocation of the capital stock. FDI might also generate positive externalities. The East Asian experience suggests that FDI could facilitate technological transfers (i.e. generate technological spillovers) not only to domestic firms in the same industry but also to domestic firms in other industries; see Okabe (2002). Furthermore, FDI could also help solve the difficulties of access to the international markets in these goods. In short, a country gaining FDI could experience not only a bigger capital stock but also possibly a (maybe temporary) increase in its total factor productivity (TFP) growth rate; while a country losing FDI could experience a (maybe temporary) slowdown in TFP growth as well as a (maybe temporary) lower capital stock.

Table 2 presents the evidence in support of the link between FDI and technological diffusion by presenting the index values of the Overall Technological Capacity, column (3), for a number of the 59 countries ranked in the *World Competitiveness Report* issued by the World Economic Forum (2000). Also shown in Table 2 are the two determinants of the Overall Technological Capacity: the Indigenous Ability to Innovate, column (1), and the Ability to Obtain Technology Transfer from Abroad, column (2). The overall technological capacity index is determined by averaging the other two indices, the “indigenous innovation index” and the “technology transfer index.”

The rankings of the Overall Technology Index for Malaysia (18), Philippines (32), and Thailand (43) are above China (48), and Indonesia (50) is only slightly below China in ranking. However, it is important to realize that the higher average rank of the ASEAN-4 in overall technology (36) comes from the higher technology transfer from abroad—the rank of Malaysia is 7, Philippines is 19, Thailand is 36, China is 43, and Indonesia is 45. China’s indigenous ability to innovate is ranked 34 which is substantially above the rank of the ASEAN-4 to innovate indigenously (46). The point is that the average ASEAN-4 economy depends critically on technological diffusion through FDI to raise its overall technological level to be above that of China. FDI diversion from China’s WTO membership is therefore likely to cause the future rank of Indonesia, Malaysia, Philippines, and Thailand in the Overall Technology Index to fall, and of China to rise.

Since Hong Kong, Japan, Singapore, South Korea, and Taiwan rank above China in both the ability to innovate indigenously and to obtain foreign technology, the diversion of FDI into China is unlikely to affect their levels of technological capacity. The fact is that these five East Asian economies are some of the sources of FDI into China and into the ASEAN-4 means that they are amongst the sources of the technological diffusion that is being discussed.

In summary, there are three levels of answers in thinking about the consequences of China’s WTO membership on the ASEAN-4. The first level is the standard analysis of a unilateral cut in China’s effective tariff rates. The result is a redirection of labor and capital away from China’s importable goods sector toward its exportable goods sector, causing China to import and export more. A more detailed examination might reveal that the additional Chinese imports will be capital-intensive goods from the developed economies, and the additional Chinese exports will be labor-intensive goods to developed and developing countries. We call the first level answer the *naïve analysis*.

The second level answer recognizes that not only would there be tariff cuts as required by WTO membership but also that the removal of the market access threat to China would likely lower the risk premium required for investing in China. The expectation generated by the latter development is that there would be diversion of FDI to China, especially from its East and Southeast Asian neighbors. We call this second level answer the *FDI Diversion analysis*.

The third level answer enriches the second level answer by pointing out that FDI would not only increase the domestic capital stock, but some argue that it could also increase technological transfers to the whole economy and improve the access of more Chinese goods to foreign markets. We call this the *analysis of the diversion of FDI with technological spillovers*.

Quantifying the Impact—the G-Cubed (Asia-Pacific) Model

The G-Cubed Asia Pacific (AP-GCUBED) model is ideal for such analysis having both a detailed country coverage of the region and rich links between countries through goods and asset markets. The AP-GCUBED model encompasses the United States, Japan, Australia, New Zealand, South Korea, the Rest of OECD (ROECD), China, Indonesia, Malaysia, Philippines, Taiwan, Thailand, Hong Kong, Singapore, India, OPEC, EEFSU (Eastern Europe and the former Soviet Union), and the Rest of the World (ROW). Each of the 18 countries in the AP-GCUBED model has 6 sec-

tors: energy, mining, agriculture, durable manufacturing, non-durable manufacturing, and services.

Each core economy or region in the model consists of several economic agents: households, the government, the financial sector and the 6 production sectors. Intertemporal budget constraints on households, governments and nations (the latter through accumulations of foreign debt) are imposed. To accommodate these constraints, forward looking behavior is incorporated in consumption and investment decisions. The investment process is assumed to be subject to rising marginal costs of installation. Aggregate consumption is chosen to maximize an intertemporal utility function subject to the constraint that the present value of consumption be equal to human wealth plus initial financial assets. International trade imbalances are financed by flows of financial assets between countries (except where capital controls are in place).

As a result of this structure, the AP-GCUBED model contains rich dynamic behavior, driven on the one hand by asset accumulation and, on the other by wage adjustment to a neoclassical steady state. It embodies a wide range of assumptions about individual behavior and empirical regularities in a dynamic general equilibrium framework. The interdependencies are solved out using a computer algorithm that solves for the rational expectations equilibrium of the global economy. It is important to stress that the term ‘general equilibrium’ is used to signify that as many interactions as possible are captured, not that all economies are in a full market clearing equilibrium at each point in time. Although it is assumed that market forces eventually drive the world economy to a neoclassical steady state growth equilibrium, unemployment does emerge for long periods due to wage stickiness, to an extent that differs between countries due to differences in labor market institutions. The model has approximately 7,400 equations in its current form with 140 jumping or forward looking variables, and 263 state variables. More technical details of the model are given in Appendix 1 of this statement.

We will undertake four sets of simulations:

1. Baseline simulation;
2. Naïve simulation;
3. Reduction in risk premium simulation; and
4. Diversion of FDI with technological spillovers simulations.

The Baseline Simulation: This simulation generates the future values of all the endogenous variables based on the assumption that the existing policy regimes in the world will persist indefinitely into the future. The tariff rates we use are based on the GTAP 4 database which contains estimates of the levels of tariff and non-tariff barriers. The baseline simulation, in short, assumes that the trade regimes in 2000 are continued forever (which includes China’s exclusion from WTO).

Counterfactual Simulation No. 1—The Naive Simulation: The only changes are the reduction in China’s trade barriers (both tariff and non-tariff barriers). We assume that trade barriers are reduced gradually over time by an equal amount (measured in percentage points) over the ten-year period of 2003 to 2012.

Counterfactual Simulation No. 2—A Reduction in the Risk Premium Demanded by FDI—The FDI Diversion Simulation: This simulation supplements the naive simulation with a 1 percentage point reduction in the risk premium demanded by foreign investors in China.

Counterfactual Simulation No. 3—FDI Creates Technological Spillovers in the Host Economy—The FDI with Technological Spillovers Simulation: We supplement the simulation of the FDI diversion case with the 5 conditions of:

1. a temporary decrease in the total factor productivity (TFP) growth rate of the manufactured durable goods industries located in Indonesia, Malaysia, Philippines, and Thailand. We assume an annual decline of 1 percentage point beginning in 2003 until TFP level is 10 percentage points below baseline TFP level in 2112;
2. a temporary decrease in the TFP growth rate of the manufactured nondurable goods industries located in Indonesia, Malaysia, Philippines, and Thailand. We assume an annual decline of 1 percentage point beginning in 2003 until TFP level is 10 percentage points below baseline TFP level in 2112;
3. a temporary increase in the TFP growth rate of the manufactured durable goods industries in China. We assume an annual increase of 1 percentage point beginning in 2003 until TFP level is 10 percentage points above baseline TFP level in 2112;
4. a temporary increase in the TFP growth rate of the manufactured nondurable goods industries in China. We assume an annual increase of 1 percentage point

beginning in 2003 until TFP level is 10 percentage points above baseline TFP level in 2112; and

5. a temporary increase in the TFP growth rate of the service industries in China. We assume an annual increase of 1 percentage point beginning in 2003 until TFP level is 10 percentage points above baseline TFP level in 2112.

The above 5 conditions are assumptions about the stances of public policy and the steepness of the learning curves in the ASEAN-4 and China. We assume that it will take a decade for the ASEAN-4 to improve their scientific bases sufficiently to offset the slowdown in technological diffusion due to the lower FDI inflows. We also assume that it will also take a decade for the Chinese sectors to fully master the new technology contained in the diverted FDI. Again these are assumptions rather than predictions, but they give indicative estimates of the impacts of a range of plausible assumptions.

The Results of the Simulations

Naive Simulation: Figure 1 reports the deviations from baseline GDP of 11 economies: United States, Europe, Australia, New Zealand, Japan, South Korea, Taiwan, Indonesia, Malaysia, Philippines, and Thailand. None of their GDP deviations are more than two-tenths of one percent from the baseline, which are indistinguishable from measurement errors. Figure 2 shows the deviations of exports of 10 out of the 11 economies from the baseline to be less than three-tenths of one percent. The largest export deviation is that of the United States which is 0.8 percent above the baseline in 2020—possibly, the reduction in Chinese protection of its import-competing industries led China to import more capital goods from the United States. In practical terms, however, China's WTO membership has no impact on these 11 economies.

Simulation of the FDI Diversion Case: Figure 3 reveals that while the deviations in GDP are negative for these 11 economies, their magnitudes are trivial. In 2020, the deviations of 10 economies are below three-tenths of one percent, and Korea's deviation is almost half of one percent. The export deviations exhibited in Figure 4 are almost the same as in Figure 2—U.S. exports in 2002 is now 0.9 percent above the baseline. On the whole, it is hard to say that any of the eleven economies are hurt in a non-trivial way.

Simulation of the Case of FDI with Technological Spillovers: We consider this simulation to be the most realistic one. Figure 5 shows substantial long-run GDP losses by four Southeast Asian economies: 7 percent for Thailand, 5 percent for Malaysia and Philippines, and 3 percent for Indonesia. The GDP of the other seven countries show minor long-run deviations from the baseline. Figure 6 reports that only the ASEAN-4 face significant export displacements. The United States, being primarily an exporter of capital goods and high value added services, has the biggest positive deviation, which is about 0.9 percent in 2020.

The interested reader can find more details of the above simulations in McKibbin and Woo (2003a), and full details in McKibbin and Woo (2003b).

Economic Impact on the ASEAN-4

Table 3 examines the export composition for the *FDI diversion scenario* and the *Diversion of FDI with Technological Spillovers scenario* for China and the ASEAN-4. There are no substantial changes from the baseline for any ASEAN-4 country under FDI Diversion. In the export compositions from the Technological Spillover simulation, we observe significant deviations from baseline in the ASEAN-4 countries. Table 3 reports that:

1. China's manufactured exports accounted for 27 percentage points of the 33 percent increase in total exports above the baseline;
2. the manufacturing sectors in the ASEAN-4 show substantial long-run declines vis-a-vis their baselines. In Indonesia and Phillipines, the drop in manufactured exports exceed the drop in total exports; and in Malaysia and Thailand the decline in manufactured exports accounted for, respectively, 97 percent and 91 percent of the fall in total exports.

This transfer of manufacturing jobs to China will not stop in the medium-run because a vast amount of surplus agricultural labor remains to be tapped. Rightly, ASEAN is concerned about whether it would return to its previous role as a supplier of minerals and primary commodities. The likelihood of this development is greatly strengthened when one realizes that the other shoe is about to drop on ASEAN. India, which is still shallowly integrated into the world economy because of its strong economic nationalism and the home to another fifth of the world labor force, is now implementing significant economic deregulation in response to the sustained

high growth in China, e.g. the cap on FDI has been raised from 51 percent to 76 percent. One sobering scenario for ASEAN is that whatever manufacturing jobs that did not move to China would now migrate to India!

This gloom-and-doom projection for ASEAN is not inevitable, however. The final outcome actually rests largely in the hands of ASEAN leaders. When the ASEAN-4 are able to implement policies to completely offset the reduction in technological diffusion from the reduction in FDI, then we are back in the FDI diversion case. In the FDI diversion case, China's insertion of one-third more workers into the international division of labor leads to further division of labor (i.e. to even finer specialisation in production activities) within the manufacturing sector worldwide rather than the displacement of the ASEAN-4 from manufacturing. The prerequisite for the lengthening of the production chains in manufacturing to create niches in manufacturing activities for the ASEAN-4 is that they are technologically versatile. For the ASEAN-4 to have such versatility, their governments must invest in strengthening the scientific and technological capability of their citizens; see Yusuf (2003) for a discussion of the Malaysian situation.

The ratcheting up of indigenous innovation in the ASEAN-4 requires, among many things, the institutionalization of synergistic relationships among the government, the business sector, and the universities. This national mobilization to promote indigenous innovation will have to overturn many taboos. An illustration of such national taboos is the Malaysian redistribution policy to reduce income inequality across races, which results in the regulation that Malay Malaysians must own at least 30 percent of a publicly listed firm; see Perkins and Woo (2000) for details. This means that a firm seeking listing must sell 30 percent of its shares at a heavy discount. The upshot from this tax on firm growth is that, unlike Taiwanese firms, few Malaysian firms have expanded beyond import-competing enterprises to achieve economies of scale and become big exporters of manufactured goods. In the case of Malaysia, whether a zero-sum or a win-win outcome will emerge from its economic interaction with China will depend on whether the enlightened self-interest concept that "a rising tide raises all ships" will prevail.

China has recently proposed the formation of a free trade area (FTA) with the Southeast Asia. This action should be recognized as a natural consequence of a fast-growing China that is anxious to undertake investments in the production of primary commodities and minerals so that its vertically-integrated conglomerates could better absorb large price shocks of raw materials should they appear. (This is also why China also recently attempted, unsuccessfully, to buy oil fields in Russia.) China's enthusiasm for an FTA with ASEAN flows directly from the convergence of its economic interests to those of the major developed countries, i.e. the minimization of disruption from huge increases in the prices of raw commodities, the breakdown of the international communication system, and the collapse of the open multilateral trading system. This last concern is particularly important because China cannot get rich by exporting only to its neighbors, it needs access to all the markets of the world to get rich. This means that any Chinese regional economic strategy is likely to be subordinate to the concern of helping to maintain an open multilateral trading system, and that if, and when, China becomes the leader of an Asian economic bloc, China is unlikely to shape it into a protectionist trade bloc, unless the European Union and the Free Trade Area of the Americas (FTAA) are already closed trade blocs.

Southeast Asia has welcomed the formation of an ASEAN-China FTA because this will increase, one, its access to the increasingly important Chinese market, two, the possibility of lengthening the production chain to permit ASEAN to occupy some niches in the manufacturing process, and, three, the inflow of FDI from China to offset the loss to China of FDI from other countries. (The reader interested in the quantitative effects of the various combination of free trade areas within East and Southeast Asia should consult Cheong (2003).)

Economic Impact on the Developed Economies in East Asia, Western Europe, and North America

For the developed economies, the integration of China yields net positive benefits from the more refined global division of labor. This is most clearly seen in how the industries in Hong Kong, Japan, Singapore, South Korea, and Taiwan have preserved their competitiveness by shifting the labor-intensive manufacturing components of their production chains to China, and by expanding at home the higher value added components of research and development, and of marketing and distribution; e.g. see Abe (2003). The reason why my empirical work does not find much impact from China's emergence on the export and GDP levels of these five developed East Asian economies is because they were already in the stage of their product cycles where they were beginning to relocate their labor-intensive industries

abroad. The emergence of low-wage China simply meant that more of these industries would be shifted to China instead of to the ASEAN-4.

Tain-Jy Chen (2003) has pointed out the possibility that the China challenge might be more difficult for Taiwan than for the other developed economies. Because Taiwanese, unlike Japanese and Koreans, incur minimal adjustment costs in fitting into the social and cultural life in mainland China, this means that the entire production chain, not just the manufacturing component, might move from Taiwan to China in the medium run.

The fact that the total value of the international trade of Western Europe and North America are not affected significantly by the rise of China is not surprising. These developed economies are now exporting a larger proportion of their capital-intensive goods and high value added services to China and a lower proportion to the other Asian economies, and importing a bigger share of labor-intensive goods from China and a smaller share from the other Asian economies. This shift in the destination of Western European (North American) exports and in the sources of Western European (North American) imports is why there are noticeable changes in the composition of bilateral trade between Western Europe (North America) and individual Asian countries, but no noticeable change in the composition of overall trade between Western Europe (North America) and Asia.

Conclusion

Our analysis suggests that the full integration of China's huge labor force into the international division of labor could cause the ASEAN-4 to face the possibility of de-industrialisation. However, this dismal outcome is by no means inevitable. This will happen only if the ASEAN-4 economies allow the drop in FDI inflow to lower the rate of technological diffusion to their economies. If the ASEAN-4 can prevent themselves from falling behind technologically, then they can also find lucrative niches in the lengthened production chains in manufacturing activities. This finding suggests that the ASEAN-4 must give the highest priority in deepening and widening their pools of human capital by speeding up the diffusion of new knowledge to their scientists and managers, and providing appropriate retraining programs for the displaced workers.

The common challenge to the governments of the developed economies from the rise of China as a major manufacturer is how to upgrade the workers who had lost jobs in their manufacturing sectors. This challenge is no different from the structural adjustment that is needed to accommodate improvements in technological innovations. Just as one should not oppose technological progress in order to save obsolete industries, one should also not oppose free trade in order to save non-competitive industries. It is a failure of political will and of economic policy when governments in the developed economies impose protection instead of funding trade adjustment programs to assist the workers in the trade-impacted sectors.

The entry of China to take its place in the international economic system will permit further specialisation of tasks in the workplace, and this is a wealth-creating outcome. The country that can provide its workforce with the depth and range of scientific training required in the new workplace will be in line to receive some of the newly-created wealth. The country that is slow in building up its scientific and technological capability is one that does not understand the right remedy for the constant structural adjustment forced by globalisation.

What has been unmentioned so far is that the fulfillment of the projected scenarios of China's impact on the global economy will necessitate China to undertake even bigger economic structural adjustments than any of its trade partners. My estimate is that the wide-ranging economic deregulation package that China agreed to implement for its WTO accession will cause at least a fifth of its labor force to change jobs over the coming decade, and this could be a politically destabilizing process if not handled adeptly, and if external shocks were to slow down economic growth.

The tradeoff between stability and restructuring that is so starkly brought to the forefront by China's admission into WTO is really not a new tradeoff. What China's WTO membership has done is to accentuate an existing dilemma and not introduce a new one. The government has always realized that the soft budget constraint of the inefficient state-owned enterprise (SOE) sector is a constant threat to price stability, and the diversion of resources to keep this sector afloat is a drag on economic growth. But serious restructuring of SOEs means much more than facing higher urban unemployment, it also means confronting the politically powerful industrial-military complex and the industrial-bureaucratic complex. Economic rents now pose a bigger obstacle to restructuring than ideological sentimentality, and, unlike the latter, they constitute a problem that the mere passing of time (i.e. the death of the remaining Stalinist sentimentalists) will not resolve. Because the greatest challenge

to the deepening of economic reform and opening in China comes from the entrenched interests within the ruling structure, Woo (2001) has suggested that China's "WTO accession could be seen as an attempt by reformers to lock economic policies on to a course for further marketization and internationalization that is costly to reverse."

While the WTO benefits to China are likely to be immense, e.g. McKibbin and Woo (2003a) shows that China's GDP in 2020 could be higher by as much as 20 percent, the WTO shocks could well stretch Chinese economic management to the limit. The granting of national treatment to foreign banks within the next three years will require China to re-capitalize the insolvent state-owned banks (SOBs) a second time since 1996, and to apply a financial tourniquet on the losses of the state-owned enterprises (SOEs) to attenuate the creation of non-performing loans. Because the reforms of the SOBs and SOEs are very expensive (in addition to being very difficult), they are likely to push China's fiscal position to the edge of unsustainability; see Sachs and Woo (2003). The outbreak of an AIDS pandemic, for example, could mean a large-scale public health program that would bankrupt the government.

Developments external to China could also prevent the fulfillment of the scenarios projected by our analysis. External conflicts over North Korea, Taiwan, islands in the South China Sea, and Tibet could see a dramatic decline in FDI, and hence in the diffusion of technology, into China. Even a vastly less dramatic external event like the acceleration of economic deregulation in English-speaking India and its greater opening to inward FDI could reduce the FDI flow into China, and China's exports of labor-intensive industrial products. In short, the realization of the potential for greater common prosperity created by China's integration into the world economy will require more than good economic management by China and its trade partners, good sense by all as well as good luck for all are also required.

Appendix

A Technical Outline of Asia-Pacific G-Cubed Model

Full details of the model including a list of equations and parameters can be found online at: <http://www.msgpl.com.au/msgpl/apgcubed46n/index.htm>. The AP-GCUBED is based on the GCUBED model (described in McKibbin and Wilcoxon, 1998), which is in turn an expansion of the MSG2 model founded by McKibbin and Sachs (1991). There have been many studies of trade reform in China but most studies ignore the role of capital flows and dynamic adjustment, e.g. Wang (2002). There are three significant qualitative differences between the AP-GCUBED model and the standard general computable equilibrium (CGE) model:

1. The AP-GCUBED is based on explicit *intertemporal* optimization by the agents (consumers and firms) in each economy. In contrast to static CGE models, time and dynamics are of fundamental importance in the AP-GCUBED model.
2. There is an explicit treatment of the holding of a range of financial and real assets in the AP-GCUBED model (money, bonds, equity, household capital, physical capital etc.). Money is introduced into the model through a restriction that households require money to purchase goods. The model distinguishes between the stickiness of physical capital within sectors and within countries and the flexibility of financial capital, which immediately flows to where expected returns are highest. This important distinction leads to a critical difference between the *quantity of physical capital* that is available at any time to produce goods and services, and the stock market *valuation of that capital* as a result of decisions about the allocation of financial capital. So the AP-GCUBED model has linkages between the financial markets and the real sectors, unlike the usual CGE models, which have real sectors only.
3. In AP-GCUBED, the behavior of agents is modified to allow for short run deviations from optimal behavior either due to myopia or to restrictions on the ability of households and firms to borrow at the risk free bond rate on government debt. The model also allows for short run nominal wage rigidity (by different degrees in different countries) and therefore allows for significant periods of unemployment depending on the labor market institutions in each country. The deviations from intertemporal optimizing behavior take the form of rules of thumb, which are chosen to generate the same steady state behavior as optimizing agents so that in the long run there is only a single intertemporal optimizing equilibrium of the model. The AP-GCUBED model's assumptions hence differ from the market clearing assumption in most CGE models.

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Figure 3 :Change in Real GDP in Other Countries - FDI Diversion Case

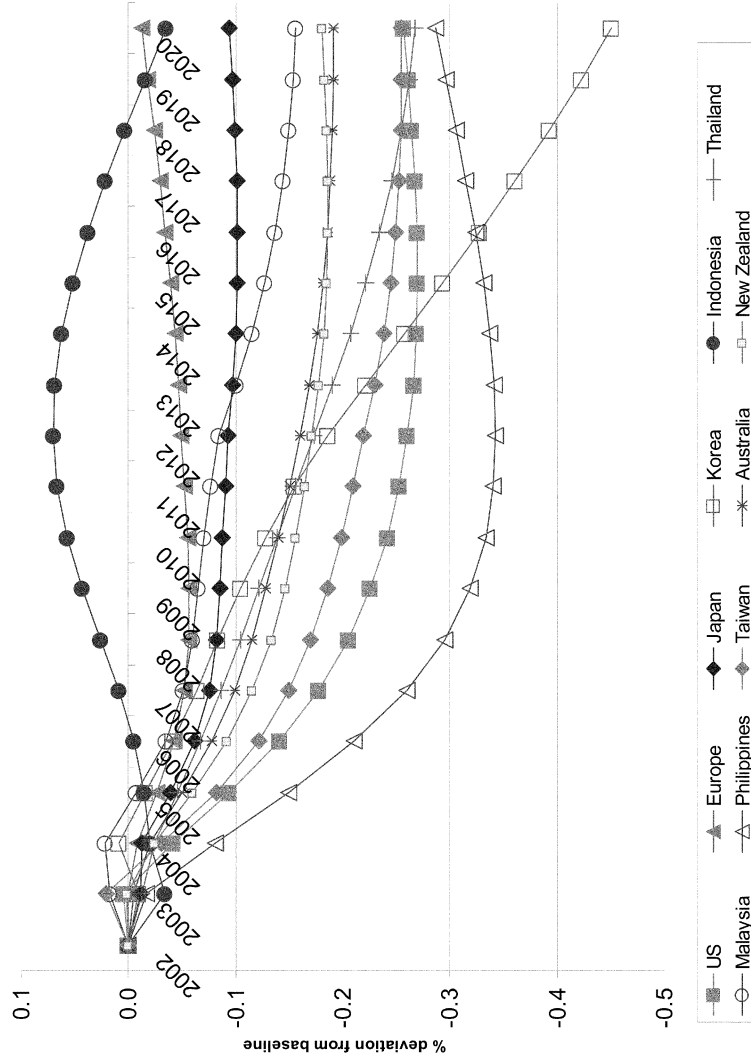


Figure 6: Change in Exports -- Case of FDI with Technological Spillovers

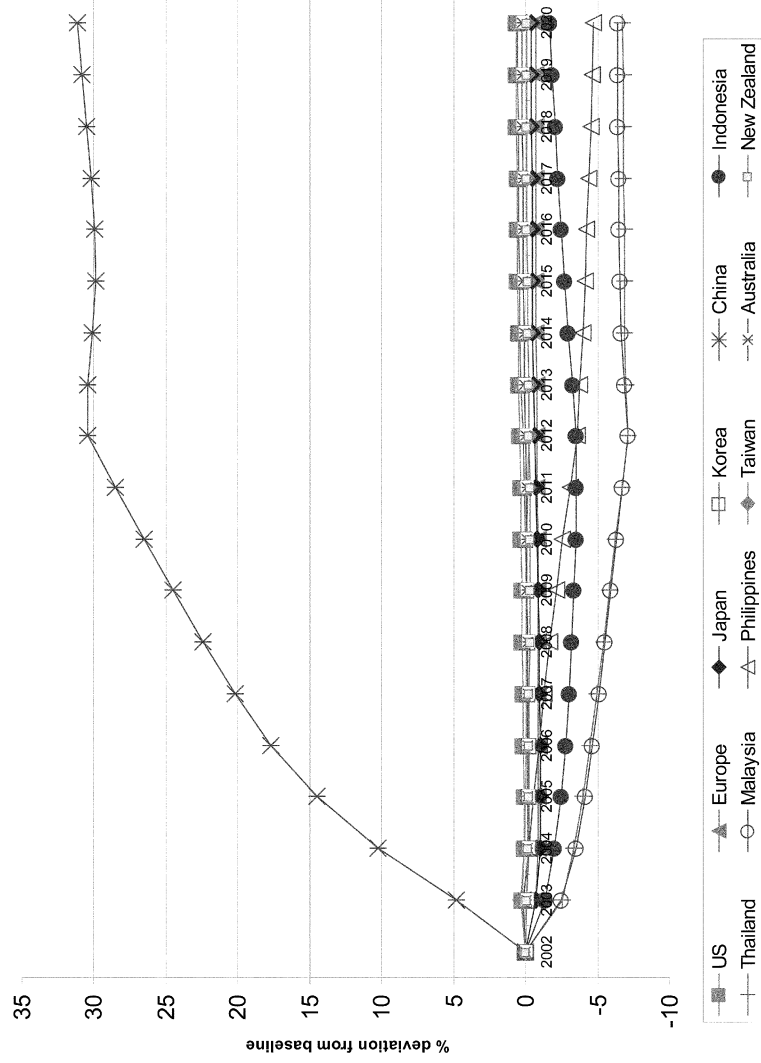


Table 1: The 10 Most Promising Destinations for Manufacturing FDI by Japanese TNCs Over the Next Three years

(frequency, expressed in percent, that the country is identified by Japanese firms responding to annual surveys conducted by Japan Bank for International Cooperation, JBIC)

Rank	1996 survey	Ratio	2000 survey	Ratio	2001 survey	Ratio
1	China	68	China	65	China	82
2	Thailand	36	United States	41	United States	32
3	Indonesia	34	Thailand	24	Thailand	25
4	United States	32	Indonesia	15	Indonesia	14
5	Vietnam	27	Malaysia	12	India	13
6	Malaysia	20	Taiwan province of China	11	Vietnam	12
7	India	18	India	10	Taiwan province of China	11
8	Philippines	13	Vietnam	9	Rep. of Korea	8
9	Singapore	10	Rep. of Korea	9	Malaysia	8
10	United Kingdom and Taiwan province of China	7	Philippines	8	Singapore	6

a The share of firms that consider the country as promising in total respondent firms (multiple responses).

b Fiscal year.

Source: United Nations Conference on Trade and Development (2002).

Table 2: Indices of Indigenous Ability to Innovate, Technology Transfer from Abroad, and Overall Technological Capacity

Index of Indigenous Ability to Innovate	Index of Ability to Get Technology Transfer from Abroad	Index of Overall Technological Capacity
USA	1 Singapore	1 USA
Finland	2 Ireland	2 Finland
Germany	3 Luxembourg	3 Singapore
Switzerland	4 Malaysia	7 Ireland
Japan	5 Taiwan	12 Germany
Singapore	14 South Korea	13 Switzerland
Taiwan	16 Hong Kong	17 Japan
South Korea	22 Philippines	19 Malaysia
Hong Kong	27 India	26 Taiwan
Malaysia	30 Thailand	36 Korea
China	34 Japan	39 Hong Kong
India	38 China	43 Philippines
Philippines	47 Indonesia	45 India
Thailand	50 ASEAN-4 (average)	27 Thailand
Indonesia	55	China
ASEAN-4 (average)	46	Indonesia
		Ecuador
		Bolivia
		ASEAN-4 (average)
		36

The Indigenous Innovation Index and Technology Transfer Index are the two components of the Overall Technology Index.

The Overall Technology Index is combined with the Startup Index (relative ease in establishing a new firm) to produce the Economic Creativity Index.

The Growth Competitiveness Index is constructed from the Economic Creativity Index, the Finance Index (relative efficiency of the financial system), and the International Index (degree of integration into the international economy).

These are the index values in 2000.

Source: World Economic Forum (2000).

Table 3: Deviation of Exports from Baseline in 2020

	China	Indonesia	Malaysia	Philippines	Thailand
Simulation of FDI Diversion					
<i>Deviation of total exports from baseline, in percent</i>	3.70	0.34	-0.04	0.12	-0.04
<i>Contribution to deviation from baseline, in percentage points</i>					
Energy	0.11	0.64	0.01	0.04	0.00
Mining	0.01	-0.02	0.00	0.01	0.00
Agriculture	-0.10	-0.02	0.08	0.04	0.12
Durable Manufacturing	1.44	-0.01	-0.08	0.02	-0.01
Nondurable Manufacturing	0.87	-0.14	0.01	0.02	-0.02
Services	1.36	-0.10	-0.06	-0.01	-0.13
Simulation of Diverted FDI with Technological Spillovers					
<i>Deviation of total exports from baseline, in percent</i>	32.64	-3.20	-6.95	-5.22	-8.09
<i>Contribution to deviation from baseline, in percentage points</i>					
Energy	0.77	0.19	-0.02	0.02	0.00
Mining	0.16	0.00	0.00	-0.01	0.00
Agriculture	0.57	-0.20	-0.30	-0.11	-0.47
Durable Manufacturing	14.34	-0.07	-4.59	-3.05	-3.94
Nondurable Manufacturing	13.11	-3.28	-2.14	-2.36	-3.41
Services	3.69	0.15	0.10	0.28	-0.26

Panel I Discussion, Questions and Answers

Co-Chair DREYER. Thank you very much, Dr. Woo. We will now begin our question period. I have Commissioner Mulloy first on my list.

Commissioner MULLOY. Dr. Woo, I find your testimony particularly interesting. On page eight you talk about the reasons why China wanted to get into the WTO, and then you give three analyses. The first you called your naive analysis. The second you call your FDI analysis, and your third, FDI with technological spillovers.

I've always had a problem with the way the PNTR debate took place in our Congress. When Ambassador Barshefsky appeared before this Commission in June 2001, describing what was the basis of her support for China's WTO entry, she said that the agreement with China secures broad-ranging comprehensive one-way trade concessions on China's part, granting the U.S. substantially greater market access across the spectrum of industrial goods, services and agriculture.

Then she went on to say China's WTO accession is a clear economic win for the United States. There was nothing in her analysis to indicate that China wasn't looking for the trade; they were looking for the investment. Now, based on your description on page eight, does that description that she gave us fall within the naive analysis?

Dr. WOO. Your observation that much of the WTO discussion neglects the impact of China's membership on the global distribution of capital is correct. Ambassador Barshefsky's assessment of the economic impact on the United States is likely to turn out to be also correct. In all the three scenarios I analysed, which are summarized in Figures 1, 3, and 5, I did not find China's WTO membership having a significant impact on U.S. GDP. I therefore concur with Ambassador Barshefsky that China's entry into WTO does not harm the United States. There are, however, other countries that could end up being worse off, but not North America.

Commissioner MULLOY. Do you think that—and then I'll ask the others to comment—that we looked on this as trying to open China's market to U.S. exports and China was looking at this to lock open our market and other markets through MFN when they got it in the WTO, permanent MFN, and that that would then cause the investment flows and the tech transfer to go to China?

Dr. WOO. Yes. Your interpretation is consistent with the facts. But I want to mention that there would be these technological transfers out of the U.S. to Asia in any case, regardless of whether China is a member of WTO or not. In other words, if China were not a WTO member, our technological transfers would have gone to Southeast Asia instead of to China. Because China is now a WTO member, we end up importing more from China and less from other parts of Asia.

Commissioner MULLOY. But with those parts of Asia, we had a much more balanced economic relationship in terms of exports and imports than we have with China? Is that not correct?

Dr. WOO. I think if you look at total U.S. exports and U.S. imports, that is not affected much by the entry of China, but the com-

position of our trade, yes, has changed and will continue to change to a large extent.

Commissioner MULLOY. Do either of you want to comment on that line of questioning? In other words, what we were thinking and what the Chinese were thinking in terms of this WTO? Because I always felt that Congress did not get the full picture when this was being debated as to what China really wanted out of this PNTR vote.

Mr. TKACIK. Well, it's clear that China saw access to the U.S. market as essential to China's growth. Over 40 percent of all of China's exports go to the United States. Now, I think, I'm not sure exactly what was going on in the Chinese mind, but what actually happened was that throughout the 1990s, many of the Asian manufacturers relocated their labor intensive production lines to China, increased the efficiency of their output, but their production lines were assembling components, basic components that had been provided by the Asian country. As an example, Taiwan would ship the plastic cases, they'd ship the motherboards, they'd ship the circuitry to China, and it would just be screwed together into a computer by a Chinese factory, and then to the United States.

What this meant was Taiwan basically got most of the money from the sale of a Chinese computer to the United States because most of the components were Taiwanese. What has happened since WTO is that the Chinese have been very successful in obliging the Taiwanese and the Japanese and the South Koreans, and the Singaporeans and anybody else to move their component production lines to China, and these are less and less labor intensive.

It doesn't make—I mean to me obviously the economic, the comparative advantage that the Chinese have is in labor. For Taiwan to then ship a capital-intensive chip foundry to China doesn't really fit in there. China was allowed by the WTO to maintain a certain value-added tax. It was not permitted to discriminate against foreign goods.

In the case of the semiconductors and I'm sure in other areas as well, what China did was it told foreign semiconductor manufacturers if you can bring the foundry to China and if you can design it in China, we'll exempt you from the value added tax. You'll get a rebate on that, which mean that automatically any semiconductors made in the United States, finished semiconductors that would be shipped to China and put in a computer automatically had a 17 percent tax on them.

Co-Chair DREYER. John, excuse me. Is that covered under the WTO?

Mr. TKACIK. The WTO permits the value added tax, but does not permit the rebates. I don't know that people are complaining about that now.

Commissioner WESSEL. Oh, yes, they are. Yes, they are.

Commissioner MULLOY. The semiconductor industry has very much complained about it. Bates, on the general principle of this, is this an investment agreement in the Chinese eyes rather than a trade agreement, this WTO entry? That's what I'm trying to get.

Dr. GILL. I would assume, and I'm not a specialist on this, Commissioner Mulloy, but my sense would be that looking at it from a political point of view, that at the time, and I think continuing

today, China sees enormous value in sort of exporting itself out of the enormous social and economic challenges that it faces at home. So any advantageous agreement that it can have, I think, to assure external markets that it can continue to be the workshop of and to the world would be advantageous to it; and increasingly, as Professor Woo has pointed out, I think it's also finding it valuable to become an investor abroad as well. So I think at the time it was probably largely a trade agreement, I suppose.

Commissioner MULLOY. Thank you.

Co-Chair DREYER. Commissioner D'Amato.

Vice Chairman D'AMATO. Thank you, Madam Chairman, and I want to congratulate the witnesses on their testimony today. This is an important hearing for us. It's the first time we've looked at China and the region, and my question is for all three of you a generic question about your view of China's attitude and practices as they're being seen in the region vis-à-vis the United States, and what our posture should be given that attitude and those practices?

Mr. Gill, you mentioned something that we looked at last year in our report, and that is confidence-building measures and the proactive Chinese diplomacy in the region in terms of confidence building measures. We were surprised to find the level of activity even a year and a half ago vis-à-vis the Shanghai Group, vis-à-vis Southeast Asia, substantive agreements with Southeast Asian countries such as Laos, agreements with the Russians, with the Indians. In contrast to this there has been a complete lack of progress in terms of developing confidence-building measures with the United States, a complete lack of movement, at stark variance with progress with the other countries of the region.

Then, we had the University of Maryland look at Chinese attitudes toward the United States as exhibited in a basket of publications, namely news dailies, for example, *People's Daily* and *People's Liberation Army Daily*. The University discovered that in terms of the Chinese message to its people on U.S. foreign policy, China was characterizing the United States in very negative terms—on foreign policy, but not on economic policy, but on foreign policy—we were being described as the hegemon, and we still are, the hegemon, characterizing the United States as a country trying to keep China encircled, trying to keep China from its rightful place in the region and so on.

Now, this Administration came to power characterizing China as a strategic competitor. We don't hear "strategic competitor" anymore. In fact, I'm told that there is a rule in the Administration not to use the word "competitor" vis-à-vis China at this time.

My question is what is your assessment of the current Chinese view of the United States in the region? Do the Chinese attitude and policies amount to a zero sum game, that Chinese power will accentuate and be heightened vis-à-vis the United States as our power diminishes? In other words, is China participating in this relationship from the perspective as a strategic competitor at the same time that we are withdrawing from characterizing the relationship as a competitor?

That would be my question. Can you turn the University of Maryland analysis on its head and say that China is acting toward the United States as a hegemon, trying to encircle us, trying to

keep us from acting in the region as we have historically? Do they view this as a zero sum game strategically and us as a competitor? Or is it true that you would characterize it more that they're working with us as a cooperative partner? How should we understand their attitude in this area? I'd like all of you to respond to that.

Dr. GILL. I think the answer to your question is pretty complicated, because I think on certain issues, yes, it is a zero sum game. And in others, there is evidence that China is increasingly recognizing the possibilities of win-win. So I think it depends on what it is you're looking at. One issue obviously where I think they see it's win-lose and pretty black and white and a pretty serious competition would obviously be over our respective influences and ability to shape outcomes in Taiwan.

I mean that's obviously a black and white issue there, and I think they see that more so I think than even we do in our country. We still have hopes, I think officially speaking, for peaceful, quote-unquote, "solutions" to the issue. I don't think China sees it in those vague terms at all. It's got to be one way and not the other.

But on other issues, and I think in the economic realm, you might want to pull in some persons who operate with China on the global level, for example, in the World Bank or other large multinational lending institutions and even in global institutions like the World Trade Organization, putting aside certain bilateral differences, I think we do have, as Professor Woo suggested, some very common aspirations with China about opening the world trade system and pushing developing world countries to be more open, because it's advantageous to both of our continental-sized economies to see the openness of the world trade system.

So I think it differs depending on the sets of issues that you wanted to examine. One other area I might suggest, just to take a look at, I think overall I think that they remain very deep-seated distrust in China about the United States, that there are certain very fundamental differences in the way our two countries look at the world, that the current improvement in relations, while it has opportunities for becoming more solid, at the moment, I think, is largely a glass half full than a glass half empty. We have a long way to go, I think, to really change the attitudes, not only in China, but in our country that might see a win-win possibility down the road.

So I'm not sanguine about this. But I would just point to some recent rumblings in China by a pretty authoritative individual named Wang Jisi, who you all have probably heard about, in which he is trying to make the argument, and we're hearing people coming through Washington now touting this argument so we'll see how it resonates here in the United States, basically boiled down to we can live with a hegemon. It's okay to be a hegemon, and we can live with it, as long as it's—it's kind of good witch/bad witch—you know, as long as it's "wang-dao," which is sort of like enlightened hegemony, rather than "ba-dao," which is evil or bad forms of hegemony.

So apparently, there is some debate in China to get their hands around the obvious fact that the unipolar system isn't going away, and it's counterproductive for them to openly confront and try to

undermine American presence in Asia, and to come up with a smarter way of going about it.

Co-Chair DREYER. Bates, what is the criterion for getting us out of the bad hegemon category into the good hegemon category because I'm worried the price may be unacceptable?

Dr. GILL. Well, I think item one is Taiwan obviously.

Co-Chair DREYER. Yes, more or less as I thought.

Dr. GILL. And I think a second and more vague set of issues would be China being reassured that we are not, in fact, attempting to, quote-unquote, "contain them," that we are allowing China to sort of grow as an emerging power in ways that China thinks is quite natural.

So anyway there's a debate, and I think that's an important way of looking at, that it depends on the issue you're asking about, and it depends on whom you talk to in Beijing.

Mr. TKACIK. I would agree with the meta-analysis of China's media. You can't find any Chinese publication that says anything nice about the United States. Wang Jisi can come here and say nice things privately to you and, you know, talk about—you read Renmin Ribao, you read Jie Fang Junbao, you read any of the major publications, and it is negative. Now, I think that the idea of China as a partner, strategic partner even now, I mean it sort of startled me to hear Secretary Powell in his speech on November 5 refer to China as a real partner—this is the way real partners interact. It sort of jarred me.

I don't see that the Chinese have been our partners in any major global initiative that we have felt was important, and that includes the war on terror, that includes Iraq, that includes Afghanistan, that includes proliferation and it also includes North Korea. I see China's participation and involvement in the North Korean issue as more counterproductive, at least from America's point of view than useful.

The sole use of China's involvement in the North Korean negotiations to me seems to be at least we can get North Korea out in the open and everybody can see how it behaves. But the Chinese have consistently—when we first approaches the Chinese on this issue, the Chinese were dead set against a multilateral engagement with North Korea. They said we'll have a bilateral meeting in Beijing under Chinese auspices, and you guys can call it a trilateral and multilateral, but we'll tell the North Koreans it's bilateral, and our foreign ministry spokesman will refuse to use the word "multilateral" or "trilateral" in any of his statements.

And during that time, we got kicked in the teeth. That was April—what—23rd of this year. We said we're not going to do this again; this is—the North Koreans behave barbarously, they're insulting, they're aggressive; we're not going to sit down with them bilaterally. We want everybody else to see what's going on.

When the Chinese found out that we wouldn't sit down with the North Koreans, and the North Koreans are desperate to sit down with us, you know, they're not doing us a favor to sit down, we're doing them the favor, we demanded multilateral talks and the Chinese said, well, look, the only way we can have multilateral talks is to figure out some way that North Korea won't be outvoted.

And the Chinese had a very active campaign with the Russians to bring the Russians in and sort of sit on North Korea's side. So when we went to the six-party talks on August 27, it was pretty much balanced. The Chinese did not go out of their way to help us. Moreover, at the six-party talks, we got kicked in the teeth again by the North Koreans, and everybody said, you know, the Chinese Vice Foreign Minister Wang Yi was visibly upset at the way the North Koreans reacted. And the Russian foreign minister was visibly upset.

Four days later in Manila, Vice Minister Wang Yi said the problem we have here is U.S. policy toward the DPRK. He did not say the problem we have here is the DPRK, and that to me is Chinese policy.

Now, two days after that, Secretary Powell said when somebody asked him about it, Secretary Powell said, well, I don't really know what he really said, you know, we don't have the transcripts of what Wang Yi said, although Reuters and AP had it and Manila Times had it, and furthermore I am sure the Chinese don't really think that way.

And when the Chinese foreign ministry spokesman was asked about it, he said, well, I don't really know what was said. We don't have the transcripts. And nobody asked him after that. Now, sometimes you can say, well, you know, hearsay evidence is inadmissible. You can't say just because somebody reported what Wang Yi said in Manila, that that's what their policy is, but I think for those of you who were lawyers, you know that there is an exception for that in the excited utterance, and I have a feeling that when Wang Yi was excited and he uttered this, that he was saying what he really thought and what was really the Chinese position. So my point is the Chinese haven't helped there.

It is a fact that the Chinese look at the United States as the hegemon, that the Chinese feel that they have a right to expand, and they are worried that the United States is trying to hem them in. I will just make one final sort of anecdote here. In May 2002, when the United States was trying to get more or less not permanent basing rights, but a fixed basing rights in central Asia to supply the Afghanistan campaign, the Chinese put pressure on both Kyrgyzstan and Kazakhstan to refuse us, to deny the United States access to their facilities.

Kyrgyzstan, God love them, rebuffed the Chinese. Kazakhstan felt under a lot of pressure, economic and geopolitical pressure, to abide by the Chinese wishes. I don't see the Chinese as helpful in anything that we've done.

I'm sorry. Let me say one more thing which is certainly when a hyperpower emerges in the world, there is a natural tendency from the lesser powers to sort of form alignments, and I think you do see this sort of tendency in Russia and China, in Secretary Rumsfeld put it old Europe, to feel if there's a way that we can join together and restrain the United States Gulliver, and I think that China is very active in that. China, from the very beginning of the war on terror had approached the French and the Russians, especially on this basis, so I don't see that we have any, any common interest and any common strategies outside of the economic sphere with the Chinese.

Vice Chairman D'AMATO. Is it fair to say you would characterize Chinese attitude toward us as a competitor more than a partner?

Mr. TKACIK. Yes, no question about it in my mind.

Vice Chairman D'AMATO. Dr. Woo.

Co-Chair DREYER. We're about to run out of time.

Dr. WOO. I'll make brief comments on three areas. How is China perceived in the region? I think the fact that the U.S.-Japan security pact is more loved today in Japan than ten years ago is a very good sign that China is regarded with some concern by the rest of Asia. We should recall that when the U.S. pulled out from Subic Bay, Lee Kuan Yew offered Singapore as the replacement base for U.S. armed forces. In general, the rest of Southeast Asia would certainly like to see the U.S. maintain a security presence in the region, although they might not say this too loudly.

The concern about China's emergence naturally differs across countries. For Southeast Asia, China's belligerence over the disputed portion of the South China Sea has raised much concern, but China's more diplomatic approaches in the last few years have calmed them somewhat. Korea and Japan are much less fearful about China than Taiwan, and for more than just the reason that China regards Taiwan as a renegade province.

A production process has three parts: one, research and design; two, manufacturing; and, three, marketing and distribution. What has been happening for Korea and Japan is that the middle part of their production chains, the manufacturing part, moves to China, while research and design, and marketing and distribution remains in Korea and Japan.

The situation for Taiwan is different. Because of the easy, almost effortless, assimilation of Taiwanese into the cultural and social life of China, the whole production chain of a Taiwanese industrial group could just move over to China.

On the issue of what is the perception of the U.S. in China, it is correct that part of the official press has many times been hostile to the United States. I think that this is because the regime occasionally sees itself as being in a tug of war with the U.S. for the hearts and minds of its people. This situation is the same as in Iran where I just visited. A significant proportion of the Iranian people see the U.S. as the paragon of political virtue, they like our political transparency and our political freedom. So much of the occasional outbreak of hostile official rhetoric in China and Iran is attributable to the need of these authoritarian regimes to maintain their political legitimacy.

The last two speakers have made the very good point that the U.S. is going to remain a world power (the hegemon, in fact) for many more years to come. Since there is nothing much that China can do about this situation, China is realistic enough to see the gains from cooperating with the U.S. in several areas. Sino-U.S. cooperation is possible as long as we are not perceived as attempting to contain China, and refusing to let China get rich according to the normal international rules.

Two areas of Sino-U.S. partnership come readily to mind: North Korea, and oil security. North Korea is a U.S. problem, only if North Korea sells nuclear arms to the rest of the world. If North Korea does not sell nuclear arms or advanced weaponry to the rest

of the world, it is then actually more of a Chinese problem than a U.S. problem. North Korea is not a particularly reliable country, it could very well end up selling arms to Taiwan. I suspect that the strong official Chinese pronouncements in support of North Korea is an attempt to maintain China's influence over an unstable regime and to prop up a much-hated regime. China recognises that the alternative to North Korea is a reunified Korea, and I think that China prefers the status quo.

Another area in which Sino-U.S. partnerships could be fruitful is in the area of oil security. As we are short of time, I will not develop this point further.

Co-Chair DREYER. Okay. We have 12 more minutes and six names on the list. So I realize these are not easy questions which can be answered yes or no. Commissioner Bartholomew.

Co-Chair BARTHOLOMEW. Thank you very much and thank you to our witnesses for being here today. They've got some different perspectives, which are always good to hear. Thank you also for your flexibility with events that were outside our control when we started this morning.

I have kind of a different angle that I'd like you to consider, which is that we are hearing, of course, that increasing democracy is supposed to be one of the pillars of the Administration's foreign policy, and we've often been told over the years that economic reform will lead to political reform in China. So far, of course, it has not. What do you think that China's increasing influence, particularly its economic influence, throughout Asia means in terms of possible reforms, democratic reforms with repressive regimes in that region?

Mr. TKACIK. I would agree that China's increasing political influence in the region can only give aid and succor to the repressive regimes. Certainly, Laos, Burma, Vietnam, and certainly North Korea breathed much more easily knowing that Big Brother, the socialist Big Brother China is the 800-pound gorilla in the region.

And I agree that for the last ten years—no, for, let's say 15 years, since Tiananmen, that China's economy has expanded exponentially. Its trade, free trade has made a great influence on the prosperity of the Chinese people. I don't doubt that. But have human rights improved? Has there been an increase in political participation? Even with the burgeoning of the Internet, is there more freedom of expression in China, and I would have to that in those ten years, the fastest ten years of economic growth, the ten years that brought them a mushrooming of production and a ballooning of international trade, every year since 1989, the State Department Human Rights Report has said either that China's human rights situation has worsened during the year or, quote, "remains poor."

So if you just go through each one of those years and say let's put them altogether, it is one step up and two steps back? It's always one step back, one step back, maybe stay the same, one step back. That tells me that anybody that says free trade and open and free trade with China has really helped political rights and human rights in China is wrong. There's no empirical evidence to show that.

I would point out that certainly the internet has caused some vast changes in the way Chinese look at information, but anybody that reads the Chinese internet or the Chinese chatrooms on a regular basis will tell you that it's full of vituperation, certainly if you're paying attention to what they're saying about the United States, and that it's very closely watched by the Communist Party.

If you are in China, if you're in any hotel in China, and you plug in your computer and you start to, you know, cruise the net, there are many, many sites that you simply cannot get. We saw that three internet activists were released in a Da-She, I guess they call it, a great act of benevolence on the part of the Chinese prior to the visit of Gerhardt Schroeder to China and the Wen Jiabao visit here. But these are drops in the bucket. They're symbolic, and I simply don't see it.

Dr. GILL. Chairman Bartholomew, thank you for your question. I have to apologize to all the Commissioners that owing to the previous delay, I'm going to have to depart, but I would like to make just a short response. I mean this obviously gets back to definitions of human rights with which you're very, very familiar. I mean how does one define them, and clearly if one defines them in the case of political rights in China, in the case of, you know, quashing of dissidents, the opportunity for other parties to have a voice, then there has been no progress at all, and we can see that throughout the 1990s, in fact, there's lot of evidence, as John has said, that things have gotten worse.

On the other hand, there is no doubt in my mind that if you expand the definition to include social freedoms, labor mobility, personal choices, those sorts of aspects, those aren't really human rights, those are other questions. Anyone who has been in China knows that it's a completely different place as it was 20 years ago, even five years ago.

And that is obviously a result of the more open economic embrace that China has taken toward the world and in trying to get rich. It's a completely different social atmosphere. That's not a human rights question, but it certainly is a completely different social atmosphere.

Now the answer to your question is—your question was, will that have an impact on other regimes in the region? And I think I would probably agree with John that doubtful for several reasons. One, those regimes have not yet themselves truly embraced the global community of international business and trade as China has. They haven't. Maybe it's because they don't have the attributes economically that China so obviously has. They haven't made themselves attractive to the international community the way China has.

So there simply are barriers in places like Laos, Vietnam, Burma, political mostly, but also I think in terms of their own natural endowments, which are going to prevent, I think, the kind of dramatic social transformation that we've seen in China as a result of its opening to the outside world. I think another reason might be that, as John has suggested, I don't think China sees that as a matter of their foreign policy agenda to do that; right?

That's not something they're going to be promoting as we might, and seeing that free trade and open economic liberalization goes

hand in hand with the political and social liberalization, I don't think China obviously sees things that way.

Again, I have to apologize to the Co-Commissioners, to the Commissioners, to the Chairman, I have to depart, but thank you very much for the opportunity, and I'd be happy to follow up.

Co-Chair DREYER. Thank you so much for being here, Dr. Gill, and I hope that if there are Commissioners with questions specifically for you, you wouldn't mind getting an e-mail?

Dr. GILL. I would be more than happy to respond.

Co-Chair DREYER. Thank you so much.

Dr. GILL. Thanks again.

Dr. WOO. Could I say something on human rights? Human rights are affected, one, by economic opening, and, two, by political opening. The Chinese have gone a long distance on economic opening, but not on political opening. But if China's economic growth were to continue the way it has been, I think that political changes would come. The political changes could come either from within the regime itself or from outside the regime. We cannot rule out the possibility of a regime that could transform itself over time in order to survive. Thank you.

Co-Chair DREYER. Looks like, Commissioner Ellsworth, you have the last question.

Commissioner ELLSWORTH. Thank you, Madam Chairman. A very short question. Our job here is to try to help Congress understand the links between economics and security in our relationship with China. Now, you are experts and intellectuals. This government, ever since World War II, has depended very heavily on economists and physicists as well as other kinds of experts to shape its policies and to help design its actions both in the Congress and in the Executive Branch.

Let me just ask you quickly. Do you have, Dr. Woo, a lot of contact with the Federal Government on these extremely important questions about economics and politics in relationship between the United States and China? Is it enough? Is it zero? What about you, John? I know that the Heritage works very hard at precisely this question. Are you satisfied with your access to and influence over the executive branch or the Congress either? Just very quickly.

Dr. WOO. Well, in my case, I was very lucky and honored to have been an advisor to Secretary Robert Rubin during '97 and '98. I have also advised about five other governments on economic policies.

Commissioner ELLSWORTH. Which ones?

Dr. WOO. China, Indonesia, Mongolia, Vietnam, and Iran.

Commissioner ELLSWORTH. Thank you. John, how do you feel about it?

Mr. TKACIK. I'm a retired Foreign Service Officer, and I've been this past week on the phone with former colleagues across the Administration. I will say that in October I think—was it October—I published a magnum opus on China's trade issues, and a good part of that was spurred by e-mail exchanges I had with colleagues in USTR and I had to apologize to one because I lifted almost word for word one of his e-mails and stuck it in my report. So I'm satisfied that we're—

Commissioner ELLSWORTH. You have special access—

Mr. TKACIK. Yeah, yeah.

Commissioner ELLSWORTH. —and you feel that you're very richly in the swim. Well, thank both of you. You're very sharp and have given very rich presentations this morning. Thank you.

Mr. TKACIK. My pleasure. Thank you very much. I'm honored.

Co-Chair DREYER. Thank you very much. And again I hope you all are reachable for a consultation on e-mail. We've really benefited a lot from this, and I hope we can continue to draw on your expertise. Thank you.

Dr. WOO. Thank you.

Co-Chair DREYER. I would like to declare a two or three-minute break so you can get up and stretch your legs.

[Whereupon, a short break was taken.]

PANEL II: ECONOMIC DIMENSIONS OF CROSS-STRAIT RELATIONS

Co-Chair DREYER. We need to get started with our next session, and Mr. Cooke will start off because he has a very important train to catch at two o'clock. Mr. Cooke is the Managing Director of the GC3 Strategy, Incorporated. Mr. Cooke, we look forward to your testimony.

STATEMENT OF MERRITT T. ("TERRY") COOKE SENIOR FELLOW, FOREIGN POLICY RESEARCH INSTITUTE (PHILADELPHIA, PA) AND MANAGING DIRECTOR, GC3 STRATEGY INC.

Mr. COOKE. Thank you, Commissioner Dreyer and other Commissioners. I'm honored to be invited back to provide an update to the analysis I presented to the Commission on August 2, 2001. And I'm particularly encouraged to see that the Commission's letter of invitation framed this panel's focus on cross-Strait economic integration and on the implications of its integration dynamic for the Asia Pacific region and for the U.S.

Two years ago, there was scant recognition in public debate on the cross-Strait situation that such a dynamic was taking place or was relevant to U.S. security interest in the region. Because the Commission is already familiar with the broad outlines of my perspective and because time for prepared remarks is limited, I will confine myself here to the six specific issues, which your letter of invitation asked me to address.

First off, the extent to which Taiwan's domestic manufacturing sector is being hollowed out by China's economic growth?

My impression is that this is more a political problem of perception to be fought out on Taiwan's electoral hustings than it is an economic problem for the Ministry of Economics or the Council of Economic Planning and Development to solve technocratically.

Fundamentally, the issue of hollowing out appears to be a concomitant of success rather than the fallout of failure for Taiwan's globalizing economy. Two decades of close integration and partnership with the U.S. in the global IT supply chain and the consequent rise of per capita income and standards of living have helped usher Taiwan into the ranks of advanced economies. And as a newly minted graduate to this elite level, Taiwan is now being forced to confront some of the standard challenges faced by advanced economies everywhere—lower rates of GDP growth, struc-

tural unemployment, susceptibility to global cycles of demand, and pressures on productivity and the production base.

China's economic rise does exacerbate these challenges for Taiwan but in few cases does it account solely for them. While Taiwan is involved in a fractious political debate on these issues, I'm confident that Taiwan as an authentic democracy and as a nimble player in the world economy will meet these challenges of industrial restructuring and economic transformation just as successfully as it has met many similar challenges in the past, and I might add as very well documented in Peter Chow's book *Taiwan and the Global Economy: The History of Taiwan in Countering and Meeting Challenges of Economic Transformation*.

Question two: the manner in which the economies of both China and Taiwan are benefiting from the unique dynamics of cross-Strait economic relations?

The evidence, while incomplete, points to a clear conclusion for most of the information technology sectors. Taiwan, China, and the United States have all enjoyed substantial benefits as the global IT supply chain has extended over the past three years from Hsinchu across the Taiwan Strait to the Yangtze River Delta, the Pearl River Delta, and elsewhere in China.

WTO accession offers the best example of the symbiotic benefits that the U.S., Taiwan and China have all enjoyed from an expanded global value chain. Taiwan is now positioned to trade off incrementally its dominance of China's IT export market in return for substantially improved access to the smaller but potentially more profitable market on the mainland.

China has gained limited access, and I would emphasize limited access, to high-return foreign markets under the tutelage and mentorship of a Taiwan partner with two decades of experience in these markets. The United States meanwhile experiences considerable consumer benefit, a steady supply of vital IT componentry and products and a more efficient global pipeline for its own researched innovation and employment.

In sum, the limited available data shows that not even marginal erosion of Taiwan equity control in the overall IT market in China has taken place since 2000. Whatever shifts in leverage may be occurring in the IT sector between Taiwan and China, whatever they may be, they appear to be happening very gradually and to involve balanced tradeoffs in access to the foreign and the domestic portions of the economy.

Question three: the economic and other forces driving the steady flow of investment capital into China from Taiwan?

Now, these, of course, are varied and one could hardly cite them all, but to name a few of the most relevant ones:

- China's large and fast-growing market for mobile telephony is increasingly prompting handset makers and their suppliers to bring production and even R&D closer to their consumer base in the mainland.
- The low cost of land, factories and labor in China have already forced Taiwan IT hardware original equipment manufacturers to relocate entire supply chains of production in order to meet the cost efficiency demands of their U.S., European, and Japanese brand name customers.

- China's Preferential Value-Added Tax system has been giving mainland chip producers a cost advantage of 11 to 14 percent over their Taiwan competitors.
- The global nature of today's capital and venture capital markets is not easily controlled by national entities.
- Finally the human capital resource in China represented by more than one billion brains with adequate, though basic, levels of health and education is compelling in business decisionmaking.

Question four: the impact of China's economic development on Taiwan's role in the global supply chain? In the interest of time, I will highlight just one key implication of this question. The relative stability of highly differentiated, high value supply chains as characterize most IT sectors as opposed to the instability of far simpler manufacturer-retailer networks characteristic of commodity products like toys, umbrellas and the like.

This distinction helps throw into relief an under appreciated fact about the historical pattern of Taiwan investment into the mainland. While many light industry sectors which really started going over to China in the early '80s, and which continued to move to the mainland in the '80s and through the '90s, while many of these firms have been swallowed up by mainland competitors, brand name athletic shoes, high performance bicycles and a number of other high value, highly differentiated value chain products have remained largely in Taiwan equity hands.

If these product sectors with their relatively lower levels of technology and slower product cycles could stay in Taiwan control for decades, there's every reason to believe that the various IT hardware sectors will stay even more firmly in Taiwan's grip in years ahead.

Question five: whether Taiwan perceives China's pursuit of regional and/or bilateral free trade agreements in Southeast Asia, for example, as regional economic catalysts or as threats to Taiwan's economic and security interests?

Taiwanese are clearly concerned that China is planning to use its FTA and CEPA initiatives to further constrain Taiwan's diplomatic space and to encroach on its economic and commercial space. For this reason, China's FTA discussions with the ASEAN nations of Southeast Asia as well as its recent offer to sign a Hong Kong-like CEPA with Taiwan are met with reactions ranging from anxiety to outright skepticism.

Memories of TSMC's shabby treatment by China's industry association, protocol snubs for Taiwan officials at APEC gatherings, and audit and inspection harassment of ChiMei's mainland operations and also Acer's operations during the last presidential election in Taiwan are fresh in people's minds. The business community views these initiatives as political posturing rather than as commercial negotiations.

And then finally question six: the implications of increasing cross-Strait economic cooperation and interdependence on the U.S.-Taiwan relationship?

I would cite three main implications of cross-Strait economic integration on the U.S.-Taiwan relationship? First, it's a fact that the cross-Strait IT interaction is being driven by larger globalization trends. With globalization, of course, comes stresses of change and

adaptation, but Taiwan also gains a higher degree of acceptance and support in an interdependent world as does China.

The U.S. has leadership experience, the WTO vehicles, and other models of interdependence, which could be shared with Taiwan and China in this regard.

A second implication relates to the perennial question of who is gaining leverage. The evidence suggests leverage is not so much in the hands of politicians in either Beijing or Taipei as it is in the hands of Taiwan's globally experienced IT firms and their U.S., Japanese and European brand name partners, particularly U.S. partners.

With a dominant share in China's export industry, a growing share in China's local market, and strong R&D roots in Taiwan, this is not a zero sum predicament for either Taipei or Beijing.

A third and final implication involves democracy trends. As a result of economic integration, Taiwan manufacturers and managers are now bringing millions of Chinese workers—Peter Chow estimates I believe about three million Chinese workers—into direct contact with global norms of business and a more universal set of values.

This development, brought about by sustained commercial interaction, would appear to directly support U.S. policy goals for the resolution of cross-Strait tension through sustained and peaceful interaction.

And in conclusion, from this perspective, I would simply point to two areas where the U.S. Government may wish to attend closely to key policy questions. Since China is now following a two-track approach, combining its old style military intimidation coupled with a new strategy of economic blandishment, the U.S. needs to understand clearly, comprehensively, and on its own terms where each track is leading.

Taipei has its ideas of where it's leading. Beijing has its ideas of where it's leading. But I think it behooves the U.S. Government to understand on its own terms where these trends seem to be leading: the facts on the ground of economic integration appear to be beneficial for all concerned, but the politics of FTAs and CEPAs are subject to manipulation by China to Taiwan's detriment.

Secondly, while the security and economic tracks may lead in different directions, they are not disconnected. Increased U.S. policy support for the economic globalization track coupled with guided management of FTA and CEPA politics is the best path towards cross-Strait and regional stabilization. This path promotes U.S. security interests by further constraining either or both Taiwan and China from jumping the political military track.

The old saying about dancing with your enemy captures the truth in the current cross-Strait situation. Economic engagement between Taiwan and China will not eliminate the chance of an outbreak of hostilities, but it will reduce that chance. Similarly, as globalization continues to push Taiwan and China into closer economic embrace, U.S. policies on the above-two issues can determine whether that embrace becomes mutually comfortable over time or ultimately injurious to the smaller party. Thank you.

[The statement follows:]

Statement of Merritt T. (“Terry”) Cooke
Senior Fellow, Foreign Policy Research Institute (Philadelphia, PA) and
Managing Director, GC3 Strategy Inc.

I am honored to have been invited back to provide an update on the analysis I presented to the Commission on August 2, 2001. In the two years since I participated in that public hearing, I have had the pleasure to meet, and work with, many of you on the present Commission in various conferences and security-related forums. I commend you for the intelligence and scrutiny which the Commission continues to bring to bear on a matter of significant security interest to the United States. I am encouraged to see that the Commission’s letter of invitation has framed this panel’s focus on cross-Strait economic integration and on the implications of this integration dynamic for the Asia-Pacific region and for the U.S. Two years ago, there was scant recognition in public debate on the cross-Strait situation that such a dynamic was taking place or was relevant to U.S. security interests in the region.

Because the Commission is already familiar with the broad outlines of my perspective and because time for prepared remarks is limited, I will confine myself here to the six specific issues which your letter of invitation asked me to address. I have provided the Commission Secretariat with a more extensive statement for the written record which embeds these remarks into the fuller context of my research. I will take this opportunity to remind the Commission that my research does not presume to contribute to rigorous macroeconomic understanding of cross-Strait economic ties. As I described in 2001, such data are hard to come by and others are better trained at piecing that particular puzzle together. My research is microeconomic and focuses on interviews with CEOs and other strategic-level corporate decisionmakers in Taiwan and the U.S. who are directing the investment decisions into the Peoples Republic of China. Also, my research into corporate decisionmaking, and the technology dynamics which underlie that decisionmaking, focuses predominantly on Information Technology sectors of the economy.

Question 1: The extent to which Taiwan’s domestic manufacturing sector is being “hollowed out” by China’s economic growth?

My impression is that this is more a political problem of perception to be fought out on Taiwan’s electoral hustings than it is an economic problem for the Ministry of Economics (MOE) or the Council of Economic Planning and Development (CEPD) to solve technocratically. Fundamentally, the issue of ‘hollowing out’ appears to be a concomitant of success, rather than the fall-out of failure, for Taiwan’s globalizing economy. Two decades of close integration in the global IT supply chain and the consequent rise of per capita income and standards of living have helped usher Taiwan into the ranks of advanced economies. As a newly-minted graduate to this elite level, Taiwan is now being forced to confront some of the standard challenges faced by advanced economies everywhere—lower rates of GDP growth, structural unemployment, susceptibility to global cycles of demand, and pressures on productivity and the production base.

China’s economic rise does exacerbate these challenges for Taiwan, but in few cases does it account solely for them. While Taiwan is involved in a fractious political debate on these issues, I am confident that Taiwan—as an authentic democracy and as a nimble player in the world economy—will eventually meet this challenge of industrial restructuring and economic transformation as successfully as it has met other, equally daunting political and economic challenges in the past.

Question 2: The manner in which the economies of both China and Taiwan are benefiting from the unique dynamics of cross-Strait economic relations?

The evidence, while incomplete, points to a clear conclusion for most of the Information Technology sectors: Taiwan, China, and the United States have all enjoyed substantial benefits as the global IT supply chain has extended over the past three years from Hsinchu across the Taiwan Strait to the Yangtze River Delta, the Pearl River Delta and elsewhere in China.

Economies and ecologies do not prosper in the absence of change and adaptation. While China’s emergence into the global IT ecosystem has brought disruptions, the change also appears to be strengthening the global ecosystem as a whole.

Worldwide, consumers have benefited from lower prices for quality IT goods. Meanwhile, U.S. brand companies at the top end of the value chain have consolidated their position and continue to reap the disproportionate return on investments (ROI), because of their brand names. In the middle of the value chain, Taiwan firms are squeezing a new revenue stream from their OEM playbook by replaying it in the Shanghai-Kunshan-Suzhou-Nanjing corridor. At the same time, they are sinking new taproots in Taiwan in fields as diverse as original design manufacture (ODM),

manufacturing-related research and high-end production (e.g. advanced TFT-LCDs, O-LCDs, and 12" wafer production). In China, local firms that have never previously participated in a meaningful way in the global economy are now supporting the low end of the global supply chain with component production and increasingly sophisticated assembly operations.

WTO accession offers the best example of the symbiotic benefits that the United States, Taiwan and China have all enjoyed from an expanded global value chain. Taiwan is now positioned to trade off, incrementally, its dominance of China's IT export market in return for substantially improved access to the smaller but potentially more profitable market on the mainland. China has gained limited access to high return foreign markets under the tutelage of a Taiwan partner with two decades of experience in those markets. The United States, meanwhile, experiences consumer benefit, a steady supply of vital IT components and products, and a more efficient global pipeline for its own research-led innovation.

In sum, the limited available data shows *not even marginal erosion* of Taiwan equity control in the overall IT market since 2000. Whatever shifts in leverage may be occurring in the IT sector between Taiwan and China, they appear to be happening gradually and to involve balanced trade-offs in access to the foreign and domestic portions of the economy.

Question 3: The economic and other forces driving the steady flow of investment capital into China from Taiwan?

In the IT realm, the forces driving the steady flow of investment capital are various. To cite a few:

- China's large and fast-growing market for mobile telephony is increasingly prompting handset makers and their suppliers to bring production and even R&D closer to their consumer base in the mainland;
- The low cost of land, factories and labor in China has already forced Taiwan IT hardware Original Equipment Manufacturers (OEMs) to relocate production in order to meet the cost-efficiency demands of their U.S., European, and Japanese brand-name customers;
- China's Export Rebate Tax system has been giving mainland chip-producers a cost advantage of 11–14% over their Taiwan competitors;
- The global nature of today's capital and venture capital markets is not easily controlled by national entities;
- The human capital resource in China—represented by more than one billion brains with adequate, though basic, levels of health and education—is compelling.

Question 4: The impact of China's economic development on Taiwan's role in the global supply chain?

In the interest of time, I will highlight one key implication of this question—the relative stability of highly differentiated, high-value supply chains (as still pertain in most IT sectors) as opposed to the instability of far simpler manufacturer-retailer networks characteristic of commodity products like toys, umbrellas, and the like.

With a simple commodity-supply network, an enterprising factory-floor manager in China can first learn a foreign-invested firm's production methods, and then jump ship to create overnight a competing factory on a lower cost-basis. Offering lower costs in commodity areas not highly-sensitive to considerations of quality of production or speed of delivery, all it takes for an upstart factory to dislodge its more globally-established competitor is a well-targeted letter to a mass-retailer in North America or Europe touting its product's lower costs.

Highly differentiated, innovation-dependent supply chains behave in fundamentally different ways. This type of supply chain—characteristic of sectors as diverse as brand-name athletic shoes, high performance bicycles, IT hardware, and automotive assembly—has a fundamentally different value-proposition. Rather than rely solely on price, these complex supply-chains are bound together by a more adaptive logic—the formula of “cheaper, better, faster.” Since the binding logic of supply chains rests on three legs rather than one, they tend to be much more stable. This helps account for the stability of Taiwan equity ownership of the IT production sector in China despite the hypercompetitive practices prevalent there.

This distinction helps throw into relief an underappreciated fact about the historical pattern of Taiwan investment into the mainland. While many light industry sectors which Taiwan moved to the mainland in the 1980s and 1990s have been swallowed up by mainland competitors, brand-name athletic shoes and high performance bicycles have remained largely in Taiwan equity hands. If these product sectors, with their relatively lower levels of technology and slower product cycles, could stay

in Taiwan control for decades, there is every reason to believe that the various IT hardware sectors will stay even more firmly in Taiwan's grip in years ahead.

For example, industry sources are now reporting that Wal-Mart is considering its own brand-name line of laptops and notebooks. These would compete with Dell and HP among others, largely on the basis of price. To bring this new line to market, however, Wal-Mart is not turning to upstart suppliers on a cost-basis. Rather Wal-Mart is turning to the same Taiwan OEMs who produce for Dell and HP and appears to be seeking its cost-advantage through leveraging the volumes and efficiencies of its own well-honed retailing model.

Question 5: Whether Taiwan perceives China's pursuit of regional and/or bilateral Free Trade Agreements, in Southeast Asia for example, as regional economic catalysts or as threats to Taiwanese economic and security interests?

Taiwanese are clearly concerned that China is using its FTA (Free Trade Agreements) and CEPA (Closer Economic Partnership Agreements) initiatives to further constrain Taiwan's diplomatic space and to encroach on its economic/commercial space. For this reason, China's FTA discussions with the ASEAN nations of Southeast Asia as well as its recent offer to sign a Hong Kong-like CEPA with Taiwan are met with anxiety and skepticism. Memories of TSMC's shabby treatment by China's industry association, protocol snubs for Taiwan officials at APEC gatherings, and audit and inspection harassment of ChiMei's mainland operations during the last Presidential election in Taiwan are fresh in peoples' minds. The business community views these initiatives as political posturing rather than as commercial negotiations.

Question 6: The implications of increasing cross-Strait economic cooperation and interdependence on the U.S.-Taiwan relationship?

I would cite three main implications of cross-Strait economic integration on the U.S.-Taiwan relationship:

First, it's a fact that the cross-Strait IT interaction is being driven by larger globalization trends. With globalization comes stresses of change and adaptation, but Taiwan also gains a higher degree of acceptance and support in an interdependent world, as does China. The U.S. has leadership experience, and models of interdependence, which could be shared with Taiwan and China in this regard.

A second implication relates to the perennial question of who is gaining leverage. The evidence suggests that leverage is not so much in the hands of politicians in either Beijing or Taipei as it is in the hands of Taiwan's globally-experienced IT firms and their brand-name customers. With a dominant share in China's export industry, a growing share in China's local market and strong R&D roots in Taiwan, this is not a zero-sum predicament for either Taipei or Beijing.

A third implication involves democracy trends. As a result of economic integration, Taiwan manufacturers and managers are now bringing millions of Chinese workers into direct contact with global norms of business and a more universal set of values. This development, brought about by sustained commercial interaction, would appear to directly support U.S. policy goals for the resolution of cross-Strait tension through sustained and peaceful interaction.

From this perspective, I conclude with the suggestion that the United States Government attend closely to two key policy questions:

- Since China is now following a two-track approach (old-style military intimidation coupled with a new strategy of economic blandishment), the U.S. needs to understand *on its own terms* where each track leads. The facts-on-the-ground of economic integration appear to be beneficial for all concerned but the politics of FTAs and CEPAs are subject to manipulation by China to Taiwan's detriment.
- While the security and economic tracks may lead in different directions, they are not disconnected. Increased U.S. policy support for the economic 'globalization track,' coupled with guided management of FTA and CEPA politics, is the best path toward cross-Strait and regional stabilization. This path promotes U.S. security interests by further constraining either/both Taiwan and China from jumping the political/military track.

The old saying about dancing with your enemy captures a truth in the current cross-Strait situation. Economic engagement between Taiwan and China will not eliminate the chance of an outbreak of hostilities, but it will reduce that chance. Similarly, as globalization continues to push Taiwan and China into closer economic embrace, U.S. policies on the above two issues can determine whether that embrace becomes mutually comfortable or ultimately injurious to Taiwan.

Co-Chair DREYER. Thank you, Mr. Cooke. Dr. Chow is Professor of Economics at the City University of New York.

**STATEMENT OF PETER C.Y. CHOW, Ph.D.
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Dr. CHOW. I'd like to thank Commissioner Robinson and Vice Chairman D'Amato and Professor Dr. Dreyer and the staff of the U.S.-China Commission for inviting me to this presentation.

I was asked to address the six issues on the cross-Strait economic integration, on the China-Taiwan relations, and its implications for the U.S. economic and security in the Asia Pacific region.

The first one, is on the problem of the Taiwan's domestic manufacturing sector which is being hollowed out by China's economic growth. The cross-Strait economic relation was pretty much induced through the structural transformation of the economies in both Taiwan and in China. Taiwan and China are at different stages of economic development, and they have some degree of complementarity as well as competitiveness.

The point I want to make here is that this close economic relation generated some legacies and some of them are not well understood by outsiders. The first one is the asymmetrical trade dependence on Taiwan's export market. Taiwan exports more than 23 percent of its exports to China, whereas China's exports to Taiwan only account for about 2.4 percent of China's total exports.

And this is the question that may create some political leverage in case the situation across the Taiwan Strait deteriorates—in case.

Number two; I think that Taiwan also faces some structural transformation in the decade of the globalization. The question of the hollowing out has no consensus among economists. Now if hollowing out refers to the phenomenon of de-industrialization in Taiwan, then it is true that the percentage of the manufacturing sector in Taiwan's total GDP has dropped from 33, 34 percent in the '80s to only about 25 percent recently.

But that phenomena is exactly what occurs in many of the industrialization process in many other OECD countries where the service sector overtook the industrial sector as the major and the dominant sector in the industrial economy.

But because the close economic relationship has not improved the political hostility between Taipei and Beijing, Taipei has to be aware and has been aware about the Beijing's strategy of exploiting the public to pressure the official and to exploit the businessmen to encircle the government. This has appeared in some of the news commentators.

So, the asymmetrical trade dependence caused some reservations if not in policy itself, but at least in the preventive policy planning process. In terms of the manner in which both the economies in China and Taiwan benefit from the unique dynamic of cross-Strait relations, I would argue that as we all know China has abundant labor supply. The State Council of the PRC estimates that by the end of 2000, China had agricultural surplus labor, as much as 317 million. So China can take advantage of inward foreign direct in-

vestment to cover the gap between domestic savings and the target rate of investment.

Also, China can also benefit from the technology transfer from the Taiwanese subsidiary in China as those subsidiaries become more and more localized and integrated with the host economy.

Number three; China can also gain the benefit of some training from those migrant workers who have previously been insulated from the global economy. Moreover, China can also learn some possible managerial expertise from those multinational enterprises including the Taiwanese subsidiary.

It was estimated that the foreign investment enterprise in China has generated about 23 million jobs, 23 million jobs in China since it opened the door in the 1978–79.

The foreign investment enterprise contributed about 52 percent, 52.2 percent of China's total export to the world. So, if we think that the Taiwanese foreign direct investment in China accounts for about ten or 15 percent in China, then it would mean that Taiwanese firms in China have generated from 2.3 million to 3.5 million jobs in China. At the same time, domestic unemployment, the number of unemployed people in Taiwan at the most is about half a million, and with a broad definition by 800,000.

All right. To put in a footnote, just in today's paper—*USA Today*—also talked about this issue of losing jobs in the U.S. due to outsourcing and offshore production. Goldman Sachs estimated that, in the last three years in the United States, among the 2.7 million jobs that are lost in the last three years in this country, about one million job loss in the U.S. was due to relocation of firms to overseas productions including China.

So here we talk about that the market orientation, the market orientation of the foreign enterprise in China has generated a very strong repercussion on the regional and the global economy.

And also a problem on domestic wage rate in the home country. In economic literature, there is a theory on so-called factor-price equalization; that is when two trading partners start to trade with each other, under the less protected environment, or a freer trade, then the country with the high wages is going to suffer from low wages because it's just like the water level in two swimming pools is going to level to equilibrium after a pipe is connected. And so high unemployment and lower wage are inevitable in the country, which trade with lower wage partner.

Also, we also realize that the legacy of trade includes the deterioration of income distribution between the trade and the non-trade sector, between the export and import substitution sectors. Therefore, integrating China into the global economy has generated much more significant impacts on the world, which is much over and above the four little tigers combined in the decade of 1970s and '80s.

For Taiwan, of course, Taiwan enjoys trade surplus with China. Among the 41 billion of the total trade, the bilateral trade between Taiwan and China, Taiwan enjoys something like 25 billion. But this is only on the current account. In terms of the almost unilateral direction of capital account, that's Taiwan's tourists visiting in China, Taiwanese residents, those immigrants to Taiwan after 1949, who have send remittance to their relatives in mainland

China, Taiwan has suffered from substantial deficits on its capital account. If we consider those unilateral capital outflows from Taiwan to China, then probably the overall trade balance is almost zero or close to zero.

All right. Now, in terms of the integration, particularly in the IT industry, Taiwanese enterprises were forced to relocate to Mainland China, not just because of the cost advantage, but because there are some discriminatory policies adopted by China. For example, we already talked about the 17 percent value added tax (VAT) that China imposed on foreign enterprises, yet subsidized domestic ones by tax rebates.

Obviously, this is against the national treatment under WTO. China also had censorship on cellular phone through the issuance of the users' license. They only issue the license to the cell phone users if the cell phones were domestically produced in China, but not for those imported from abroad. China used "market access" to attract foreign direct investments. So, this is another discrimination against foreign products. Of course, there are some other economic factors, which have attracted the Taiwanese firm to make investments in China. But some of those economic factors were further aggravated by manipulation of the Chinese government to attract foreign capital.

Therefore, Taiwan faces a very big dilemma in terms of the policy planning on its trade with and investment in China. That is, there is a heavy trade dependence, economic dependence on China's market, but politically the Taiwanese aspiration of maintaining an independent sovereignty, de facto independent sovereignty at least is subject to undercut by China's political offensives.

Now, on the impact of China's economic development on the role of the global supply chain, I think from this analysis in my written statement, we found a very interesting global supply chain, particularly on the IT industry. Most of the semiconductor industry in this country, located in Silicon Valley of California, are engaged on the research and the design only, the so-called fabless firms. And, they subcontract manufacturing production to Taiwanese firms, which partly engaged in offshore production in China. Taiwanese entrepreneurs were able to control their production and to meet the "Just in Time" expectation from their customers in the U.S.

The point I want to make here is that we don't put all the eggs in one basket. Therefore, the disadvantage of dependence upon one single supplier as a choice of an industry is similar to put the U.S. oil dependence on OPEC, oil imported from OPEC. Of course, the question of trade dependence between IT industry, IT products and oil/oil industry is not the same. But who can foresee that there would be some dramatic change in China, who can foresee that it won't become an enemy or at least a hostile regime to the United States, when Washington was having a honeymoon with the deposed Shah in the past.

So the risk of political unrest and upheaval in China could disproportionately affect the global supply chain. And this would be counterproductive to the U.S. economic and strategic interests. So U.S. could possibly play a role to minimize or to mitigate the potential risk by requiring the Taiwanese in the subcontracting process not to engage all the offshore production in one single country.

This is the very minimum insurance premium that the United States can undertake without attaining additional costs for its taxpayers.

In terms of economic forces and the others, what I want to say is that, yes, China is pushing for more free trade agreements with ASEAN and the CEPA. But the question is—under the WTO trading dovetailed framework, all the free trade agreements must be an open regionalism rather than exclusiveness as they are doing now.

I think the intention of China is very clear. ASEAN plus three or ASEAN plus China all want to exclude Taiwan and to marginalize Taiwan and so as to exclude the United States from being a participant in the Southeast Asia region. And also China expands the so-called CEPA, the Closer Economic Partnership, with Hong Kong and Macao. But as I put in my written testimony, if you reverse the CEPA, C-E-P-A, that tends to upset APEC. CEPA is the opposite of APEC. So that's why they upset the APEC which the United States Government has strongly supported to promote a free trade agreement among the industrial countries in the region by the year 2010, and among all the developing countries by the year 2020.

So I think instead of working on or pushing for those trading blocs, or regional trading agreement, I think there should be an open regionalism and to include all the important participants in the region to join this endeavor.

The other thing that the United States can do is, if open regionalism is too long to reach in the foreseeable future, to resume the trade negotiation with Taiwan and to sign the free trade agreement with Taiwan. Taiwan has been desperately trying to break out of the isolation initiated by China. In fact, Taiwan helped the American allies in the backyard of Latin America by signing a free trade agreement with Panama, which is a symbolic breakthrough. But I think if an FTA between United States and Taiwan is signed in the near future, it will restore or reinforce the confidence of the business community in Taiwan and to demonstrate that they are not alone in the struggle for trade liberalization and economic prosperity.

Finally, I would say that the increasing economic integration between Taiwan and China could possibly reduce, could possibly reduce, only possibly reduce the possibility of military confrontation, but did not resolve the political dispute on Taiwan's sovereignty.

So while China still refuses to negotiate with Taiwan, on an equal basis under the WTO framework, one must know that WTO is not a political arena, but rather is a trade forum. It is a natural platform for both Taiwan and China to deal with their trade related issues under the WTO framework. By the way, the United States has helped so much for both Taiwan and China to join the WTO. But neither Taiwan nor China started to negotiate on bilateral trade issues under the WTO framework so far.

So one thing we can do is to use the WTO as a platform to resolve those trade issues, if not the political issues, the trade issues, and then to reach what I call a Pareto optimum. A Pareto optimum in economics means both parties can benefit and neither party is worse off. And no other alternative can make it better. And that is what I propose—use the WTO as a framework as a platform for

China and Taiwan to negotiate with each other on trade-related issues, because the World Trade Organization is what the the American government supported. Why don't we turn the WTO to that direction?

I've got two—three points to make. That is, number one; use the WTO as a platform for both Taiwan and China to start to negotiate without any precondition on their trade-related issues. And number two is that the United States to engage in some sort of censorship on high-tech technology by controlling and by diversifying the global supply and require the Taiwanese subcontractors not to put all their eggs in one basket—that is, not to rely their offshore production in a single country. And number three, is to do away with those minor disputes, which have blocked on the U.S.-Taiwan free trade agreement, and to speed up the negotiation of U.S.-Taiwan FTA as soon as possible.

There are four pending issues between Taiwan and the United States to sign that free trade agreement. Those issues are: rice import, pharmaceutical products, intellectual property rights and telecommunications. What I argue is that a free trade agreement should be based on a broad macroeconomic perspective and a dynamic interest rather than on a sector-by-sector cost/benefit analysis.

Again, I appreciate this opportunity to present my point of view, and I'd be happy to answer any questions from the Commissioners. Thank you very much.

[The statement follows:]

**Statement of Peter C.Y. Chow, Ph.D., Professor
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***The Impacts of China's Economic Growth and Cross-Strait Economic
Integration on China-Taiwan Relations: Implications for U.S. Economic
and Security Interests in the Asia-Pacific Region***

**I. The Extent to Which Taiwan's Domestic Manufacturing Sector is Being
"Hollowed Out" by China's Economic Growth**

Taiwan and China are at different stages of economic development with different endowments of natural and human resources. Hence, there is a complementarity as well as competitiveness between these two economies. Since the mid-1980's, Taiwan has transformed itself from a capital importing into a capital-exporting country. Meanwhile, China's economic reform and open door policy also transformed itself into an emerging market economy, and to attract foreign capitals for its development. Trade and foreign investment are complement, rather than substitute in the bilateral trade between China and Taiwan. Much of the trade flow across the Taiwan Strait was induced by Taiwanese direct investment in China.

The first wave of Taiwanese foreign direct investment (FDI) in China was mostly engaged in small scale, with an average dollar amount of less than \$1 million per case. Most of those investment projects were mainly in labor-intensive industries which Taiwan had no longer had its comparative advantage in the world market after its currency appreciated in accordance with the Plaza Accord in 1986. The second wave of FDI in China was gradually expanded to relatively larger scale of production with an average dollar amount of \$2 million or more per case. Investment projects were gradually expanded to more technological-intensive industries and to some lower-end sectors of high-tech industries.

Many economists in Taiwan believed that the threshold of outward FDI in China occurred in 1994 when China's Reminbi (RMB) devalued nearly 40% against the U.S. dollar. China's unilateral devaluation of its currency in 1994 accelerated Taiwanese FDI in China to take the advantage of new competitive edge on the world market in general, and in the U.S. in particular. The worldwide recession of information industry in 2001 made the third wave of Taiwanese FDI in China. The new wave of outward FDI was dominated by investment in electronic and information industries, which accounted for nearly 40% or more of Taiwan's total FDI in China.

In the past three years, the scale of Taiwanese FDI in China was increased to an average of \$3 million per case.

In order to compete for the orders from the “fabless” semi-conductor firms, computer and information industries in the U.S., many Taiwanese foundries and manufacturing firms were forced to engage in offshore production and outsourcing for cost advantages. In 2002, 46.9% of Taiwan’s IT hardware was produced in China, whereas those produced domestically only accounted for 36.3%. It was estimated that more than 40% of Taiwan’s total outward FDI was destined to China in 2002. The ever-increasing trend of concentrating FDI in China was aggravated after Taiwanese government deregulated its foreign investment policy—the so-called “active openness and effective management”—in China in 2001. Statistics of the total amount of FDI varies, but it was estimated from a conservative of \$40 billion by Taiwan’s Ministry of Economic Affairs (MOEA) to \$67 billion by its Central Bank. The accuracy of FDI statistics also depends on whether or not to include those indirect FDI in China by Taiwanese firms through some tax haven places such as U.S. Virgin Islands and Cayman Islands.

While globalization is not without legacy and no transition is pain free, Taiwan, with its economic structure dominated by small and medium enterprises (SMEs), certainly would have more pains and take more time to overcome its painful transformation process. The incumbent government in Taiwan has been facing an unprecedented challenge of internal and external constraints to overcome its globalization syndrome. In addition to macroeconomic stabilization policies, Taiwan would need to implement some necessary structural adjustment policies and manpower programs to retrain those dislocated workers in the “niche industries” in the next 5 years. Therefore, to transform itself into an island of “Green Silicon” and to generate another economic miracle in the 21st century.

Economists have no consensus on the so-called “hollowing out” phenomenon. The question of whether Taiwanese manufacturing industries have been “hollowing out” due to accelerated outward FDI flows and offshore production was further complicated by ideological polarization and national identity among scholars in Taiwan. If “hollowing out” means de-industrialization, then it is true that there is a declining share of manufacturing sector in Taiwan’s total Gross Domestic Product (GDP), which dropped from 33% in the 1980’s to 25% in the late 1990’s. But that phenomenon is exactly the course of industrialization, which had occurred in most OECD countries when their economies became matured and service sector took the lead as the most significant sector of their economy.

Nevertheless, Taiwan’s government has been worried that China might exploit its economic leverage by using economic sanctions to achieve Beijing’s political goals. Beijing’s strategy of “exploiting the public to pressure the official” and “exploiting the businessmen to encircle the government” has been a big concern in Taipei. Therefore, Taiwan should not, and could not follow the footsteps of Hong Kong, which depends a lot on its expanding service sector to absorb those labor forces displaced from manufactured industries amid its high unemployment. (Offshore production of Hong Kong’s manufacturing industries in China reduced its total number of manufacturing firms from more than 80,000 to about 18,000 due to its integration with the Pearl River Delta). For its survival in the globalization, Taiwan has to upgrade its knowledge-intensive industries and to maintain its technological lead in those high-tech industries less it itself be Hong Kong-ized, economically and politically.

What Taiwan needs to watch out for is its economic integration with China has led to an “asymmetric trade dependence” on China’s market. Asymmetric trade dependence referred to the fact that Taiwan’s trade dependence on China’s market is much greater than China’s trade dependence on Taiwan’s market. Taiwan’s exports to China accounted for 22.56% of its total exports, whereas China’s exports to Taiwan only accounted for 2.44% of its total exports. This is mainly due to the relative market sizes between Taiwan and China. Since the 1990’s, China has replaced the U.S. as the largest market for Taiwan’s exports. Lopsided dependence on China’s market could possibly implicate its domestic politics toward China, on the controversial issue of “national identity” and even its de facto “political sovereignty.” Historical examples of such “hollowing out” and the subsequent political fallout are numerous, but Taiwan authority has had a hard time to convince its business entrepreneurs to diversify its outward FDI due to geographic proximity and cultural affinity with China.

Moreover, Taiwanese economists are relatively sharper in micro managements of cost benefit analysis, rather than in macro planning for a grand strategy for its national development. Topics such as on externality resulted from FDI in a hostile country on economic and national security were not too popular at all in the media network and opinion forum, which have been reportedly alleged to be infiltrated by

Chinese capital from the mainland. Proposals on controlling technology diffusion to China, on imposing an upper limit on foreign investment in China and to levy a national security tax on FDI in China were hard to implement on an immature democracy like Taiwan under which the incumbent has not controlled the majority in the legislative body.

II. The Manner in Which Economies of Both China and Taiwan Benefit From the Unique Dynamics of Cross-Strait Economic Relations

According to State Council of the People's Republic, China has more than 317 million agricultural surplus labor to be employed. This is a typical model of "unlimited supply of labor" in development literature. From the dynamics of cross-Strait economic interactions, China gets:

- i. Inward FDI to fill up the gap between domestic savings and investment for its target rate of growth.
- ii. Technology transfers from Taiwanese subsidiaries as they became more and more localized with their host economies.
- iii. Limited training of migrant workers who were previously agrarian workers and were insulated from the world economy prior to China's economic reform.
- iv. Support of foreign invested enterprises (FIEs), which provide new available factory jobs for China's working population by adopting some standardized production techniques.

It was estimated that one percentage point of economic growth in China would generate an additional one million new jobs in China. An 8% of economic growth is a miracle in the rest of the world outside China, but is just about right for China to absorb its ever increasing migrant labors and those laid-off from China's ailing state-owned enterprises (SOEs). Hence, inward FDI would help China to absorb that surplus labor, and mitigate its socio-political pressure of unemployment.

It was estimated that foreign enterprises in China have created nearly 23 million jobs for China since China's economic reform and open door policy. By the end of 2002, FIEs contributed 52.2% to China's total exports. China's cumulated FDI stock was estimated to be \$430 billion in 2002. If Taiwan's FDI in China accounted for 10 to 15% of China's total inward FDI, then one probably could argue that Taiwanese firms in China have generated 2.3 to 3.5 million jobs in China. Nevertheless, Taiwan domestic unemployed people was estimated to be near a half million only, or 800,000 at a broader definition of unemployment. But, in order to maintain their international competitiveness, those Taiwanese firms have had to engage in offshore production rather than stay at home to be driven out from the world market. This is a process of structural transformation in Taiwan as its economy has been highly open and closely integrated with the global economy.

However, since most FIEs in China are either export-oriented or aiming at its potential domestic market, the market orientation of FIEs in China has strong repercussions on China's economy, on regional as well as global economies too. China as a factory of the world economy would create significant impacts on the trade and economic structures as well as labor employment in its neighborhood countries and its trading partners including the U.S.

In economics literature, the trade theory of "factor-price equalization" implies that with freer trade and investment flows, many of China's trading partners including the U.S. would suffer from lower wages and higher unemployment rates, especially in their import substitution industries. Moreover, while freer trade will benefit both trading partners, income distribution will be deteriorated between the trade and non-trade sectors and between the export and import-substitution sectors unless appropriate social welfare policies are implemented. The ongoing U.S. economic recovery may move faster than anticipated, but the unemployment rate would remain stubbornly high due to dislocation of labor in those import-competing industries. Integrating China into the global economy has generated much more significant impacts on the world economy than did the four little tigers (Hong Kong, Korea, Singapore and Taiwan) combined in the period from the 1960s through 1980s.

For Taiwan, additional pains of trading with China occurred in its ailing real estate and housing market due to the emigration of half a million affluent multinational employees residing in China. The declining real estate and housing market, many of which have been serving as collateral for direct finance, led to the ever-aggravating non-performing loans in many of its commercial banks. Taiwan's domestic financial crisis is not inevitable, but much of its problems were rooted from over-lending to those firms invested in China. To provide a safety net for those unemployed people, Taiwan's government has to expand its unemployment compensation benefits and suffer from a swollen government budget deficit in recent years—

though the cumulative government debt, as a percentage of total GDP was limited to 40% by law.

Since the 1990s, electronics and electrical appliances sectors have been accounting for more than 40% of Taiwan's total outward FDI in China. Technological diffusions through "spillover effects" of FDI are exemplified by engagements of Taiwanese IT subsidiaries in China in expanding R&D functions. China has taken over Taiwan in some lower end of production lines in the IT industries. Many of Taiwan's IT subsidiaries in Beijing, Shanghai and other parts of the Yangtze Delta have created a set of strong "industrial clusters" for China. In fact, China was able to adopt the "leapfrogging competition" strategy, which has enabled itself to surpass other rivals through bypassing certain stages of technological trajectory, and to jump straight into a new generation of high-tech industry by the end of the 20th century. China's export of high-tech products to the U.S. increase from 5.1% of total U.S. imports of high-tech products in 1996 to 17.4% in 2001. China's market share in the U.S. increased from 3.3% in 1991 to 8.22% in 2000, whereas Taiwan's market share in the U.S. decreased from 4.27% to 3.89% in the same period.

Certainly, much of Taiwan's exports to China were induced by its outward FDI in China. Taiwan has been enjoying a substantial trade surplus against China in a bilateral trade of \$41 billion; Taiwan has a trade surplus of \$25 billion against China in 2002. But, on the capital account, the nearly unidirectional capital flows to China have offset its trade surplus a bit. The overall balance, which includes both current and capital accounts, is much less than what has been shown in any official trade statistics. Until Taiwanese investors are free to send their profits through remittance back to their homeland, the macroeconomic benefit of investing in China is subject to public scrutiny.

In terms of competing for technology upgrading, Taiwan has contributed more for China than the other way round. While Taiwan's major sectors are characterized by their vertical disintegration and pursuit of OEM/ODM contracts for brand names without access to the final market, China was able to take the advantage of "de-linking manufacturing and R&D" by many Taiwanese subsidiaries. In 2002, about 55% of Taiwan's desktop PC, 40% of its notebook, 94% of CD/DVD/RW were produced in China by Taiwanese subsidiaries. In spite of the fact that Taiwan-based firms may still remain in the driver's seat in terms of profit distribution, its global supply chain could become vulnerable to probable China's economic sanction, if Beijing intends to pursue its reunification of Taiwan at all costs as Premier Wen Jiabao declared recently.

It is a unique development to have both economies become more and more integrated, but both governments in Beijing and Taiwan could not even negotiate with each other. The dilemma of having an economic dependency on China's market and political aspiration of maintaining "independent sovereignty," de facto or de jure, has aggravated since the Taipei lifted its indirect trade with and investment in China. Consequently, the paradox of "economic dependence, but political hostility" has undermined Taipei's leverage in dealing with China.

III. Impact of China's Economic Development on Taiwan's Role in the Global Supply Chain

(a) What Has Been Taiwan's Role in the Global Supply Chain?

Taiwan took several steps before it reached what it is today. From technology of transistor radios from RCA in the early 1960s to the third largest producer of IC products in the early 1990s, Taiwanese firms benefited from U.S. technological assistance and a "reverse brain drain," especially during and after the recession in 1981-82 in the U.S. Having developed from a manufacturing subcontractor, an assembly-line producer, and then to become an oligopolistic giant of the lower end of IT industries, Taiwan now has the capability to manufacture the highest quality IT products for many world-class companies like Dell, IBM, Compaq and Hewlett Packard. The evolutionary change of Taiwanese IT firms by engaging in offshore production and outsourcing in recent years has expanded their international horizon on their grand global strategic planning. Hence, peace and stability on the Taiwan Strait is imperative to maintain the sustainability of that global supply chain.

(b) Why Should the U.S. Care About Taiwan's Role in the Global Supply Chain? Why is This Important to Us?

Because many U.S. computer and information industries have relied on Taiwan as one of their major suppliers in recent past, Taiwan has a direct linkage with American economic and strategic interest. When the electric fuse failure disrupted the chip production at Hsin Chu Science and Industrial Park during the September 21 earthquake in Taiwan in 1999, the stocks of many U.S. computer companies were crumbling on Wall Street.

The points that I would like to make here are:

- i. China's cheap labor is fine for producing technically simplistic and standardized commodities like shoes, textile/clothing and other labor-intensive products, but production of sophisticated components of high-tech such as chips and other computer peripherals require more stringent training, quality control, management, etc. Taiwanese subsidiaries in China would have to insure that OEM production of these parts and components in China have met the quality standard and delivery schedule required by their customers. Disadvantage of dependence upon one single country, as supplier of choice for one industry is similar to U.S. import dependence on oil and gas from OPEC if China decides to run against U.S. strategic interests in the region. While the risk of U.S. dependence on fossil fuels, of course, is different from that of its imports dependence on chips and IC products, there is still a potential to adversely impact the industry that undergoes very rapid and short business cycles. Who could foresee that Iran would become a hostile country to the U.S. when Washington had a honeymoon with the deposed Shah Pahlavi in the 1960s and 1970s?
- ii. Risk of political unrest or upheaval in China could disproportionately affect the global supply chain. The current logistic operation of global supply chain is systemically organized in the following way; the innovative design made by those "fabless" semi-conductor firms and design houses in Silicon Valley, California, subcontracted to wafer foundries in Taiwan through OEM and OBM, and then manufactured, tested and assembled by Taiwanese subsidiaries in China is a subset of globalization of high-tech industries. Taiwanese firms were the largest producers of more than 14 IT products in the global supply chain, most with greater than 50% of world market shares. Any probable disruption on the global supply chain of IT products—from Silicon Valley in California through Hsin Chu Science Industrial Park in Taiwan, and to Kunshan nearby Shanghai—would create significant impact on the IT market/industry in the world. Therefore, to insure the sustainable growth of IT and other high-tech industries, it is advisable for the U.S. to intervene with Taiwan IC industries by mandating them to diversify their offshore production sites, and not to over-concentrate their production sites in China alone. This goal could be achieved easily, if the U.S. firms would require that Taiwanese subcontractors really control the "strategic components" of those IC products at their home base in Taiwan, and to allow those less essential parts and components to be scattered around Southeast Asian countries so as to maintain regional balance and stability. By doing so, U.S. economic and security interests in the Asia-Pacific region will be better insured without paying any premium as additional costs from its taxpayers.

IV. The Economic and Other Forces Driving the Steady Flow of Investment Capital Into China From Taiwan

- (a) Is there a need for much explanation here? What are the primary reasons? Obviously, there are push forces internally and pull forces externally. Geographic approximate and cultural affinity led Taiwanese investors destined to China. Taiwanese firms were motivated by economic incentives of profit maximization without political consideration—though the resultant impact of offshore production in China on domestic politics is substantial.
- (b) Do many businesses decide to open in China so they can avoid environmental regulations? This would be a good argument for requiring a proportion of manufacturing products to be originated from countries where the regulations are stronger and/or regulatory authorities are less corrupt, etc.
- (c) China adopted a strategy of "substituting market access with technology" by imposing a 17% of value-added tax (VAT) on foreign produced IC chips, and granting tax rebate for domestic firms. China also induced FIEs to invest in China through government control of licenses on cello-phones. In fact, this policy is against the "national treatment" under the WTO. But, few people realized it and the issue has not been brought to the attention of the WTO yet.

V. Whether Taiwan Perceives China's Pursuit of Regional and/or Bilateral Free Trade Agreements, in Southeast Asia for Example, as Regional Economic Catalysts or as Threats to Taiwanese Economic and Security Interests

Undoubtedly, China has never felt comfortable about Taiwan's aspiration of being an active participant in the regional/global supply chain. China signed a free trade agreement with ASEAN countries—the ASEAN plus China, and a Closer Economic Partnership Arrangement (CEPA) with Hong Kong and Macao. But, China has never made them "open regionalism" as mandated by the trading framework of the

WTO. Meanwhile, by blocking other individual members states of ASEAN such as Singapore from signing bilateral FTA with Taiwan, China has been trying to marginalize Taiwan from the Asia-Pacific region, and undercut U.S. strategic interests in maintaining regional stability and balance.

Moreover, one should point out that by excluding the U.S. from the ASEAN plus one, and or ASEAN plus three (China, Japan and Korea), both the U.S. and Taiwan were equally suffering from China's rising hegemonic power in the region. It was argued that China's initiation of CEPA is directly against APEC, not just in the opposite alphabetic wording, but also in its deeds. As every American citizen understands, the U.S. Government has been pushing for an APEC-FTA in 2010 among developed countries and 2020 among all developing APEC members in the region. But, China chose to exclude the U.S. from participating in the regional trading bloc as an important partner. Therefore, China's hegemonic economic integration, either under ASEAN plus one and CEPA, is threatening to U.S. strategic interests. China's motivation today is similar to that of Japanese military regime in the 1930s when it initiated the "Greater East Asian Co-Prosperity Sphere" in Southeast Asia.

To avoid being marginalized from regional trading blocs and to further integrate its economy with the global one, Taiwan signed a FTA with Panama in September 2003 as a symbolic achievement in its efforts to expand international horizon in Latin America. Taiwan is helping the American backyard in Latin America by expanding its trade and investment flows with countries in the Southern Hemisphere. On the other hand, the U.S. Congress charged the U.S. International Trade Commission to conduct a study on the probable impact on the U.S.-Taiwan Free Trade Area. It is important for both the U.S. and Taiwan to resume their trade negotiations on TIFA (Trade and Investment Framework), and to resolve those pending trade issues such as import of rice from the U.S., the intellectual property rights protection (IPRs), pharmaceutical products and liberalization of telecommunication so that a U.S.-Taiwan Free Trade Area Agreement could be signed any time soon. By signing a FTA with Taiwan, which could serve as a "hub of regional operation center" for many U.S. firms in the Asia-Pacific region, the U.S. could better protect its strategic and economic interests in the region. The U.S. Government should, at least, offer Taiwan a FTA agreement on similar conditions as it has offered in the U.S.-Chile FTA agreement signed in 2002. Policy assessments on the impacts of FTA should be based on macro-dynamic and overall national interest, rather than microeconomic analysis of cost-benefit for individual sectors or industries.

VI. The Implications of Increasing Cross-Strait Economic Cooperation and Interdependence on the U.S.-Taiwan Relationship

The trade pattern across the Taiwan Strait has been dominated more and more in intra-industry trade as projected by many model simulations. In general, trade friction is much easier to resolve under intra-industry than inter-industry trade because of inter-relatedness between trading partners. Hence, economic mutual interdependency between China and Taiwan will further increase in the foreseeable future. How would that development affect the U.S.-Taiwan relationship? I have the following points to make:

American and Taiwanese people have shared a common value of freedom, peace and democracy. Since Taiwan's democratization gained its momentum under former President T.H. Lee in the early 1990's, Taiwan has consolidated its democratic foundation and political infrastructure to make its socio-political system more and more compatible with the U.S. The U.S. has been and still is the most important ally for Taiwan in its pursuit of economic prosperity and democracy. Yet, the increasing cross-Strait economic cooperation has made China the largest trading partner for Taiwan. China and Taiwan is a unique pair of trading partners—closer economic relations amid political hostility. Never before have any two rival regimes engaged in so close economic integration between them as China and Taiwan have had.

While economic integration across the Taiwan Strait has mitigated the possibility of military confrontation, it has not resolved the political dispute on Taiwan independent sovereignty, *de facto*, if *de jure*. Despite the fact that the U.S. has been working so hard for both of them to gain access to that world trading body, China is not willing to negotiate with Taiwan, and has not followed the "rules of game" under the WTO to negotiate with Taiwan faithfully on trade-related issues.

If the U.S. intends to identify the stabilizing forces in the Asia-Pacific region, then the U.S. would have to count on Taiwan's continued prosperity with freedom and democracy, not to observe the probable development of Taiwan's being integrated with a totalitarian regime in China. The U.S. should try to help Taiwan to overcome its structural transformation in its economic development and democratic consolidation, not to observe it to be merged with a Communist regime, which has no time-table to legitimize its leadership, by any democratic process. The bottom line is for

the U.S. to recommend that both China and Taiwan utilize the WTO as a platform to resolve their trade-related issues and to institutionalize their trade regimes to make their bilateral trade flows become compatible with the WTO framework.

VII. Summary and Conclusion: A Pareto Optimum on Cross-Strait Economic Integration

Economic and trade relations across the Taiwan Strait have been undergoing an evolutionary process from indirect, quasi-direct to direct and open trade. In spite of political hostility, trade and investment flows have been increasing steadily, and both economies in China and Taiwan have become more and more integrated informally. As trade and investment flows across the Taiwan Strait have been increasing steadily, economic mutual interdependence between China and Taiwan has been deepening as well, though there is an asymmetric trade dependence on China's market.

A Pareto optimum on economic integration across the Taiwan Strait means both China and Taiwan can be benefited, and neither is adversely affected by the trade and investment flows. Under such circumstance, no other trade-off could make one better off without making the other worse off. Hence, Pareto optimality is an ideal paradigm of maximum social welfare for all. The status quo of the trade regimes across the Taiwan Strait is that China and Taiwan, in spite of political rivalry on Taiwan's sovereignty, are two WTO members who have been trading steadily with each other without normalizing their trade and commercial relations. A Pareto improvement for Taiwan means to enhance its welfare without losing others' benefits including the status quo of Taiwan's de facto independent sovereignty.

Due to China's military intimidation to attack Taiwan, political offensive to lure Taiwanese compatriots for unification, and diplomatic isolation to undercut Taiwan's international status, Taiwan has to consider the "spillover effect" or "externality" in trading with a political rival such as China. The externality of trade with and investment in China includes both economic and non-economic interests. Hence, it is necessary for Taiwan to internalize these externalities by defining Pareto improvement in all aspects of social welfare including the tangible and intangible benefits of Taiwan's "de facto" independent sovereignty. A Faustian trade-off between economic integration and political sovereignty is not a Pareto improvement for Taiwan.

Trade is a two-way traffic and expansion of the bilateral trade flow must be a "non-zero sum game" or a "positive sum game." It is naïve for either trading partner to think that one could take the advantage of further economic interactions at the cost of the other under the trading framework of the WTO.

Trade and investment flow could not, and should not be politicized as an instrument for China's drive for unification. To further smooth the trade and investment flows across the Taiwan Strait, it is necessary to institutionalize the systemic mechanism on trade and economic issues by setting aside any other political disputes. Hence, the WTO provides an excellent platform for both China and Taiwan to deal with each other on trade-related issues without affecting the status quo of their political relations, and to serve as a buffer stock for both of them to resolve their trade disputes if needed. Hence, the U.S. could push both China and Taiwan to pursue a probable paradigm shift toward a Pareto optimum in the era of post WTO entry.

Since democracy is a universal value for all human societies, I am sure that both American and Taiwanese people have strongly believed that freedom and democracy will eventually overcome authoritarianism and totalitarianism. I hope that China will eventually follow the "rules of game" of the WTO trading framework without imposing any pre-conditions on Taiwan's sovereignty to engage in its trade negotiation with Taiwan. China has to understand that the WTO is not a political arena but rather a platform for trade negotiations, under which China has to deal with all its members including Taiwan on an equal basis.

China should not underestimate the political wisdom of Taiwanese people whenever foreign threat and invasion become a reality. The rising of Taiwanese nationalism and the aspiration of Taiwan identity will become stronger and stronger as long as China continues to antagonize Taiwan. China has to realize that its illegitimate claim of Taiwan's sovereignty is totally counter-productive for further trade and investment flows across the Taiwan Strait. And its military intimidation and diplomatic isolation against Taiwan will generate more resentment among Taiwanese people, nurture Taiwanese nationalism, and the syndrome of Asian Orphan among Taiwanese. All these policies are detrimental to further economic and trade relations across the Taiwan Strait. China needs to move more vigorously by expressing its "good will" to negotiate with Taiwan without any pre-condition so as to reach a Pareto optimum on the cross-Strait trade.

Finally, I must reiterate that the U.S. has a strong economic and security interest to maintain the smooth trade and investment flows along the global supply chain.

As a Pacific power, the U.S. would certainly like to maintain the peace and stability in the Asia-Pacific region under which the relations across the Taiwan Strait is a central focus. The U.S. could further secure the global supply chain of high-tech products by subcontracting with Taiwanese firms, and require them not to engage in offshore production in any single country. Moreover, American support on Taiwan's structural transformation is crucial, and an U.S.-Taiwan FTA would reinforce Taiwan's confidence in upgrading its economy as a "Green Silicon Island." As the U.S. has supported both China and Taiwan to access to the WTO, the U.S. should further push both of them to fully exploit the WTO as a platform to negotiate with each other faithfully.

Panel II Discussion, Questions and Answers

Co-Chair DREYER. Thank you, Dr. Chow. This was very enlightening actually from both of you. The first applicant to ask questions is Commissioner Robinson.

Chairman ROBINSON. Thank you. Dr. Chow, I had a quick question for you concerning your recommendation of the signing of a free trade agreement between the U.S. and Taiwan. In your view, would that in any way run contrary to the three communiqués?

Dr. CHOW. I don't think so because this free trade agreement, number one, is permissible under WTO framework. We have already signed NAFTA with Canada and signed the NAFTA with Mexico. It is a trade-related issue, not political one.

Now I don't think that U.S.-Taiwan Free Trade Agreement would complicate with what you call the three communiqués between Washington and Beijing because those are the political issues.

Chairman ROBINSON. Yes. And what would you anticipate China's reaction to be?

Dr. CHOW. Well, China has never felt comfortable for any Taiwan's initiatives leverage in terms of enhancing Taiwan's international visibility. So I don't think that should be a factor to be considered.

By the way I should point out that the Taiwan joined the WTO not as an independent country. Taiwan humbly and realistically joined the WTO as a customer territory of Taiwan, Penghu, Kinman and Matsu. So this has nothing to do with the sovereignty, that big issue. So, a FTA with Taiwan is compatible with the WTO, Commissioner Robinson, you don't have to worry about China's reaction.

Co-Chair DREYER. Commissioner Wortzel.

Commissioner WORTZEL. I'd like to thank both witnesses for excellent testimony. I have a question for Dr. Chow. You've advocated here orally and in your written testimony that the United States begin to treat both the WTO and a free trade agreement as a political tool rather than to negotiate agreements on their merits of economic benefit and mutual economic benefit.

And you seem to have advocated that not only the United States, but really the world begin to use this economic framework, the World Trade Organization, as a political tool to put Beijing and the Republic of China on Taiwan in a position to negotiate with each other. Isn't that a little contradictory? And that's really the question. I mean you either have an economic agreement between economies that stands on its own merits and is used for mutual benefit or you really take that entire organization and replace what should happen in the United Nations with the WTO.

I don't understand how you get to where you're going?

Dr. CHOW. Okay. Let me make it clear. Okay. I don't think I advocated that FTA or WTO as a political tool. I'm saying let FTA be FTA. Let WTO be WTO. All right. WTO is the place where the trading partner or the contractor party could negotiate on their trade related issues without dealing with the national sovereignty and which could be done both if both (China and Taiwan) just start to negotiate on some of the pending issues on trade and investment and including the fact with no preconditions. So that's what my position is.

All right. So WTO is not a political arena. It's a trade forum. It's a trade organization, and I don't advocate the U.S.-Taiwan FTA as a political tool against any third parties either. Number one, I think what I'm saying is that United States shared the fundamental value of the free trade with other nations, and since Taiwan has done so much in liberalizing its trade and Taiwan wants to further liberalize the trade and to deal with the United States. So there is a tremendous and there are a lot of good reasons for the United States to sign the free trade agreement with Taiwan.

I think the U.S. ITC, the United States International Trade Commission was charged by the U.S. Congress to conduct a study on that, and they found that nobody is going to be hurt by a FTA between the U.S. and Taiwan. Even Taiwan's free trade is not against any third party at all. It would benefit both American and Taiwanese people to further promote the free trade and enhance the economic and security as well as the regional strategic balance in Asia Pacific.

More important is that Taiwan has been isolated, been marginalized because China doesn't want Taiwan to participate in any of the world organizations including the APEC. Even with the APEC, there is a problem of the diplomatic protocol. Taiwan is a member of the APEC, but Taiwan's democratically elected President was not allowed to attend the summit of the APEC.

So you see that China has every intention to downgrade Taiwan as a local government, which is not the interest for this Administration or other branches of this government. And I don't think it's accepted by the American people either.

Co-Chair DREYER. Commissioner Bartholomew.

Co-Chair BARTHOLOMEW. Thank you and thank you to our witnesses for their very interesting testimony. Mr. Cooke, I just have one question about a statement you make near the end of your testimony about this implication involving democracy trends. You mentioned that Chinese workers are being brought into direct contact with global norms of business and more a universal set of values.

From what I have heard about a lot of the conditions under which Chinese workers are working, I don't know specifically whether it's in Taiwanese plants, but overall, the conditions are pretty bad, and if that's what we're advocating as a universal set of values, I'm a little troubled by it. I mean we're talking about lack of workers' rights. I'm talking about close to slave labor conditions in some places. In fact, there are slave labor conditions in some places.

What's the factual basis? Am I misunderstanding things?

Mr. COOKE. I realize that comment in relation to Taiwan manufacturers might catch people's attention and seem slightly provoca-

tive, but my point is that particularly in the IT chain, the efficiencies are so great and the partnerships are so close with the Dell's of the world, the HP's, the Siemen's and Phillips', that in relative terms it's absolutely undeniable, anytime you go into a Taiwan equity-owned plant in Dongguan, on the outskirts of Guangzhou, in Shenzhen, the norms of the treatment of the employers is going to be better than you would have found, in relative terms, in virtually any comparable, purely domestic Chinese employment opportunity.

So that's the point that I was trying to get at. Taiwan manufacturers and managers are tough and they get a lot of work out of their employers, and it's not Ben and Jerry's. However, they are in a continuum directly connected to the types of standards that make HP and Dell comfortable, and there is continual training that's going on and movement in the right direction. (Post facto note: see appended article by Joseph Kahn from the December 7, 2003 edition of the *New York Times* entitled "Ruse in Toyland" for an example of how the foreign end of the global supply chain tends indirectly to exert an ameliorative influence on appalling labor practices in China).

So in relative terms, that's the point I was trying to make.

Co-Chair BARTHOLOMEW. Okay. Thanks for the clarification, and you're talking below mid-level management. You're actually talking about people who are doing the manufacturing work. Is there something special about IT production that you think calls this forth? Is it because they're Taiwanese plants that this is being called for? Why do you think that this is different?

Mr. COOKE. Well, I think it's to some degree an efficiency issue, a business efficiency issue. As a limited example, proper lighting and ventilation are not only beneficial to the workers working under those conditions, they are also good for the overall efficiency of the production operation.

Co-Chair BARTHOLOMEW. Thank you.

Co-Chair DREYER. Commissioner Bartholomew picked up on the same thing I did. I had heard that complaints, and usually complaints instigated by Chinese authorities I think, that not only were Taiwan entrepreneurs on the mainland miserable employers but so were Koreans and Singaporeans and so on down the line. I suppose that the idea is that if you're going to get cheap labor, you've got to keep it as cheap as possible and get the maximum efficiency out of it.

And for a while—I haven't heard this recently—but it seemed like the Chinese government was actually doing the unthinkable and inducing these Chinese employees of foreign firms to organize into union-type operations that they wouldn't want to spread to the rest of China. I wonder if you could comment on that.

Mr. COOKE. Well, I think you're getting at a very important issue. Because remember, of course, that there is a continual supply of people showing up at the factory doorstep waiting to get any chance to work. But the salient distinction, I think, is what I referred to before between highly complex global supply chains and very simple manufacture retail operations where a factory manager can undercut a globally established firm just by doing it cheaper, by exploiting laborers and writing a letter to a mass retailer some-

where saying, you know, this coffee mug, I can get it to you for 27 percent less.

In that second area of business where there is not a complex highly defined, highly elaborate global supply chain, there is a problem, because the factory managers just burn out their workers and the next day they'll open the door to a new worker. But these by definition are industries that don't require much worker training.

So I think that question always has to be approached is what kind of manufacturing operation are we looking at? Are we looking at coffee mugs or are we looking at motherboards.

Co-Chair DREYER. But in reality, it's probably not three million workers because there are more people making coffee mugs and things than work in IT. So I think maybe the three million is on the high side of the estimate.

Mr. COOKE. Right. And I think all the Commissioners have appreciated that there is a slight skewing perhaps in my perspective because my research is looking at—

Co-Chair DREYER. High tech.

Mr. COOKE. —at high tech.

Co-Chair DREYER. I see.

Mr. COOKE. Almost exclusively.

Co-Chair DREYER. CEPA, the Closer Economic Partnership Agreement that was signed with Hong Kong and Macao [I moved this phrase into an earlier sentence for clarity]—it strikes me that CEPA is going to be a non-starter with Taiwan because its situation is so different from Hong Kong's, and that as I understand CEPA, this is treated as a domestic matter, and of course Taiwan, or at least the government of Taiwan would never agree to anything that treated it as a domestic matter.

And of course, the situations of Hong Kong and Taiwan are, in fact, different. First, Hong Kong's economy has been in the doldrums whereas Taiwan's economy has been picking up, and I think the reason the CEPA appealed to Hong Kong is because Hong Kong feels that pressure—what was that wonderful metaphor you used about the water and the swimming pools coming to the same level? That is exactly it. Yes. Shenzhen is siphoning business away from Hong Kong, and Hong Kong saw a closer economic partnership with China as a way to reinvigorate its economy get back, but in the end you could never expect Tung Chee-hwa to say no to Beijing, whereas it is otherwise with Taiwan and its leadership. So I guess my feeling is that at least as currently constituted, the CEPA is never going to appeal to Taiwan. I wondered what you gentlemen think about that?

Dr. CHOW. Yes, I think CEPA does not appeal to Taiwan's leaders, not just the government, but also the opposition leaders. I did some interview with some major politicians from major parties, and asked what is their reaction to the CEPAs? And they say, gee, I'm only running for the President or I'm only running for the Congress. How can we accept that kind of agreement, you know, at least in the foreseeable future? And I don't think any politician in Taiwan is going to run for the Presidency by declaring that I would be the Tung Chee-hwa in Taiwan, and get elected.

Co-Chair DREYER. Terry.

Mr. COOKE. Three comments. I've always found this one so paradoxical that it makes me smile. As you pointed out, the reason a CEPA was necessary for Hong Kong was as a political fix for the economic hemorrhaging that Hong Kong was suffering under its accession agreement.

From Taiwan's point of view, their situation is the exact opposite of Hong Kong's. They have the benefit of economic interaction with China that Hong Kong has somewhat lost, while being free from the political strictures that Hong Kong has.

So from Taiwan's position, it's a band-aid solution for Hong Kong. Why would they give up anything politically for a band-aid solution? It's a stalking horse for China to use its one country/two systems argument. If they accept CEPA, China gets to say, see, one country/two systems can work.

And third of all, they don't need it because their situation is fundamentally the opposite of Hong Kong's, and probably the reason that direct links gets caught up politically is because Beijing recognizes that if they give direct links to Taiwan, it's going to hurt Hong Kong even more and Beijing can't afford to let Hong Kong hurt even more.

So from Taiwan's point of view where people are pretty savvy and pretty discerning, I think they just see this as Beijing playing to the international gallery, appearing reasonable by making an economic proposal that is a total absolute non-starter.

Co-Chair DREYER. Yes, it's interesting that so many people advance this as an idea of China that is reasonable and accommodating when, in fact, it isn't that at all. That was a very interesting point you made about China not wanting Hong Kong to slide further, which it obviously would if there were a CEPA and a free trade agreement across the straits.

Commissioner Reinsch.

Commissioner REINSCH. Thank you. I just have a question and comment. For Mr. Cooke, I was going to ask this at the last panel and didn't have a chance, so I'll ask you. If you can respond in the context of the IT sector which is, I guess, your specialty and actually the most relevant area that would be helpful.

It seems to me one of the things we need to think about is sort of the micro question of when or if the Chinese are going to be able to transition from—if you heard the last panel—assembly contract manufacturing, whatever you want to call it, to design and development of original products, and sort of the creative end of the manufacturing process, particularly in IT.

My question is has that already begun to happen? If so, comment on that. If it has not already begun to happen, do you think it is going to, because there are some people who would answer that question saying no, never? And, why or why not?

Mr. COOKE. I think as a generalization, the only migration of meaningful R&D that you're likely to see in the IT sector in China will fall under one of two categories. Either it's where China is a bona fide global market driver at the consumer level, and that doesn't happen in very many sectors at all, and it doesn't appear likely to happen in many sectors for some time.

Mobile telephony is one such sector. There are so many people in China and mobile telephony represents a solution at the con-

consumer level at so many ways, and it is within reach for a consumer's purchasing power, that mobile telephony is a market driver and you will get some R&D moving just because it has to be close to the consumer base.

The only other type of meaningful R&D that I think you're likely to see shifting over is to tap the brainpower of the billion plus people, but it will be within the architecture of a regionally or globally distributed management system for R&D. In other words, an R&D operation for servers is not likely to go lock, stock and barrel over to China and padlock the doors in Hsinchu, Taiwan.

But specialized areas of R&D will be delegated from Hsinchu to various places in China, but then that R&D will be assembled and packaged back in Taiwan and also in Silicon Valley and the Austin-Dallas corridor and places like that.

Commissioner REINSCH. Okay. Thank you. The only other comment, I think, on a different subject, I really—I'm sorry.

Mr. COOKE. There is one other relevant thought, and excuse the interruption, but I think this is an important one. The semiconductor industry is different from IT hardware, and I think an area of scrutiny we have already talked about the value added tax, and I know that the industry through the Dewey Ballantine study has locked on that, I think it's a very good thing, that there is attention locked on that.

I think another area that requires attention is the issue in semiconductors between manufacturing and design, and design is, of course, an R&D type function. And it's very clear. I don't think China itself has the investment capital to be placing bets on \$2 billion foundries, and it leaves it to international capital largely to finance its foundries.

So on the manufacturing side, there is not a well-defined and explicit policy. There does not appear to be a well-defined and explicit policy by China necessarily promoting manufacturing. They know that the Koreans lost a lot of money in DRAMs, and I don't think they are confident they know how to play the game. But I think they are targeting design and I think that's the important issue.

Commissioner REINSCH. How can they target design without targeting the manufacturing capabilities at the same time?

Mr. COOKE. Well, the two have to work hand in hand. But I think what they are really trying to build up in a competitive sense is their design capability, and that's where the bleeding into the military would take place.

Commissioner REINSCH. You want to say 25 words about software at the same time or not?

Mr. COOKE. My personal perspective on this is that what is happening in India is going to throw that issue into very, very interesting relief because so much of this is driven by global dynamics and the fact that India is a comparably scaled country as China. I personally think India is going to be able to outperform and out compete China globally in the software arena at least for commercial applications. In terms of military applications, however, China's software efforts appear more threatening.

Commissioner REINSCH. Well, I'll defer the other matter. Thank you, Madam Chairman.

Co-Chair DREYER. Commissioner Mulloy.

Commissioner MULLOY. Mr. Cooke, one, I wanted to thank you for your testimony. You were very helpful two years ago when you came here, and I didn't understand the extent of the economic relationship between Taiwan and China, and then subsequent to your testimony, we had a chance to go to Shanghai and actually see some of that Taiwanese investment, which was really interesting.

Mr. COOKE. Thank you.

Commissioner MULLOY. You lived in Taiwan as a member of our Foreign Commercial Service. In fact, you headed that office in Taiwan. You lived there how many years?

Mr. COOKE. Three years.

Commissioner MULLOY. Dr. Chow has indicated that he thought a free trade agreement might not have political problems. From your perspective, how do you think the PRC would react to our entering or talking about a free trade agreement with Taiwan?

Mr. COOKE. I think that China would be delighted to translate its position of relative weakness in global markets and to get the validation from the U.S. of us fixating and focusing on the China market to the exclusion of Taiwan. I think a FTA with Taiwan would have the salutary effect in China, and I know there are some serious obstacles in the way. I'm not trying to minimize, but in the big picture, an FTA with Taiwan I believe would have the salutary effect in China of reminding China that free trade relationships are built up over many years, and are the result of accomplishments and real partnerships and not just potential.

Commissioner MULLOY. So do you think the PRC would have a major political problem with us entering a FTA with Taiwan?

Mr. COOKE. From my vantage point, I don't see how they could have a major political problem because (a) it's, as far as I understand, WTO consistent, and (b) it is in line with the rhetoric that Beijing always advances that politics and economics are totally separate and we're all for economics, it's just the political shenanigans that we don't like.

Commissioner MULLOY. That's very interesting. I wanted to then ask Dr. Chow, are you from Taiwan originally?

Dr. CHOW. Yes.

Commissioner MULLOY. In your testimony, you talk about the trade theory of factor-price equalization, which implies that many of China's trading partners would suffer from lower wages, higher unemployment rates, deterioration of income distribution, and ever increasing budget deficits due to expanding social welfare payments for dislocated workers.

Does that analysis apply to China's trade with the United States in your view?

Dr. CHOW. If you look at the textile industry in New England, the furniture industry in South and North Carolina, you will get what I think what I have pointed out. Even though the factor-price equalization, that is a theory in trade, but it says that eventually if, under the free trade, the low wage country is going to gain higher wages. Those higher wages is going lower, just like two levels of the swimming pool, it's going to get to equilibrium if they are connected by a pipe. But, of course, there are some assumptions on that economics theory.

But if you see some of the labor-intensive industries in the United States, you will get some more empirical evidence of what I say.

Commissioner MULLOY. But does your analysis apply to the overall, or are you just only talking about labor-intensive industries?

Dr. CHOW. Not just labor intensive industries, but will cover all other trading industries, too.

Commissioner MULLOY. You didn't qualify it in your testimony. I'm just trying to understand.

Dr. CHOW. Okay. I can re-phrase that. Of course, China is a labor abundant country and the most obvious example would occur in the labor-intensive industry, but this trend also expands to the low end, the low end of the high tech industry, such as assembly of high-tech products and some digital testing instruments, some minimal testing. So it's not just the labor intensive but some other low end of high tech industry would be adversely affected. And look at the United States unemployment rate, which lost to the trade and globalization. Japan, also suffered from its offshore production, too. Japan used to subcontract their component parts with the affiliated industries, and since they engaged in offshore production. Japan's unemployment rate rises. So this is the legacy of globalization.

Commissioner MULLOY. Let me just follow up on one last thing. Dr. Woo, who testified on the first panel, said our economic relationship with China will be a win-win. Do you agree with that?

Dr. CHOW. Well, of course, I don't—yes if we manage the trade issue problem appropriately, it could be a win-win in the longer term. But before reaching the long run equilibrium, the problem we face now is that you have to implement some other complementary, social welfare policy to retrain those dislocated and unemployed people to make them back to the job market and to make them compatible with the new skill requirements. So you have more work to do before we can reach that win-win scenario in the longer run.

Commissioner MULLOY. Thank you very much.

Co-Chair DREYER. Are there any other questions? Commissioner Wessel.

Commissioner WESSEL. Let me understand if I could, and thank you both for being here and Mr. Cooke, for your return. My recollection was factor-price equalization theory was not limited to low-end jobs, but rather dealt with all factors of production.

Mr. COOKE. Right.

Commissioner WESSEL. And I believe Mr. Cooke talked about India earlier and software writing. Isn't the problem not only for Taiwan but also for the United States that as you look at the pools changing their levels, that there are few things that we in the U.S. will have the advantage of in the future, and that the factor-price equalization theory would either indicate a stagnation or a decline in our own wages and living standards?

Dr. CHOW. Yes, that's a challenge that we have to face and we cannot resist that because, on the one hand, we want to pursue the free trade policy. We don't want to put too many trade protections—at least to maximize free trade, and to push for free trade

as much as we can, and also participate in the development of the trend of globalization.

But on the other hand, we have to know that free trade is not without legacy, and the globalization has its own discontent. And I think you are right, that the factor-price equalization is not just limited to the labor-intensive product at the low end, it applies to all sectors of other industries, too. But the United States as a leader of the world economy has no choice but to face the challenge, and to upgrade its own technology and to maintain the technological lead. As far as the United States (and the rest of the other world too) can maintain the technological lead in some sectors of the economy (to maintain comparative advantage in the niche industries), it will be all right.

Commissioner WESSEL. Let me question in the sense that we've now seen with the Seattle WTO, the Cancun Ministerial, and the failure or I would say what many would deem a failure of the Miami FTAA, that the American public is getting concerned that pursuing free trade as one also looks at the leveling of the pools, and they're losing all their water, they're not terribly pleased and don't believe that we should have a mindless approach to this.

You indicated earlier, as I understand it, that as we look, for example, at the need to move forward quickly on a U.S.-Taiwan free trade agreement, that we should not be hung up on intellectual property. Yet, I think there are many who believe that intellectual property is one of the few remaining benefits or competitive advantages we have here in the United States.

I would argue to you that as we look at IT, as we look at Mr. Cooke talked about telephony and mobile telephones and giving up R&D, that if we were to give up R&D, if we give up our intellectual property, there is little left that would allow us to support the level of income and standard of living we have here in the United States and the support for free trade and continued liberalization will evaporate.

Dr. CHOW. First of all, let me make clear, I did not advocate that we give up the demand for Taiwanese government to honor its commitment to intellectual property right protection. Actually, I personally advocate that Taiwan should try their best to fulfill the U.S. expectation. But you understand, there are some divergent cultural attitudes and social background difference in terms of intellectual property, and Taiwan's government and the ruling party have worked very hard to please the U.S. that they are doing something.

It takes a little while for them to meet 100 percent expectation from Washington. But the other issues which is to me are very minor; on rice imports, U.S. requires minimum market access (purchase) of 144,000 tons each year, which costs only 30 million, and is less than 0.1 percent in the bilateral trade between U.S. and Taiwan. But our government pushes the Taiwanese very hard to demand it has to have minimum purchase of 144,000 tons a year. What Taiwan did was, okay, we go with the tariff quota equivalent. We go through the WTO rule. I think what Taiwan did on the rice import is exactly the rules, the rules set by the WTO.

No, I think those are the minor—in terms of overall macro dynamic; the overall national interest and the benefit for the U.S.—

Taiwan FTA is much greater than those sectoral cost/benefit. And actually, Taiwan has made some concession in terms of telecommunication liberalization, and also add that on the U.S. demand is the pharmaceutical product, which is beyond or beside the Taiwanese commitment to WTO, but Taiwanese government is still willing to work with the U.S. on those issues.

So I think under such circumstances, the minimum the U.S. should do is to resume the negotiations (with Taiwan) and to put it on equal footing as what the U.S. did in trade negotiations process with Chile on the U.S.-Chile FTA. Thanks.

Mr. COOKE. Commissioner Wessel, if I may, just two very simple points on that. One key question is whether the competition from China is pushing Taiwan off the ladder or prodding Taiwan to a higher rung, and as long as it's prodding it to a higher rung, I think that is actually is—in a way it is helping Taiwan reposition itself in the global economy. There is, of course, also the danger that in the process it gets pushed off the ladder.

And also just from the vantage point of having been very engaged in Taiwan in the very important discussion about protecting intellectual property rights, I think there are too easy extremes that both would perhaps represent policy mistakes and then a more complicated area in between that represents the creative dynamic policy balance.

On the one hand, I don't think we should be taking any pressure off Taiwan to conform in the IP area. It's absolutely vital to what we represent in the global economy.

The other extreme, which goes back to Commissioner Mulloy's question is I think it would be a mistake to just give China a free ticket to say that we're never going to consider engaging seriously with Taiwan on the FTA question. That would be making the perfect the enemy of the good, and it would be encouraging China to think that economic potential is more important than economic performance and proven economic partnership which Taiwan has demonstrated.

So I think those would both represent policy mistakes and there's some issue of calibration in between those as to how the FTA issue should move forward.

Dr. CHOW. Can I add?

Co-Chair DREYER. Yes, please.

Dr. CHOW. I have just published a booklet on the U.S.-Taiwan free trade agreement, so after I get back to New York, I send a copy to every Commissioner if I get the mailing address free.

Co-Chair DREYER. Thank you. Could you autograph mine?

Dr. CHOW. Yes, everyone.

Co-Chair DREYER. Thank you.

Dr. CHOW. Every Commissioner, yes.

Chairman ROBINSON. If there are no other questions, I will close this morning's hearing, and we thank you very much, Mr. Cooke and Dr. Chow, and we hope we can call upon you again.

Dr. CHOW. Thank you very much for inviting me.

Mr. COOKE. Thank you all.

[Whereupon, at 1:15 p.m., the hearing recessed, to reconvene at 2:10 p.m., this same day.]

AFTERNOON SESSION, 2:10 P.M., THURSDAY, DECEMBER 4, 2003**OPENING REMARKS OF CHAIRMAN ROGER W. ROBINSON, JR.**

Chairman ROBINSON. Thank you so much for all being seated, and we would like to begin our afternoon session. As the fire drill evacuation of this morning put us behind schedule a bit, and we deferred the opening statements of the Chairman, Vice Chairman, as well as the two Co-Chairs of today's hearings, Commissioners Dreyer and Bartholomew, I would like to begin the afternoon session with my opening remarks as well as those of my colleagues.

Today, our Commission will hold the fifth in its series of hearings during the 108th Congress. Our hearings in September and October on the questions of China's exchange rate and investment policies, and the geopolitics of China's growing energy requirements, respectively, offered a useful framework for the discussion we'll be having today on the security dimensions of China's emergence as a regional economic power.

China's currency and industrial policies impact its economic relations with its Asian neighbors just as they do with respect to the United States. The so-called hollowing out of industry is not an expression confined to headlines in the United States. South Korea, Japan, and Taiwan all face similar challenges from China.

There is a growing acknowledgement in Asia of China's central role in the region's web of trade, investment, manufacturing and distribution. For some regional neighbors, China is a fierce competitor for trade and investment dollars. For others, China represents an expanding market for its goods and a potential source of investment.

In many cases, China represents both dynamics at the same time. What is clear is that China's growing economic clout in the region inevitably will expand its political influence in the area with corresponding economic and security consequences for the United States.

While today's focus is on the economic dynamics of China's relations with regional states, the political and security dimensions are always in play, particularly with respect to the relationship between Taiwan and China.

Recently, new tensions have arisen as a result of Taiwan's decision to hold national referenda on a number of issues. China reportedly views this democratic development as a provocation, and has engaged in threatening rhetoric concerning any actions by Taiwan that it interprets as movement in the direction of independence, including referenda on unrelated subjects.

Given this environment, the United States would be well advised to maintain its long-standing unstated policy of not actively supporting, but also not opposing, Taiwan's independence or democratic moves in that direction with the goal of a peaceful outcome.

Moreover, it would be counterproductive and even perilous for our government to allow itself to be perceived as in effect endorsing Beijing's view of what constitutes a quote "provocation" unquote in cross-Strait relations.

Today with experts organized in four panels, we'll explore some of the details of China's growing economic prowess, first in an overview which we had this morning, followed by more country specific

discussions. We will consider the implications of these regional economic trends for the country's involved as well as for American economic and security interests.

We appreciate the participation of all of our distinguished panelists who have committed their time and effort to enrich our hearing today and in turn the Commission's work in this vital area of our legislative mandate.

The Co-Chairs, as I've mentioned, of today's hearing will be Commissioners June Teufel Dreyer and Carolyn Bartholomew. Commissioner Dreyer presided over the morning session. Commissioner Bartholomew will take the gavel this afternoon. I'm now pleased to turn over our proceedings to Commission Vice Chairman D'Amato. Thank you.

[The statement follows:]

Prepared Statement of Chairman Roger W. Robinson, Jr.

Today our Commission will hold the fifth in its series of hearings during the 108th Congress.

Our hearings in September and October—on the questions of China's exchange rate and investment policies and the geopolitics of China's growing energy requirements, respectively—offered a useful framework for the discussion we will be having today on the security dimensions of China's emergence as a regional economic power. China's currency and industrial policies impact its economic relations with its Asian neighbors, just as they do with respect to the United States. The so-called "hollowing out" of industry is not an expression confined to headlines in the U.S. South Korea, Japan and Taiwan all face similar challenges from China.

There is a growing acknowledgment in Asia of China's central role in the region's web of trade, investment, manufacturing and distribution. For some regional neighbors, China represents a fierce competitor for trade and investment dollars, for others China represents an expanding market for its goods and a potential source of investment. In many cases, China represents both dynamics at the same time. What is clear is that China's growing economic clout in the region inevitably will expand its political influence in the area, with corresponding economic and security consequences for the United States.

While today's focus is on the economic dynamics of China's relations with regional states, the political and security dimensions are always in play, particularly with respect to the relationship between Taiwan and China. Recently, new tensions have arisen as a result of Taiwan's decision to hold national referenda on a number of issues. China reportedly views this democratic development as a provocation and has engaged in threatening rhetoric concerning any actions by Taiwan that it interprets as movement in the direction of independence, including referenda on unrelated subjects.

Given this environment, the United States would be well-advised to maintain its long-standing unstated policy of not actively supporting, *but also not opposing*, Taiwan's independence or democratic moves in that direction with the goal of a peaceful outcome. Moreover, it would be counterproductive, and even perilous, for our government to allow itself to be perceived as, in effect, endorsing *Beijing's view* of what constitutes a "provocation" in cross-Strait relations.

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The Co-Chairs of our hearing today will be Commissioners June Teufel Dreyer and Carolyn Bartholomew. Commissioner Dreyer will preside over the morning session and Commissioner Bartholomew will take the gavel after lunch. I am now pleased to turn over the proceedings to our Commission Vice Chairman Dick D'Amato.

OPENING REMARKS OF VICE CHAIRMAN C. RICHARD D'AMATO

Vice Chairman D'AMATO. Thank you, Mr. Chairman. The impact of China's new diplomacy, heightened economic activity and political muscle on U.S. strategic interests in Asia is a matter of continuous interest to this Commission, and these activities are increasingly noted and written upon by political commentators across the world.

The reason is simple and obvious: the United States has long been a Pacific power, indeed the dominant power in the Pacific, and has far-flung alliances and friendships throughout the region.

And to be blunt, China is on the make. Research conducted by the University of Maryland at our direction show that Chinese public writings and press attention indicate a deep sense of competition on the part of the Chinese regime at what it regards as U.S. crowding in the Asia region, depicting the United States as a hegemon, which, as you may know, is a highly derogatory word in the Chinese language, who works to encircle China, keep her chained up, and attempts to deny her a rightful place in the sun.

Thus, China plainly regards the United States as a competitor power, not a cooperative power engaging her in the region. Unfortunately, China's leaders broadcast continuously this negative characterization of U.S. foreign policy through its controlled media and protected Internet to its population.

There are some tentative signs that this attitude might be softening over time, in particular the apparent cooperative actions that have been taken to resolve the Korean nuclear crisis. The jury is out on this, however, and the latest Chinese proposal on the Korea matter is unsatisfactory on the issue most important to the Congress, that is an effective verification regime.

Let me also point out that the Taiwan matter is a subject that the Commission has devoted and will continue to devote substantial attention to. Taiwan is, of course, a major success story for the United States in that a new democracy has been created there, which as democracies are wont to do is exercising its rights and vocalizing. It follows the other successful experiments in democracy which the United States has had a hand in Asia since World War II, of course, Japan, South Korea, and the Philippines, Thailand and even Indonesia.

Congress has directed the Commission to develop a detailed record as to the legal and policy foundation of the U.S.-Taiwan relationship, which is grounded, of course, in the Taiwan Relations Act. The Taiwan Relations Act was written almost wholly in the Congress and is a central foundation of departure of U.S. legal and political guidance on our relations with that island.

Presidents from Jimmy Carter to Ronald Reagan to the present incumbent have repeatedly reiterated that policy, that the U.S. would take every appropriate step to defend Taiwan's right to exist, to be free from bullying, certainly not tolerate any attempt by Beijing to forcibly include Taiwan within Beijing's sovereign orbit, which today would amount to a dictatorship extinguishing a settled democracy.

For the Chinese, of course, it is a matter of power in Asia. For the U.S., it should be simply a matter of standing by the commitments for peaceful evolution that have been the keystone of U.S. policy for many decades. Surely we are not taking the position that we value potential democracies in the Middle East above actual democracies existing in Asia. The dynamics of our relationship with China in Asia are now a fast-moving game with many faces. We are seeking a better understanding of the stakes for U.S. trade and investment in the region and to refresh and stimulate our relationships with our treaty partners and friends.

The Commission looks forward to the testimony by our distinguished panelists this afternoon. Thank you, Mr. Chairman, and I'll turn it over to our hearing Co-Chairman, Commissioner Bartholomew.

[The statement follows:]

Prepared Statement of Vice Chairman C. Richard D'Amato

The impact of China's new diplomacy, heightened economic activity and political muscle on U.S. strategic interests in Asia is a matter of continuous interest by the China Commission. And it is being increasingly noted and written upon by political and economic commentators across the world.

The reason is simple and obvious—the U.S. has long been a Pacific power, indeed, the dominant power in the Pacific, and has far flung alliances and friendships throughout the region.

And, to be blunt, China is on the make. Research conducted by the University of Maryland at our direction shows that Chinese public writings and press attention indicate a deep sense of competition and even hostility on the part of the Chinese regime at what it regards as U.S. crowding in the Asia region, depicting us continuously as a "hegemon," a highly derogatory word in the Chinese language, who works to encircle China, keep her chained up and attempts to deny her a rightful place in the sun. Thus, China plainly regards the U.S. as a competitor power, not a cooperative power engaging her in the region. Unfortunately, China's leaders continuously broadcast this negative characterization of U.S. foreign policy through its controlled media and protected Internet, to its population.

There are some tentative signs that this attitude might be softening over time, in particular the apparent cooperative actions that have been taken to resolve the Korean nuclear crisis. The jury is out on this however, and the latest Chinese proposal on the Korea matter is unsatisfactory on the issue most important to the Congress, i.e., an effective verification regime. Indeed the latest Chinese proposal we are told contains so little on this subject that the negotiations have been postponed for several months, a development of very serious concern to us.

Let me also point out that the Taiwan matter is a subject that the Commission has devoted and will devote considerable attention to. Taiwan is, of course, a major success story for the U.S., in that a new democracy has been created there, which, as democracies are wont to do, is exercising its rights and vocalizing. It follows the other successful experiments in democracy which the U.S. has had a hand in, namely Japan, South Korea and the Philippines, Thailand and even Indonesia. Congress has directed this Commission to develop a detailed record as to the legal and policy foundation of the U.S.-Taiwan relationship, which is grounded, of course, on the Taiwan Relations Act. The TRA was written almost wholly in the Congress and is the single point of departure of U.S. legal and political guidance on our relations with that island. Presidents from Jimmy Carter, to Ronald Reagan to the present incumbent have repeatedly reiterated that policy, that the U.S. will take every appropriate step to defend Taiwan's right to exist, to be free from bullying and certainly not tolerate any attempt by Beijing to forcibly include Taiwan within Beijing's sovereign orbit, which today would amount to a dictatorship extinguishing a settled democracy. There are some, unfortunately in this country who believe Taiwan has gotten in the way of better U.S.-China relations. However, certainly a case can be made that this is an issue manufactured primarily in Beijing, and being imposed on the U.S. as a test of our resolve. For the Chinese it is a matter of power. Surely we are not saying that we value potential democracies in the Middle East above actual democracies existing in Asia. For the U.S. it should be simply a matter of standing

by the commitments for peaceful evolution that has been the keystone of U.S. policy for many decades.

Congress is entitled to a complete rendition of the negotiating and historical record of Executive branch activities vis-à-vis Taiwan, some of which is not well understood and have not been satisfactorily communicated to the Congress.

The dynamics of our relationship with China in Asia are now a fast moving game with many faces. We are seeking a better understanding of the stakes for U.S. trade and investment in the region, and to refresh and stimulate our relationships with our treaty partners and friends. The Commission looks forward to the testimony by our distinguished panelists.

**OPENING REMARKS OF COMMISSIONER CAROLYN BARTHOLOMEW
HEARING CO-CHAIR**

Co-Chair BARTHOLOMEW. Thank you. Welcome back to our hearing on the impact and implications of China's growth as a regional economic power. We have a very full afternoon this afternoon with two 90-minute panels addressing trends in China's interactions with Northeast Asia, Southeast Asia, South Asia and Central Asia/Russia. Our distinguished panelists will provide both historical perspective and analysis of recent developments.

Before we begin, Mr. Chairman, I would like to thank my Co-Chair Dr. June Dreyer, and the Commission staff, particularly Steve Schlaikjer and Josh Eisenman, for their work on today's hearing. Thank you, Mr. Chairman, and Mr. Vice Chairman for your leadership and for your comments on the importance of supporting Taiwan's democratic processes.

The Chinese government's increasing verbal belligerence toward Taiwan is a serious concern. President Bush made a major speech recently about the importance of democratic reform in the Middle East, but how can we talk about expanding democracy if we are not willing to uphold it where it already exists?

A number of recent articles in the popular press have focused on China's increasing prominence throughout Asia using Indonesia, Thailand and even Australia as examples where U.S. leadership is assailed and Chinese leadership is feted. It is, therefore, with great disappointment that I note the Administration's refusal to send a witness to appear before us today.

They have missed an opportunity to articulate their views on China's role in Asia, what it means for U.S. interests and what their policy is on these important topics. The Administration's absence must leave us to draw our own conclusions.

We are fortunately assisted in that exercise by this afternoon's panelists. The first panel focused on Northeast Asia will consider the issue of hollowing out of industrial sectors in two of the most economically developed countries. Does hollowing out exist? If so, is it a result of China's increasing dominance in segments of the global supply chain or in attracting inward foreign investment? How do the Japanese and South Korean people and their leaders view China today—as an economic and security threat or as a trade and investment opportunity? As a trade partner or as a competitor?

Our panelists on these topics are: Dr. Edward Lincoln, Senior Fellow at the Council on Foreign Relations; Mr. L. Gordon Flake, Executive Director of the Mansfield Center for Pacific Affairs; and Dr. Naoko Munakata, a Senior Fellow at the Research Institute for Economy, Trade and Industry in Japan who currently is a Visiting

Scholar at the Sigur Center for Asian Studies at the George Washington University.

Our second panel will look at China's relations with its other Asian numbers. I'll talk before that starts about the people who will be testifying then. Asia is an enormous and complex continent, rich in many things, including challenging policy questions. We recognize that in trying to cover so much ground, we are giving very little time for our panelists to discuss their scholarship and their papers.

I commend our panelists to the audience today and note that the papers in their entirety will be posted on the Commission's Web site and will be made part of the official record of the hearing.

Thank you to our panelists for appearing before us today. We look forward to your testimony, to the opportunity to discuss your findings, and I understand that Co-Chair Dreyer has a statement she'd also like to make.

**OPENING REMARKS OF COMMISSIONER JUNE TEUFEL DREYER
HEARING CO-CHAIR**

Co-Chair DREYER. Well, Co-Chair Dreyer will make this very, very brief, so that our witnesses can get going because you're the reason we're here. But I'd just like to spell out the congressional mandate. In its instructions to us, the Congress asked the Commission to assess China's regional, economic and security impacts including—and this is an exact quote—“the extent of China's hollowing out of Asian manufacturing economies and the impact on the United States economic and security interests in the region.”

Congress also directed us to—this is again a quote—“review the triangular economic and security relationship among the United States, Taipei and Beijing.”

Last year in the Commission's report to Congress, we noted China's growing economic impact on Asian countries and recommended that Congress encourage the Administration to consult with other Asian countries to look collectively at the impact of this hollowing out phenomenon with respect to China on regional economies and on U.S. economic relations with the region, which is the reason you all are here, with our gratitude.

I'd like to echo Commissioner Bartholomew's words on our disappointment, perhaps even annoyance, at the fact that there is no one here from the Department of State East Asia and Pacific Division. We had invited Assistant Secretary of State James Kelly to lead off the proceedings, and it appears that neither or nor his staff will be able to attend because they are all involved with Premier Wen Jiabao's visit a week hence.

And I would also echo Commissioner Bartholomew's words on Taiwan. This Administration and previous Administrations have repeatedly reiterated the need for the United States to defend democracy and to nurture democracy in many different areas of the world. Hence, the idea that the current Administration would stand back and allow Taiwan, an economically prosperous democracy, to be intimidated by Beijing's threats and even apparently actively acquiesce to Beijing's wishes is something that concerns us greatly.

We look forward to your testimony.

PANEL III: CHINA AND NORTHEAST ASIA

Co-Chair BARTHOLOMEW. And briefly, ground rules, of course, are each of the panelists will be given ten minutes to present your oral remarks. We'd like to hear from each of you before we go into questions and a reminder to my colleagues up here that the questions including the answers are limited to seven minutes a person. Thank you very much.

Dr. Lincoln.

**STATEMENT OF EDWARD J. LINCOLN, Ph.D.
SENIOR FELLOW, THE COUNCIL ON FOREIGN RELATIONS**

Dr. LINCOLN. Thank you very much. Let me start by thanking the Commission for this opportunity to speak to you. I have written testimony, which I believe you have received that discusses the broad economic relationship between East Asia nations and China. This is based on work that I have been doing for a book that will be out shortly.

I would note that the East Asia that I have in my data is a broader definition than Northeast Asia, which I understand is technically the focus this afternoon.

In my oral presentation, I just want to very briefly summarize what's in the written statement and add a few comments to expand upon that. There are basically three points that I want to make.

One is that China is certainly of rising economic importance to the rest of the region. Second, hollowing out, by and large, is not occurring by any definition that economists would understand. I am an economist by training. And third, there is an interesting rise of new institutions involving countries in Asia, but that I do not see this as moving toward any kind of a regional bloc in which China would be the dominant participant.

Let me start with the rising importance. As has been the case for the United States and for Europe, China has affected all the countries in this region. It is a rising share of their exports and imports. For East Asia, other than Japan, for example, 12 percent of their exports now go to China versus close to zero two decades ago. For imports, that ratio is now nine percent. I think Naoko Munakata will probably give you more data on Japan.

I would add that I see all of the nations in the region embracing this growth of China's relative importance. I could point out, for example, that Japan was an early and vigorous supporter of getting China into the WTO when those discussions were going on during the 1990s. But it's also important to note, from our American perspective that the rising ties that the region has with China do not seem to have come at the expense of the United States. If the relative share of trade with China is up for the region, then the relative share of their trade with somebody else has to be going down.

But that is not true for the United States and by and large not for their relationships with Europe. It is the other parts of the world, the Middle East, Latin America, Africa, that have all diminished in a relative sense as trading partners for East Asian countries.

So that suggests to me that we don't see an Asian region that is coalescing in something that you might regard as a bloc by attenuating ties with the West.

The second point is hollowing out. Let me start with Japan. If we look at Japan's trade with Mainland China alone, we see a rising trade deficit; something that I think many people might associate with some kind of hollowing out. If, however, you look at Japan's trade with China and Hong Kong, that deficit disappears until last year. Certainly, the surplus that Japan has had has been going down, but last year was the first year in which they had a small deficit with this broader China region.

As I'm sure you know, there's tremendous difficulty in the trade data because of the fact that so much trade flows through Hong Kong, and so I personally think it's more appropriate to look at trade with this broader definition of China than just mainland China alone.

Perhaps more to the point of hollowing out is direct investment, particularly direct investment by the manufacturing sector, and here we certainly see that in the case of Japan, there has been a flood of Japanese direct investment over the past 18 years or so, since 1985 when the yen began to shoot up strongly against the dollar.

However, relatively little of that investment has gone to China. Last year, Japanese investment in China was just over \$2 billion. The bulk of Japanese investment including in manufacturing actually goes to developed countries, the United States and Europe in particular, and of the portion that goes to developing countries, a lot of goes to Asia as a whole of which only a part is going to China. I do not see a strong shift in the direction of China, although perhaps Ms. Munakata will have some further data on that.

If we look at the rest of East Asia, and remember this includes Southeast Asia, these countries have a fairly sizable trade surplus with China, so in that sense, certainly there doesn't appear to be hollowing out occurring.

For these countries, the concern has been whether China is sucking inward direct investment away from them in the competitive market for investment?

We do know that the total flow of direct investment into China has held fairly steady, around \$40 billion a year, while the flow of direct investment into Southeast Asia has dropped a great deal. However, if you look at the Southeast Asian countries, that drop can be attributed mainly to a withdrawal of investments from Indonesia and a large drop in investment to Malaysia. I would argue this has nothing to do with China. This has to do with political turmoil in Indonesia following the 1997 financial crisis and the change in government in '98 and some doubts on the part of investors in Malaysia concerning what the investment regime will be there since there were some controls on capital flows and repatriation of profits put in place by the Malaysian government.

So frankly I don't see the drop in investment into the ASEAN countries as being the pull of China so much as it is internal problems in ASEAN. And by the way, if you look at other countries like Korea, there really has not been a drop of inward investment.

In fact, the story for Korea is that it has attracted more direct investment over time including after 1997 because the Koreans in a period of distress have actually become more open to investment.

They need foreign expertise. They're more willing to accept foreign expertise embodied in ownership of firms.

So I don't think that there is that much of a problem of hollowing out going on in Northeast Asia or East Asia more broadly.

The third point concerns regional institutions. There are principally two things that have been happening in this region. One is a government-to-government dialogue called the ASEAN plus three grouping, and the expansion of bilateral and sub-regional free trade agreements.

The ASEAN plus three group has come up with only one major policy initiative, and that was the expansion of bilateral swap agreements between central banks in East Asian countries to help certain countries defend their currencies if there was a repeat of what happened in 1997.

The lenders in these arrangements have been Japan, Korea, and China. However, the amounts are relatively modest and frankly from an economics perspective these swap arrangements are largely irrelevant because the big story in Asia has been the gradual move of countries to floating exchange rates. Swap arrangements are basically immaterial when you have floating exchange rates.

I would add, by the way, that of the suppliers of this money, China does not stand out as the dominant supplier. It's the Japanese Central Bank that has put up the most money. The Chinese have offered something on the order of \$5 billion which is not a large sum and it's split among several bilateral arrangements.

On free trade areas, we do see an expansion, but I think here the bigger story is that this expansion has been relatively slow and cautious. The Chinese themselves as far as I know are really not thinking of free trade areas other than the one they have initiated with ASEAN. The Japanese government has moved forward with this, but again fairly slowly.

And more importantly, I see governments in the region interested in free trade areas with partners outside the region as well. So again, it doesn't appear to be a bloc. It doesn't appear to be China-centric. With that, I will come to a close, as I see the red light blinking.

[The statement follows:]

**Statement of Edward J. Lincoln, Ph.D.
Senior Fellow, The Council on Foreign Relations**

East Asia and China

East Asian nations have experienced a rapidly expanding economic relationship with China in the past two decades. From an economic standpoint, that relationship is positive—hollowing out of Asian economies due to the rise of China is not occurring. Overall, other governments have embraced the expanding economic relationship with China because they understand that to do so is both to their direct economic benefit and creates ties that draw the Chinese government into a more productive relationship. Obviously, the large size of the Chinese population, rapid growth of the economy, and anecdotes of hollowing out imply a certain amount of anxiety about the growing economic ties, especially in media. Those anxieties notwithstanding, East Asian governments are clearly on track to stick with this economically and politically advantageous course.

This paper makes three main points concerning these relationships. First, the rise of China as a trade partner has been substantial and sustained. Second, hollowing out is not occurring in any meaningful sense. Third, although attitudes of politicians and the media around the region may be mixed, policy actions taken by govern-

ments in the region indicate a clear choice to embrace China economically, but that embrace hardly represents any dominance of the region by China.

For purposes of this paper the term “East Asia” refers to Japan, South Korea, Hong Kong, Macau, Taiwan, and the ASEAN nations of Southeast Asia. The following discussion generally separates Japan, the huge developed economy in the region, from the rest. Also, because of the confusion in trade and investment statistics caused by the transshipment of goods through Hong Kong and the use of Hong Kong as a hub for investment into China, the trade data presented here include Hong Kong (and the much smaller Macau) as part of the Chinese area.

1. Rising Trade Linkages

As China has opened up to trade and investment, and as the Chinese economy has continued to grow rapidly, China has become a more important trading partner for many nations, and the rest of East Asia is no exception.¹

Figure 1 shows the exports of East Asian countries other than Japan to the China area as defined above. Beginning in the second half of the 1980s, the region’s exports to China rose fairly steadily from 5 percent to 12 percent of their total exports. Meanwhile, exports to Japan fell sharply (from 27 percent in 1981 to only 13 percent by 2001). As a result of these two trends, China is now as important an export destination for this region as Japan. There has, however, been little real change in the share of exports destined to the United States, which, except for a bubble in the 1980s when the dollar was very strong, have fluctuated between 17 and 20 percent.

Figure 2 shows Japan’s exports by region. Japan’s exports to China have also risen, though not as much, slowly drifting up from 7 percent in 1981 to 13 percent in 2001. Meanwhile, the rest of East Asia other than the China area and the United States both remain much more important export destinations for Japan. Other than the unusual bubble in Japanese export dependence on the United States in the first half of the 1980s when the dollar was strong (and the yen unusually weak), the share of Japan’s exports destined to the United States has fluctuated between 25 and 30 percent. The notion of Japan’s economic relationships shifting away from the United States toward China is not true (a conclusion that other data in this paper will reinforce).

Figure 3 shows the source of imports of the region other than Japan. The trends are quite similar to the export trends in figure 1. Imports from the China area have expanded moderately from 3 percent to 9 percent in 20 years. Imports from Japan have fallen, from a peak of 26 percent in 1986 to 17 percent by 2001. The United States has been a source of a steady 17–18 percent of the region’s imports until the very end of the 1990s, declining to 14 percent in 2001. The recent drop in the share sourced from the United States does not appear to be due to any displacement by China (since the Chinese share was up only 2 percentage points, and the earlier upward drift in China’s share was not associated with any decline in the share imported from the United States).

Figure 4 shows the source of Japan’s imports. Japan has experienced a much more pronounced increase in the share of its imports sourced from China than was the case for the rest of the region—climbing from only 4 percent in 1981 to 17 percent in 2001. Meanwhile, the United States has been the source for 18 to 24 percent of Japan’s imports (and the rest of the region for a somewhat similar share). The share of imports from the United States shows a sizable drop, from 24 percent back to 18 percent since 1998. In fact, if this figure included 2002 data, it would show that imports from China had become slightly larger than from the United States. Once again, however, it is not at all clear that the drop in the U.S. share is at all caused by the rise of China’s share since the earlier sustained rise in China’s share was not associated with any drop in the U.S. share. The more likely explanation is that Japan’s recession of 2000–2001 affected the kinds of capital goods that Japan tends to import from the United States, while the shift toward low value-added imports from China (such as textiles and apparel) continued unabated.

The trade data confirm the rise of China as a global trading partner, though obviously that impact varies for Japan and the rest of the region and is different for exports and imports. China certainly does not dominate East Asian trade patterns, though the increase in its importance as a trading partner is unmistakable. In addition, the rise of China is all the more noticeable because it has come at a time of

¹The source data for this discussion comes from the IMF’s *Direction of Trade* data set on CD-ROM. The numbers used here come from work done for my forthcoming book, *East Asian Regionalism* (The Council on Foreign Relations and the Brookings Institution, 2004). The IMF has now updated its data set to include 2002 data. However, I had neither the time nor access to the most recent version of the data set to include 2002.

sharply diminishing trade linkages with Japan. Thus, within the region all players are well aware of the relative rise of China and decline of Japan. Trade ties with the United States, however, appear to be little affected by the rise of China; we have remained an important trading partner for Japan and the rest of the region even as they have expanded their relative ties with China.

2. Hollowing Out?

As in the United States, some concerns have been expressed around the region concerning the possibility that China is hollowing out their economies. In Japan, these come in the form of fears that cheap imports from China are displacing domestic production—either from indigenous Chinese firms (as in textiles) or from Japanese firms that have relocated production. In Southeast Asia, the concern revolves more around foreign direct investment, with fears that foreign firms will shift the focus of their investments from Southeast Asia to China.

Conceptually, hollowing out is a difficult concept, and one that economists find dubious. One could, for example, argue that a rising trade deficit with a particular trading partner represents a net loss of manufacturing jobs, thereby hollowing out the manufacturing sector. However, economists argue that bilateral trade balances have little meaning; a nation might have a rising deficit with one partner offset by a rising surplus with another. Nevertheless, for the sake of argument, the following discussion looks at the trade balances of Japan and the rest of the region with China.

Figure 5 shows Japan's trade balance with China—shown as both the balance with mainland China alone, and with the broader China area. With China alone, Japan has shifted from balance or a small surplus in the 1980s to a deficit of \$27 billion by 2001. That rising deficit has become the principal reason for some Japanese to argue that they are being hollowed out by China. However, there are three critically important problems with this view:

1. If one accepts the view that much of trade with Hong Kong is really trade with China, then the picture changes considerably. With the broader China area, Japan has had a surplus until 2001. Admittedly, a decline in the surplus set in after 1993, and the balance turned negative in 2001—a trend that might continue. Nevertheless, the picture is considerably different than when looking at mainland China alone.
2. How can one talk of Japan hollowing out when the nation continues to have a sizable global trade surplus? In 2001, for example, Japan had a global surplus of \$48 billion. In that context, the deficit with China has little meaning, since the deficit was more than offset by surpluses with other trading partners (such as the United States). In fact, to the extent that Japan's deficit with China represents imports of low value-added products, and the surplus with the United States represents exports of high value-added products, Japan is losing nothing important. That is, it might experience a shrinkage of labor intensive industries, but that shrinkage is more than offset by expansion of sophisticated, capital intensive industries.
3. Even if one were to take the extreme view and regard the \$27 billion deficit with mainland China as a net loss, this is a minor development in the broader context of the Japanese economy. In 2001, gross domestic product originating in the manufacturing sector amounted to 104 trillion yen, or \$858 billion at the average exchange rate for the year.² Thus, the \$27 billion deficit with China represented only 3 percent the size of the total manufacturing output in the Japanese economy (keeping in mind that even this estimate is excessive since the import figure is the total value products while the manufacturing sector figure is only for the value added, which excludes the value of raw material inputs purchased by the manufacturing sector). This is hardly a percentage that is very meaningful.

Figure 6 shows the trade balance of the rest of East Asia with China. For this set of countries, the whole question of hollowing out is moot. Even looking at trade with mainland China alone, these nations have been close to balance, with very small deficit in the 1980s and small surpluses of \$1 billion to \$4 billion in recent years. Trade balance with the broader China area shows a rapidly rising surplus, rising to a level of \$20 to \$25 billion in recent years. The more important conclusion is that both exports and imports with China have been expanding very rapidly for

²Economic and Social Research Institute, Cabinet Office, Government of Japan, *Annual Report on National Accounts of 2003*, <http://www.esri.cao.go.jp/en/sna/h15-nenpou/3main/3gdp/Inomlnl90/cm3n.xls> (November 25, 2003).

this set of economies, implying that the region is benefiting from the unusually rapid growth in trade.

Viewing the question of hollowing out through investment is difficult. At any moment in time, multinational firms have only a fixed amount of funds available for investment around the world. Therefore, a decision to invest in one country means less investment somewhere else. Sorting out why firms choose to invest or not invest in particular countries, however, can be difficult. With those difficulties in mind, the following discussion looks at some of the investment developments.

For Japan, the issue has been whether domestic manufacturing firms are shifting their production abroad. In a very general sense, this has been happening since the 1980s. As shown in figure 7, the ratio of overseas production to domestic production in manufacturing has increased from a very low 3 percent in 1985 to 14.5 percent by 2000. Until 1985, Japanese firms demonstrated an unusually strong desire to keep production at home. Thereafter a combination of the doubling of the yen against the dollar from 1985 to 1987, rising fears that some principal markets like the United States were moving in a protectionist direction, and a rising need in some industries to be close to their overseas customers, caused firms to change their policies. It is difficult, however, to regard this as hollowing out: what was unusual was the rather extreme aversion firms had to overseas production prior to 1985 and not the subsequent shift.

Furthermore, even if one were to regard the relocation of production overseas to represent a hollowing out, little of this investment has gone to China. Figure 8 shows the destination of the annual flow of Japanese foreign direct investment in manufacturing. China has been the destination of 10 percent or less of Japanese annual investment, except for a short period when it peaked at 18 percent in 1995. In 2002, Japanese manufacturing investment in China was only 9.6 percent of the total flow of new investment, coming to only 171 billion yen (\$1.4 billion at 2001 exchange rates). Even using investment in broader China makes little difference. In 2002, the combined Japanese investment in China plus Hong Kong was only 176 billion yen (still \$1.4 billion).

In contrast, the United States and Europe have attracted far more Japanese manufacturing investment, with 30-to-40 percent of the total coming to the United States in most years, and 30 percent to Europe in the past several years. The dominance of manufacturing investment in developed countries rather than developing ones like China indicates the importance of Japanese fears of protectionism, and the importance of locating manufacturing close to customer bases as a motive for investment. Investment in China to take advantage of cheap wages is simply not a very dominant motive in Japanese investment.

These data on Japan suggest that if the Japanese want to worry about hollowing out, they should be blaming it on the United States and Europe, which have taken the bulk of Japan's investment in manufacturing (and an even higher share of total foreign direct investment). Furthermore, the amount of investment in China is almost trivial. In fiscal 2002, the Japanese economy had 71.5 trillion yen (\$600 billion) in non-residential fixed private sector investment.³ The flow of direct investment to China, therefore, was only 0.2 percent the size of domestic investment.

The story for Southeast Asia is slightly more complicated. Here the question is about the behavior of foreign firms; are they shifting their direct investment from Southeast Asia to China? This worry has certainly been expressed in the years since the Asian financial crisis of 1997. While the annual flow of direct investment to China has been on the order of \$40 billion in recent years, the flow of direct investment into the ASEAN countries has dropped—from a peak of \$30 billion in 1997 to \$13 billion in 2001. It is understandable that ASEAN governments would feel that perhaps investments that might have come to their countries were now going to China. There are three important reasons why the fears expressed in ASEAN are unfounded.

Figure 9 shows direct investment flows into ASEAN, and largely debunks the notion that the region is suffering because China is sucking in these investments.

1. Note that the average annual flow into ASEAN from 1989 through 1994 was \$14 billion. The jump to \$30 billion by 1997 appears to have been more of a speculative bubble since the annual flow has now subsided to the pre-1995 level. To be sure, with economic growth in the region, one would also expect the level of inward direct investment flows to be rising over time, but certainly the drop from the unusual peak of 1997 provides an exaggerated picture of the situation.

³Economic and Social Research Institute, Cabinet Office, Government of Japan, "GDP at Current Prices, Fiscal Year," <http://www.esri.cao.go.jp/en/sna/qe033/gdemenua.html> (November 24, 2003).

2. The drop in inward investment is very uneven. To a large extent, the decline since 1997 is due to an actual withdrawal of direct investments from Indonesia and a sharp decline in 2000–2001 of investment into Malaysia. In Indonesia, foreign investors became uneasy about the continuing political instability of the country. Malaysia has also experienced the consequences of both its decision to impose some capital controls in 1997 during the crisis and uncertainties surrounding the eventual change in political leadership. Neither of these developments is at all related to China. Perhaps investments that might have gone to these two countries ended up in China, but the cause lies within Indonesia and Malaysia.

3. Even this level of annual inflow represents a substantial level of investment inflows. Table 1 shows inward direct investment flows as a share of domestic gross capital formation. Even with the drop in the dollar value of flows, the principal ASEAN countries (with the exception of Indonesia) are generally attracting as much investment as China relative to their total capital formation. This level of inward direct investment is also close to the global average for developing countries.

Therefore, while it was convenient for Southeast Asian governments to fret that they were losing out to China in attracting investment to their region, there is little reason to believe that this represents a real concern. If Indonesia can convince investors that it has a stable, business-friendly government and can contain terrorist threats, then investment will return.

3. Regional Institutions and Policies

Two developments have occurred in East Asia since the mid-1990s: the initiation of a regional dialogue among cabinet ministers and leaders called ASEAN+3, and the formation of bilateral and sub-regional free trade areas. These represent an interesting and largely positive willingness of other governments in the region to engage in discussion with the Chinese government on economic policy matters.

ASEAN+3 brings together the ASEAN governments with China, South Korea, and Japan. Begun initially as a mechanism for coordinating views in advance of the dialogue between East Asian governments and the EU in 1996, this group now brings together both various economic ministers and leaders of its members. This mechanism provides an opportunity for East Asian governments to talk among themselves without the American government in the room. The two major powers in the group are Japan and China, so in a crude sense, the Chinese government has an opportunity to act as more of a regional leader (as does Japan). Certainly it is an interesting development that the other governments in the region have been willing to talk with the Chinese and Japanese without the Americans around. Overall this represents a positive development, demonstrating a rising level of confidence among East Asian governments (and especially the smaller economies of ASEAN) in engaging in discussions with the Chinese government without the cover of the United States in the room as a balancing power.

A principal cause for East Asian governments to emphasize their interaction through ASEAN+3 was their frustration over the response of the U.S. Government and the IMF during the 1997 Asian financial crisis. Believing that they had been treated shabbily, they were eager to talk among themselves about regional issues. This motivation might suggest that the region is pulling away from its close relationship with the United States, moving toward greater dominance of the two giants in the region, China and Japan.

However, the only real policy decision made by this group has been a very weak move to enhance the ability of regional central banks to borrow money from one another for the purpose of defending their currencies. This development is embodied in the Chiang Mai Initiative endorsed by the ASEAN+3 governments in 2000 and a set of subsequent individual bilateral swap agreements between pairs of central banks. Table 2 shows the status of these agreements as of the fall of 2003. The Chinese government has chosen to participate in these swap agreements by offering to lend money to some other central banks, suggesting a new regional activism on their part (since it is one of only three central banks along with Japan and South Korea that are on the lending side). These swap agreements represent an interesting development in which central bankers in the region have managed to hammer out agreements among themselves, but there are several important reasons why these agreements are not important in substantive terms and do not represent any real drift of the region into a China-centered regionalism.

1. The agreements themselves are largely trivial. The total of \$30 billion negotiated so far is actually quite small when viewed in the form of how much is available to any individual borrower to defend its currency. Thailand has only \$6 billion available, an amount that could be overwhelmed by foreign exchange markets rather quickly. Therefore, the agreements are more symbolic than real.

2. Initial concerns that these agreements might enable the region to act with greater independence from IMF guidance (by using their own regional funds to help countries defend currencies rather than giving in to IMF policy guidance in times of crisis) have not materialized. The Japanese government insisted during the negotiations leading up to the Chiang Mai Initiative that only 10 percent of the amounts shown in this table be activated by the individual decision of the lending country; the remaining 90 percent can be activated only with explicit approval from the IMF. Therefore, these agreements do not represent a move of the region to a more independent stance.

3. China's role is largely symbolic. It has offered only \$6 billion so far, in individual amounts of \$1 billion to \$2 billion. This gets the Chinese government some international recognition as a player in this game, but hardly represents a dominant position.

4. The whole mechanism is rendered at least partially moot by the decision of a number of countries in the region to switch to floating exchange rates (which obviates the need to mobilize sudden large amounts of foreign exchange reserves to defend a currency, since the currency is moving on a daily basis which eliminates fears of sudden large movements). Therefore, these agreements are unlikely to be activated in the future.

The other regional policy development has been the evolution of bilateral and sub-regional bilateral areas. Table 3 shows the status of these agreements as of late 2003. China has made an interesting move by beginning negotiations with ASEAN for a free trade area. That ASEAN countries were willing to enter into this negotiation represents an increased level of confidence on their part that they could negotiate a fair agreement with their giant neighbor, and that such an agreement would be politically acceptable in their countries.

However, viewed broadly, these agreements—existing and under negotiation—do not represent the incipient formation of a regional bloc or a move toward Chinese dominance of the region for three important reasons.

1. There is no indication that governments have a strong preference for agreements with partners within the region as opposed to those outside the region. Singapore has already signed a number of agreements with governments outside the region, including the United States, Australia, and Canada. South Korea's first FTA has been with Chile. Thailand is now negotiating with the United States. Therefore, there is no indication that East Asian countries will end up locked into a bloc dominated by China.

2. There is no evidence that the Chinese government is very interested in pursuing free trade agreements with other partners in East Asia (that is, South Korea or Japan). In general, China's interests lie with the WTO as a mechanism to gain better access to global markets and as a lever to bring domestic reform. The FTA with ASEAN has its roots more in political strategies than economic ones. Trade between China and the ASEAN countries is not large, so that an FTA would not have a major impact on either side. However, the offer has gone a long way to allay the fears in ASEAN about being hollowed out at the expense of China.

3. For a bloc to emerge, it would be necessary for Japan to join in a broader grouping including China. So far the Japanese government has had no real interest in engaging China in such a negotiation. Indeed, the Japanese government has been unable so far to even counter the Chinese offer to the ASEAN grouping, largely because of an unwillingness to address the problem of removing barriers at home to agricultural imports.

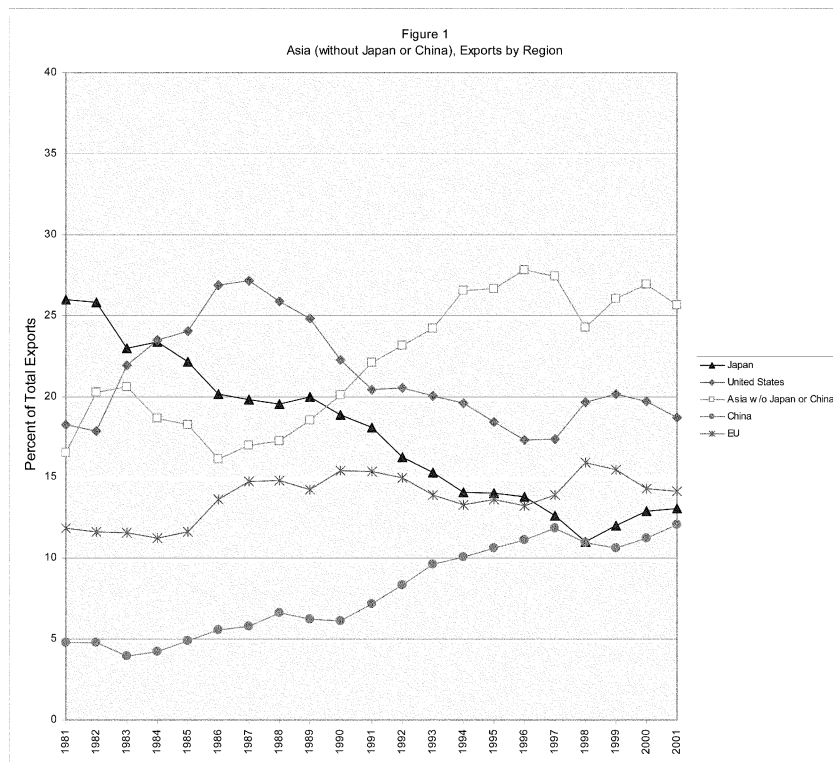
For all these reasons, it is difficult to discern any real move in East Asia to form a more cohesive economic bloc built on regional free trade agreements, and especially one centered on China. The more important conclusion from both the swap agreements and free trade agreements is the rising comfort level that governments in the region have in engaging the Chinese government. There is no reason to expect that this trend of embracing China economically will be reversed, barring some unfortunate security policy move by the Chinese.

Conclusion

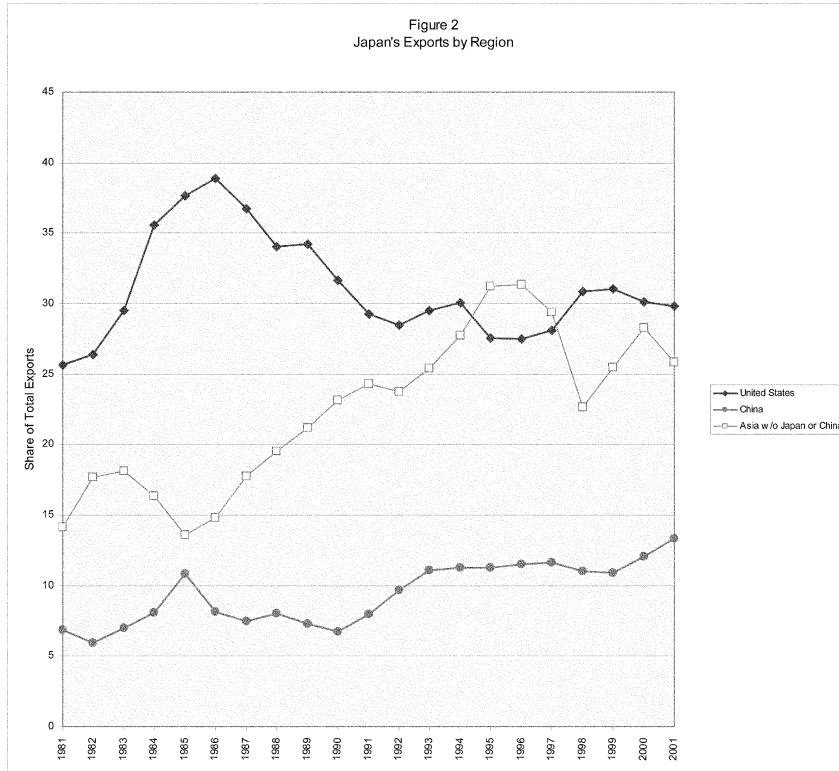
The emergence of the Chinese economy on the global economy has had an important impact on the other economies of East Asia. As has been the case for the United States and other countries, China has become a far more important economic partner than it was 10 or 20 years ago. Given the enormous size of the Chinese population, this has understandably led to some concerns around the region that China's emergence and continued high growth could be detrimental to others in the region. Those fears are not borne out by the analysis in this paper.

China has certainly become a more important trade partner for other nations in the region. But in no meaningful sense has China been hollowing out the manufac-

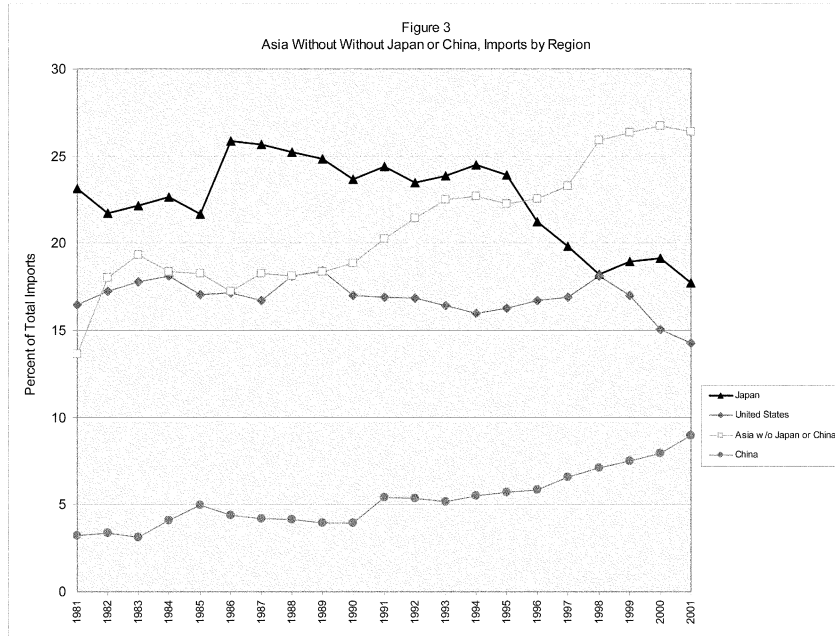
turing sectors of the others. In fact, the rapid rise of two-way trade without the emergence of large bilateral deficits implies that the other nations of the region have benefited from expanded export sales. Looking at direct investment flows, the fears in ASEAN that they are losing in the competition for new foreign direct investments are not true. The drop in foreign direct investment has more to do with political turmoil in Indonesia and questions about political transition in Malaysia than with China. Finally, there is no strong indication that the region is coalescing around China through regional institutions and regional policy decisions. The more important conclusion on regional institutions and policy discussions is that the regional governments are now showing a healthy ability and willingness to engage the Chinese government in economic policy discussions (even if the actual importance of regional agreements is limited).



Source: International Monetary Fund, *Direction of Trade*.

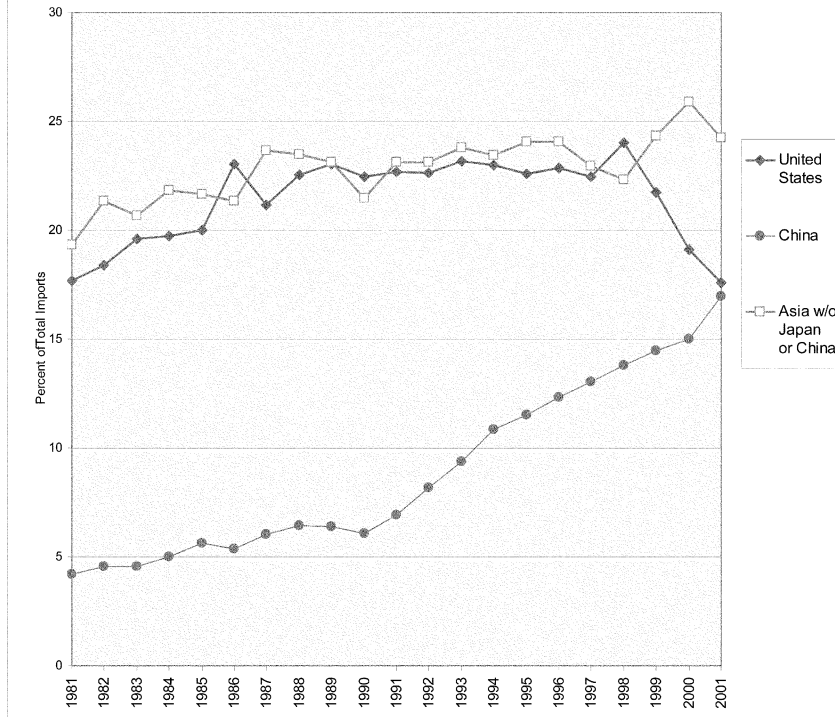


Source: See figure 1.



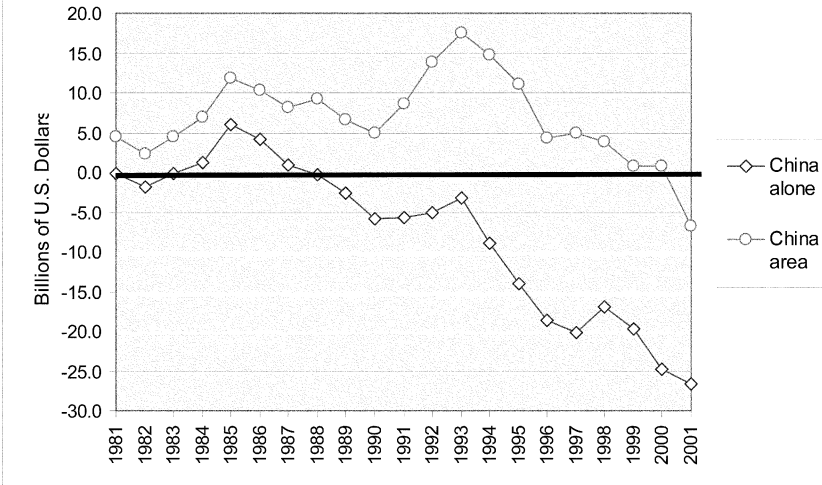
Source: See figure 1.

Figure 4
Japan, Imports by Region



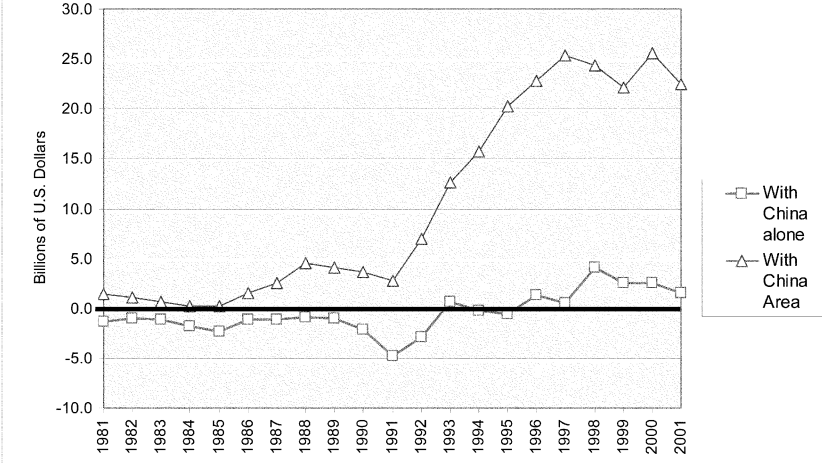
Source: See figure 1.

Figure 5
Japan's Trade with China:
Trade Balances

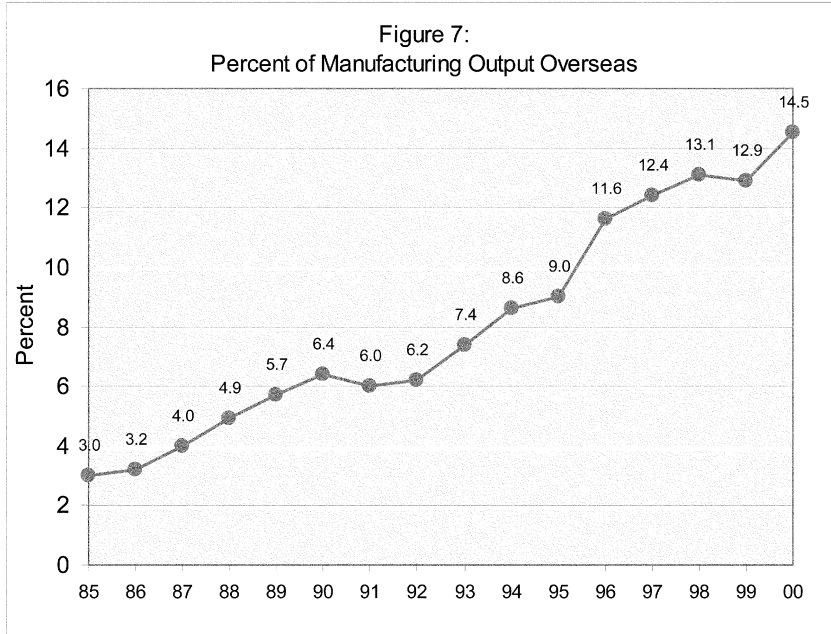


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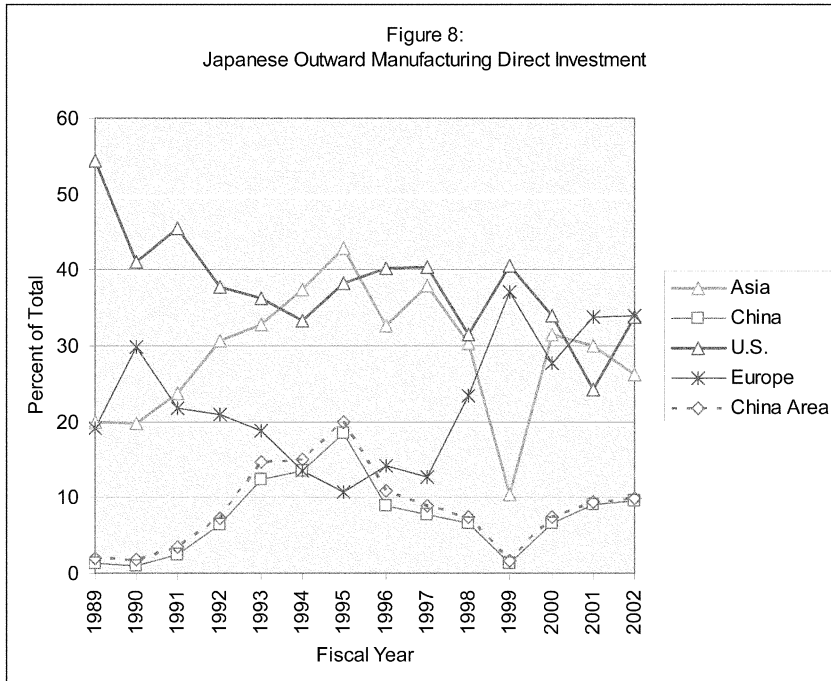
Figure 6:
East Asia (without Japan) Trade Balances with China



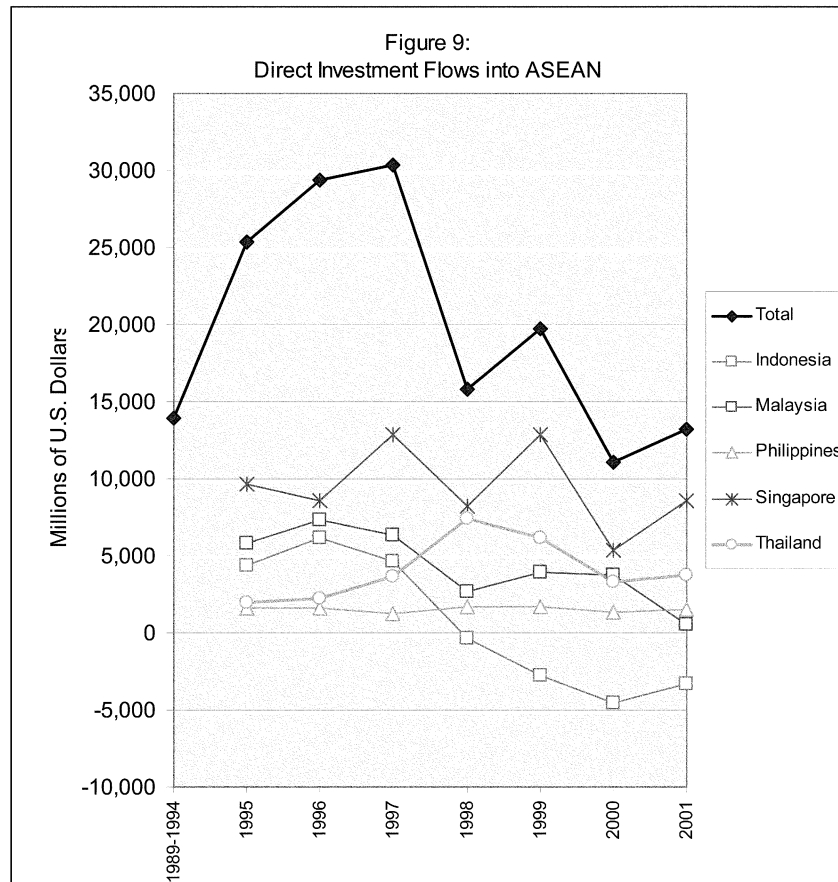
Source: See figure 1.



Source: Ministry of Economics Trade and Industry, *Chusho Kigyo Hakusho* (Medium and Small Enterprise White Paper), 2001 edition (on CD-ROM).



Source: Ministry of Finance, <http://www.mof.go.jp/english/elc008.htm>.



Source: ASEAN Secretariat, *Statistics of Foreign Direct Investment in ASEAN 2002 Edition*, <http://www.aseansec.org/14549.htm>.

Table 1: Inward Direct Investment Flows as a Share of Gross Fixed Capital Formation

Country	1989 to 1994 Average	1995	1996	1997	1998	1999	2000
All Developing Economies	5.7	7.6	9.1	11.1	11.4	13.4	13.4
Indonesia	4.0	7.6	9.2	7.7	-1.5	-9	-12.2
Malaysia	19.4	15.0	17	14.7	14	22.2	16.5
Philippines	7.5	8.9	7.8	6.2	12.7	4	9.2
Singapore	30.3	31.2	24.6	29.4	20.8	42.4	19.8
Thailand	5.0	2.9	3	7.1	20.5	13.9	10.4
China	7.9	14.7	14.3	14.6	12.9	11.3	10.5

Source: UNCTAD, *World Investment Report 2002*, Annex Table B.5 (and similar table in 2001 report).

Table 2: ASEAN+3 Foreign Exchange Swap Agreements*Amounts in Billions of U.S. Dollars*

Lender:	Japan	South Korea	China
Borrower:			
Japan	—		
South Korea	2		
China	3	2	
Malaysia	1	Under negotiation 1	Under negotiation 1
Thailand	3	Under negotiation 1	2
Philippines	3	Under negotiation 3	Under negotiation 1
Indonesia	3		
Singapore	Under negotiation 3		
Sum:	18	7	5

Table 3: Status of Bilateral and Regional Free Trade Areas 2003

	Japan	China	South Korea	Taiwan	Singapore	Other ASEAN
Agreement signed and implemented or in process of implementation	Japan-Singapore	Bangkok Agreement	Bangkok Agreement Korea-Chile		Singapore-Japan Singapore N. Zealand Singapore-U.S. Singapore-EFTA	AFTA Thailand-Laos
Under negotiation	Japan-Mexico	China-ASEAN			ASEAN-China Singapore-Mexico Singapore-Canada Singapore-Australia	ASEAN-China
Study group (either joint or simultaneous but separate by both parties)	Japan-South Korea Japan-Malaysia Japan-ASEAN		Korea-Japan	Taiwan-U.S.		ASEAN-CER ASEAN-Japan
Idea floated (by government officials or private sector interests)	Japan-Thailand Japan-ASEAN Plus Three ASEAN Plus Five ASEAN Plus Five plus India		Korea-Mexico Korea-U.S. Korea-China Korea-Japan-China	Taiwan-Japan Taiwan-Singapore Taiwan-N. Zealand		

Co-Chair BARTHOLOMEW. Thank you, Dr. Lincoln. Mr. Flake.

**STATEMENT OF L. GORDON FLAKE, EXECUTIVE DIRECTOR
THE MAUREEN AND MIKE MANSFIELD FOUNDATION**

Mr. FLAKE. Well, I'm also honored to have a chance to testify this morning, and I think you'll find some interesting both parallels and contrasts between the experience of Korea and in Japan.

When I was invited to prepare this testimony, I was actually in Korea at the time at a conference of U.S., Korean and Chinese, focusing on that triangular relationship there, so it was quite timely, and I must say there's also some rather large discrepancies in how the Koreans view China right now and the way the United States view China, and I think this will be of interest to the Commission.

I would propose to start off just discussing, you know, some of the recent trends which are rather dramatic as opposed to more incremental changes you've seen in the relationship with China—with Japan rather—and then talk about some of the implications that the Commission is particularly interested in.

The trends really have largely gone unnoticed in the United States, but it's been more of a boom as opposed to this slow gradual increase in relationships, and it's largely because there was a long period of pent-up demand. South Korea did not normalize relations, economic or political, with China until 1992, right immediately after the Seoul Olympics and as part of this effort of the South Koreans at the time to pursue a Nordpolitik, as tied into the politics as you might imagine of North Korea and cross-recognition, but after that period of time, and really for the last 11 years, year on year trade between South Korea and China has increased about 20 percent per year.

And so of interest in particular to the United States, in the last year alone, in the year 2002, China overtook the United States as the primary destination of South Korean outgoing foreign direct investment.

In July of this year, China overtook the United States as South Korea's largest export market, and by the end of this year, by most estimates, China will overtake the United States as South Korea's largest trading partner. And so again, it's been a rather dramatic change. And the way I just presented that, I think you might, as an American, kind of step back and feel there's a real threat here.

The Koreans obviously see it very differently. The general Korean perspective on this is it's all good because they see it primarily as an expansion of their trade rather than supplanting of one with the other. There has not been a corresponding, very similar to the Japan, decline in the U.S. trade with South Korea. In fact, U.S. trade with South Korea has continued to increase as well.

In fact, this has been the further expansion in both trade and investment, you know, kind of the rising tide that floats all boats, and the South Koreans are the ones who are floating and quite pleased about that, if you might imagine.

The driving factors behind this are actually very similar to some of the driving factors between the United States and Chinese trade. South Korea in the mid-1990s became a member of the OECD and, you know, has reached a relative level of development. They just,

as we, find, you know, the low value added, very inexpensive products, consumer products from China, extremely attractive, and so particularly in the last four years, as the South Korean economy has been largely consumer purchasing driven, find those extremely attractive just like we do here, and at the same time find in China a ready market for the relatively higher end, you know, South Korean electronic goods and telephones, computer chips, computers, the like, cars, in particular.

This has also resulted in a relatively large wave in relative terms of South Korean investment into China. Last year, South Koreans invested, I think, it was about \$1.72 billion into China, and the investment, as you might imagine, you know—I'll here move on to one of the primary concerns indicated by the Commission—and that is a question of hollowing out—you might foresee that that would be, you know, a considerable dent for investment not going into the South Korean domestic economy.

There is growing concern among South Korean economists about hollowing out, but it tends to be much longer term in terms of perspective. If you look at the year 2002, you know, the amount of South Korean investment, that \$1.79 billion I mentioned, accounts for less than five percent of the equivalent investment in manufacturing in the South Korean domestic economy.

So in relative terms, it's still relatively small. The overall, you know, percentage of outgoing South Korean foreign direct investment, not including, of course including China, still is less than ten percent of the local domestic investment into manufacturing activities, and as Dr. Lincoln pointed out, one of the side effects of the last five years of rather dramatic opening and reform in South Korea has been that South Korea, which traditionally pursued an economic model which did not rely on foreign direct investment, which rather relied on loans and borrowing, you know, and then their own domestic production, has become more open to foreign direct investment than ever before. So while there has been an increase in their own outgoing foreign direct investment, there has been more than a corresponding increase in incoming foreign direct investment from around the world, as they've reformed their own economy.

And there lies a very interesting side effect, which is one of those intangible ones but I think very real, in China as an engine of reform or motivation for reform in South Korea. The South Koreans are extremely cognizant of the threat or the competition they face with the Chinese and they can use that to generate the necessary domestic consensus to drive the reform process within that country. The notion is whenever you speak to a South Korean, that we are a shrimp among whales stuck between Japan and China and the U.S., and if we don't do things first and fast, you know, we're going to be eaten by it.

And that's why I think you saw South Korea kind of emerging as the poster child of the post-IMF era after the Asian financial crisis in 1997, because they were acutely aware of the consequences if they didn't do it. And these are not new issues to South Korea. These things really began taking place in the early 1990s when South Korea at that time described it as what they called a mid-level technology pinch. Their worry was that China, not only

China, but China and Southeast Asia, you know, would eat away at their traditional advantage and low value added, low cost goods, and yet they wouldn't be able to compete at the upper levels with the United States and Japan and Germany, et cetera.

In some ways, South Korea's adjustment to that concern in the mid-'90s is paying fruition today when you see companies like Samsung that in every respect are world beaters, in fact, have a leg above Sony, and again, you can see China as kind of the driving force behind that and the fear of China in some respects.

Let me talk a little bit more about the China shock if you will. The Koreans view the normalization of economic relations with China in 1992 as something akin to their normalization of relations with Japan in 1965. They called that the Japan shock. This is called the China shock and it's very much been a double-edge sword.

On the one hand, just as for us, it represents this enormous mass market, you know, where they can market their goods, they can get in at the early edge of the wave and invest and establish not only market share but brand identity within China, but at the same time, of course, there's a real fear in the Koreans' mind of China as a competitor not only for their own domestic market, but for traditional Korean markets around the world, and so there is this kind of constant feeling they've got to keep running.

But again in contrast to Japan or the United States, Korea with its small size has probably more than any other Asian in Northeast Asia fully bought into the ideology of open markets, market liberalization and free trade, and so they tend to view these things not as some nefarious Chinese plot but as just realities that have to be dealt with.

In other words, this is the way it is, and as a result Korea always has to be running to keep up, and the perception is they've got to be ready twice as fast to be able to keep ahead of the Chinese in this regard.

I would also kind of point out that these trends, you know, that are a concern in terms of hollowing out in the outgoing foreign direct investment really aren't limited just to China. These are all things that are ongoing in terms of the hollowing out of Korea's manufacturing sector long before Korea opened up its relationship with China. It had already begun with the other countries in Southeast Asia, so it's kind of a longer process. There is one key difference there, and that is, of course, the proximity of China to Korea, the fact that in China you have a nation next door that has ethnic-speaking Koreans, it's very close, just across the Yellow Sea, and so it has been a very attractive market not only for Korean goods but for Korean outgoing foreign direct investment.

Let me speak very briefly, if I might, about some cultural factors here, which I think are probably more interesting and which very much distinguish their experience with those of Japan. Korea, if you recall, if we just review Korea from the prism of the Cold War and the Korean War, you know, you might expect the Koreans to look at China very much in a negative light, but if you view Korea as they do, in the scope of their 5,000 year history, where for the bulk of it, Korea recognized its position in the Chinese universe.

They were clearly an admitted Suzerain kind of state underneath the Chinese umbrella. And as such, there's a deep-seated cultural linguistic affinity for all things Chinese, and as a result, while at the same time that double-edged sword I talked about that resulted from the opening of diplomatic and economic relations with China has also at the same time been greeted with a certain degree of affinity. There's been a real boom in kind of pop culture influence between the two countries. There has been an extreme boom in terms of the number of Korean students going to China.

In the year 2002, there were 36,000 Korean students studying in China as opposed to 49,000 in the U.S., but just in a very short period of time, the unofficial estimates are that those who are going without visas are probably already around 60,000 in China, so there's been a remarkable turn back to what are historical cultural roots.

Now, just very briefly, in the last few seconds, let me talk about some of the anticipated, as you might imagine, impacts on foreign policies. The most immediate impact, of course, is that Korea will no longer be able to function as the hub it kind of envisioned itself in Northeast Asia, but is more likely to be a spoke on the Chinese hub, if you will, and the typical political impacts are those that will result from questions of Taiwan, questions of the Dalai Lama's visit, the sensitive, but I don't think those are necessarily unique to the China-Korea relationship. They have kind of impacted almost every country in the region and perhaps the world. So I'll stop there.

[The statement follows:]

**Statement of L. Gordon Flake, Executive Director
The Maureen and Mike Mansfield Foundation**

Summary

The opening of economic relations with China has been a considerable boon for South Korea. To date, the rapid expansion of Korea-China trade and investment has had few economic or political downsides for Seoul, but has instead been the source of considerable growth and stability for Korea's economy. However, longer-term concerns over the growing competitiveness of Chinese firms, the hollowing out of Korea's manufacturing sector, and an increase in China's regional political and diplomatic clout commensurate with the growth of its economy compete with the potential presented by the growing Chinese market to cloud the future.

Recent Trends

The development of economic relations between South Korea and China over the past decade has been dramatic. At the beginning of the 1990s, China was a relatively minor trade partner for South Korea, yet by the end of this year China will have become South Korea's dominant partner in trade and investment.

While the security situation on the Korean peninsula remains essentially unchanged since the Korean War and the onset of the Cold War, South Korea's economic relations with its wartime adversary have been completely transformed. According to KOTRA (The Korean Trade-Investment Promotion Agency), in July 2003 China surpassed the U.S. as the largest destination for Korean exports. Earlier this year China claimed the top spot from the U.S. as a destination for Korean foreign direct investment, and by the end of 2003 it is likely that total annual trade between Korea and China will exceed total trade between the Korea and the United States.

Such developments are all the more remarkable in light of the fact that South Korea and China only normalized diplomatic and economic relations in 1992. The truth be told, however, when Korean trade with Hong Kong and Taiwan (much of which is actually destined for or emanates from China) is factored in, these milestones were actually passed much earlier. In numbers, direct bilateral trade between Korea and the PRC has gone from \$4.4 billion in 1991, the year before the

normalization of relations, to \$41.1 billion in 2002 and has already reached \$39.8 billion in just the first three quarters of 2003. (Source KITA—Korea International Trade Association. www.kita.org).

Overall Korea-China trade has averaged more than 20 percent growth year-on-year for the last decade, and most economists predict that even with moderate rates of growth in China's economy, bilateral trade volume will more than double to over \$100 billion annually by 2010 if not earlier.

The driving factors behind these trends are not difficult to understand. Much of recent South Korean economic growth has been driven by record levels of consumer spending, and Korean consumers are buying up the same low-cost goods from China to which we in the U.S. have become so addicted in recent years. On the other hand, China's rapid economic development and growing middle class have been snapping up relatively more expensive and higher tech Korean products.

On the investment front, Korean firms have been attracted by the same low wage work force that has made China the world's largest destination for foreign direct investment. China's natural attractiveness for investment has been accentuated for Korean firms by China's relatively close proximity and the existence of a ready-made work force in the form of Korean-speaking ethnic minorities in China. Of course, Korean firms primarily want to invest in local production to take advantage of labor costs and position early for name recognition and market share in the rapidly increasing Chinese domestic market. In this regard, Korean firms have been remarkably successful at riding the Chinese "wave."

According to the Korean Ministry of Finance and Economics, 34% of the total amount of outward Korean investment (US\$5.06 billion last year—on an approval basis) was destined for China. Total Korean investment in China in 2002 was US\$1.72 billion. As indicated earlier this amount for the first time surpassed Korean investment made in the United States, which totaled US\$1.37 billion in 2002.

The expansion of Korea-China economic relations has been accompanied by and in many cases facilitated by the normalization and acceleration of Korea-Chinese political and diplomatic relations. Following the initial success of South Korea's *Nordpolitik* under President Roh Tae Woo, successive South Korean administrations have made the improvement of bilateral relations with China a top priority. The level and frequency of high level exchanges, which have even included top level defense officials, have steadily increased and stand in sharp contrast to the strained and seemingly anachronistic relationship between China and its wartime ally, North Korea. By any possible measure, relations between South Korea and China far surpass those between China and North Korea. While much attention was lavished on Kim Jong Il's train treks to Beijing in May of 2000 and January of 2001, the next generation of Chinese leaders as embodied by President Hu Jintao and Premier Wen Jiabao is reported to have little affinity for or even patience with North Korea. In contrast, there has already been a summit between President Roh Moo-Hyun and PRC President Hu Jintao in July of 2003.

On a cultural level as well there has been a revival of traditional Korean interest in and in many cases affinity for things Chinese. Korean tourism to China has dramatically increased as has the bi-directional flow of pop culture. In education alone there has been somewhat of a "China Boom" in Korea. In 2002, the approximately 36,000 Korean students officially studying in China accounted for 44 percent of the total number (85,829) of foreigners studying in China. Interestingly, despite having a much smaller population, the number of Korean students in China far outpaced those from Japan (16,084) or the United States (7,359). Korean diplomats in China estimate that the actual number of Korean students in China, including those visiting on a short-term basis is actually much higher, perhaps as high as 60,000. If accurate, this number would exceed even the number of Korean students in the U.S., which totaled approximately 49,000 in 2002.

This is not to say that the trend lines in Korea-China relations have been without friction. South Korea has run a relatively consistent trade surplus with China and this coupled with Korean concerns about a flood of inexpensive Chinese products has led to trade frictions on both sides that have spilled over into the broader public realm. Most memorable was the "garlic war" in 2002 where a Korean attempt to stem the inflow of Chinese garlic led to Chinese retaliation on much higher value Korean electronic imports and a rather hasty Korean retreat. While China's admission to the WTO has placed bilateral trade disputes in the context of international rules and norms, Korea has been the primary target of Chinese legal action on trade issues.

Implications

The opening of trade and economic relations with China was greeted in Korea with both trepidation and anticipation. The potential embodied in the huge Chinese

market and the prospects for the overall expansion of China's economy have represented somewhat of a double-edged sword for Korea. The expansion of the Chinese market is at once one of the major sources of growth for the Korean economy, while at the same time, Chinese firms are increasingly likely to compete with Korean firms both in the global marketplace and in Korea's domestic market.

The implications of the Korea-China relationship, however, extend far beyond Korea's domestic economy and include not only Korea's role in the region, but also its relationship with the United States, and the all-important question of Korean Peninsula reconciliation.

Impact on Korea's Economy

Some Korean scholars have considered the opening of trade with China to be a "shock" to the Korean economy comparable to the "shock" experienced when Korea normalized relations with Japan in 1965. As might be expected, this "shock" is viewed both with fear and as an opportunity. One overriding concern, particularly in Korea's manufacturing sector, is that China's economic ascendance will inexorably lead to the hollowing out of Korea's manufacturing sector. Ultimately, the worry is that Korea will not be able to compete with Chinese competition both at home and abroad and that this will lead to the flight of Korea's manufacturing sector. These concerns have focused on China more than on any other significant trading partner such as the U.S. or Japan primarily due to cost factors and China's geographical proximity to Korea. To many Koreans, the "giant sucking sound" that Ross Perot heard coming from Mexico during the NAFTA debates can now be heard across the Yellow Sea.

Concern over the decline of manufacturing is of course not unique to Korea, nor is China the only recipient of Korean foreign direct investment or competitor for the market niches traditionally dominated by Korea. However, the concern is particularly acute in Korea due largely to the fact that despite its OECD status and its historic rates of development, it does not yet consider itself a fully mature economy, ripe for or prepared for the "hollowing out" that has impacted other more developed economies. In an August 30, 2003 report on the issue, the Samsung Economic Research Institute (www.seri.org) reported 1,800 cases of overseas investment by Korean firms in 2002 compared with 1,000 cases in 1994. More significantly, the ratio of Korea's total outward FDI to domestic facilities investment now approaches 10 percent. To put Korean investment in China in perspective, even with China commanding the lion's share of outgoing Korean FDI in manufacturing, the total amount of manufacturing investment in China by Korean firms still accounts for only around 5 percent of Korea's domestic investment in manufacturing.

While still relatively small, the trend lines worry Korean analysts who point to the danger of the hollowing out taking place too early in this stage of Korea's development. For example, the Korean manufacturing sector "constitutes 29.6% of the nation's whole economic output, hires 26% of the labor force, and its export takes up as much as 35% of the nation's GDP." (SERI, *Korean Economic Trends*, August 30, 2003, www.seri.org). By contrast, the manufacturing sector constitutes approximately 13 percent of employment in the U.S. and 20 percent in Japan.

These concerns are not new in Korea. They were commonly voiced in the early 1990s as the Korean footwear and textile industry fled, not just to China but throughout the region. The concern then, which is mirrored today, is that Korea was stuck in a "mid-level technology pinch." In this view Korea is struggling to keep abreast of China and other low-wage economies that continue to erode what was once Korea's advantage in low-value added products, particularly in manufacturing. While on the upper end of the scale, Korea is unable to compete fully with the most advanced economies in terms of technology.

Such concerns, however, tend to be longer term in nature. Moreover, Koreans tend to view these trends as inevitable, even natural—ones that must be adapted to rather than fought. As such, with the exception of a few minor trade disputes, Korean concern over its economy is not yet reflected in political relations between Korea and China. More intangibly, fear of Chinese competition is widely regarded within Korea to have been a primary motivating factor behind Korean economic reforms.

In the short run, the positive benefits of the expansion of ties with China are undeniable. While the relative portion of Korea's trade with the U.S. and Japan has decreased, from a Korean perspective this trend represents a much-needed diversification of Korea's export market. In fact, Koreans widely credit the expansion of Korean trade with helping their economy to not only survive but thrive during the chronic downturn of the Japanese economy and the recent U.S. downturn. Similarly, while not abandoning the U.S., Japanese or European markets, many if not most Koreans see their future as tied to the Chinese market.

Impact on Korea's Foreign Policy

To date, China's growing economic relationship with Korea has yet to translate into untoward Chinese political or diplomatic influence on Korean politics or diplomacy. The relationship with China has not been in a vacuum, and Korea's ongoing relationships with the United States and Japan, have provided a counterbalance. Korea has also been one of the foremost supporters of international and regional institutions. At any rate, the relationship with China remains largely economic in nature and while challenged in recent months, Korea's primary security relationship in the form of its alliance with the United States, and by extension its relationship with Japan through the U.S. alliance, remains preeminent.

The impact on Korea's economic diplomacy is likely more pronounced. In recent years, Korea has envisioned a role for itself as the business and financial hub in Northeast Asia. In this view it is squarely in competition with China, which sees Shanghai as taking on that role. The more that Korean investment pours into China and the greater the expansion of China's trade not only with Korea but also with the other countries in the region, the more difficult that it will be for Korea to lay claim to the title of "hub." More accurately, Korea will likely become a spoke of a Chinese hub. This of course has longer term impacts for Korea's role as China assumes a central position in the region and Korea's economic fate is increasingly tied to China. An alternate and perhaps more accurate view is that there will not be a single trade and investment hub, but rather multiple hubs and spokes resembling the U.S. domestic airline system.

Given modern history on the peninsula, the most obvious worry about Chinese influence on Korean policy would be how it affects the continuing divide of the Korean peninsula, and in particular relations with North Korea. This too tends to be a sword that cuts both ways. At present it is ironically the Republic of Korea that appears to be lobbying the PRC to work together against what they perceive to be a dangerous U.S. hard line toward the North. Both South Korea and China are firm in their aversion to instability or conflict on the peninsula and are working together toward a diplomatic solution. As Korean and Chinese positions are largely in sync, there is little room for China to use economic leverage to influence South Korean policy on the North Korea issue. Conversely, South Korea can be considered to have greatly influenced the Chinese willingness to take a more active role in mediating the current crisis surrounding North Korea's nuclear program. To be sure, China would almost certainly not have taken such an active role without South Korean support or in the face of South Korean opposition.

If there is a political price South Korea has paid for its improved relations with Beijing, it is in the litmus test issues that China demands of nearly all of its relationships. China has successfully pressured South Korea—which has a sizable Buddhist population—to forego visits by the Dalai Lama, and has of course been most sensitive about Korea's relationship with Taiwan. A further issue that is of particular sensitivity to China is the status of North Korean refugees in China. While this issue is of particular concern to religious groups and human rights organizations in South Korea, the South Korean government remains ambivalent about the refugee flows to the point that it has yet to become a serious issue in Korea-China bilateral relations.

China-North Korea Relations

While the Commission has previously considered China's relations with North Korea, it is still worth noting that despite the dramatic expansion of China-South Korea economic relations, China arguably maintains greater economic influence over North Korea than South Korea. This is not due to significant levels of trade or investment—both remain moribund—but rather to that fact that China continues to provide North Korea with essential energy and food inputs. This lifeline has never given China proactive influence over North Korea, as it was seen by North Korea as a Chinese effort to shore up its own interests by avoiding the collapse of North Korea and the resulting instability in the region. Such key transfers of food and grain, however, do provide China with a negative or punitive influence over the North—something which until this year it was not willing to wield. The most noticeable shift in China's position occurred this March when China apparently temporarily cut off its main oil pipeline to North Korea in a successful attempt to induce North Korea to attend three-party talks in Beijing regarding the nuclear issue.

Implications for United States

In conversations I had during a visit to Seoul three weeks ago, two prominent members of the Korean National Assembly from two different parties expressed their concern that the U.S. was ceding to China too large a role in addressing the North Korea crisis. Their worry was that South Korea would get sucked back in to

a traditional suzerain relationship with China. Much of the Korean elite today are U.S. or Western educated and have fully bought in to the belief that South Korea's interests are best served by maintaining a strong relationship with a great power that is "far away." While China holds an undeniable cultural allure for Koreans, the extent of this allure is also limited by the nature of China's system and society. As long as the process of opening, liberalization, and reform continue in China, and more importantly as long as China continues to grow economically, South Korea will inevitably be drawn closer to China. That said, however, the extent to which Korea and its institutions have democratized should not be underestimated. In its core values of democracy, human rights, the rule of law, and economic liberalism, Korea will likely remain much closer to the U.S. at least until and if China more clearly pursues a similar path.

To date, the Chinese-Korean economic relationship has served as a backdrop for Korean interest in and affinity for China. However, it is difficult to make the case that the relationship thus far has been a zero-sum competition with the United States for South Korea's favor. To the extent that there are serious problems in the U.S.-ROK alliance, and there are, they have more to do with changes in Seoul and Washington—particularly in regards to policy towards North Korea—than with the rise of China.

Nowhere is the axiom "the only constant is change" more true than on the Korean peninsula. Ultimately, the respective roles of the U.S. and China in either resolving or failing to resolve both the current nuclear crisis on the peninsula and the continuing division of Korea will be key determinants of future relations with Korea.

Co-Chair BARTHOLOMEW. Ms. Munakata.

**STATEMENT OF NAKO MUNAKATA, SENIOR FELLOW
RESEARCH INSTITUTE OF ECONOMY, TRADE AND INDUSTRY (RIETI)
JAPAN VISITING SCHOLAR, SIGUR CENTER FOR ASIAN STUDIES
THE GEORGE WASHINGTON UNIVERSITY**

Ms. MUNAKATA. Thank you for the opportunity to appear before this Commission. My statement before you is based solely on my personal opinion and does not represent any organization with which I am or was associated. With your permission at this point, I would like to make a short statement and submit my longer testimony for the record.

I will discuss the impact of China's rise focusing on two issues. One is how China's rise is perceived in Japan. The other is how China's new activism in regional economic cooperation affects Japan's regional economic policy. Both issues have a significant impact on the U.S. position in Asia, which I will touch on briefly.

The argument that China was an economic threat gained momentum in Japan around the year 2000. First, imports from China accelerated in 2000. Second, Japan's foreign direct investment to China started rising again in 2000. Unlike previous FDI surges, this surge accompanied a substantial retrenchment of domestic operations. Japan's decade long economic stagnation had significantly eroded its manufacturers' commitment to maintaining domestic employment.

Also, electronics companies made high profile investments to produce state-of-the-art consumer products. The moves by the assembly makers prompted their suppliers to produce in China as well. It was feared that the manufacturing shift would move upstream until China acquired a full-set industrial structure at the expense of Japan.

Third, local Chinese companies have begun rapidly enhancing their competitiveness, not only in price but also in quality, technological sophistication and overseas presence. China's competitiveness is derived not only from inexhaustible human resources but also from the diversity of foreign companies that interact and de-

velop agile local players, a set of strengths that has been hard to find in Japan.

Starting around 2002, however, a positive atmosphere emerged in the Japanese business sector. First, China became the fastest growing export market for Japan. Second, the profitability of Japanese investments in China started to improve. Third, some local Chinese companies have recently begun to actively seek business partnerships with Japanese counterparts. These developments are not windfalls, but the reward for those Japanese companies that are focused on their strengths and making conscious efforts to limit the damage caused by various problems in China.

The recognition that China also provides a vast opportunity gained a solid foothold in the media and the wider public as market sentiments about the Japanese economy improved earlier this year.

At the same time, there remained various problems in China. They include rampant infringement of intellectual property, insufficient implementation of WTO rules, and the lack of transparency in many aspects of the local business environment. Moreover, China's economic weaknesses including that in the banking sector may have significant global implications warranting closer international attention. In my opinion, the bottom line is that we all must adapt to and live with the rise of China. Japan should focus on its own strengths and accelerate structural reforms while at the same time working towards closer international cooperation to help solve China's problems.

Next I would like to discuss China's impact on Japan's regional policy. Shortly after Japan and Singapore launched FTA negotiations in late 2000, China became active in pursuing a free trade area with ASEAN. There is a growing perception that Japan and China are engaged in an FTA race seeking not only to counter the trade discrimination each other's FTA create, but also to compete for the dominant leadership position in the region.

Many observers perceive that China is ahead of Japan in the game. Some argue that China poses a threat to Japan in this regard as well.

In fact, Japan and China are the exact opposite of each other in terms of their priorities and behavior. China is driven by a political agenda of reassuring ASEAN and expanding its influence in the region. It makes bold moves without messy democratic processes, but struggles with the implementation of its legal commitments. Japan is motivated by an economic agenda of cutting business costs in the region and stimulating domestic reform. Japan tends to be caught up in the details, in the face of resisting forces, which assume that legally binding agreements once concluded are enforced no matter what. Thus, Japan and China are, in fact, playing complementary roles, which, if managed well, could produce great synergies in building regional institutions.

China's speed and skill prompt Japan to accelerate its domestic reforms. The goodwill that China wins provides a positive atmosphere in the region that will encourage cooperation for building regional institutions and help Japan achieve its goals. For its part, Japan should urge China to focus on the implementation of agreements on the ground.

Lastly, I will discuss the implications for the United States of China's rise and regional developments. China's rise will not directly erode U.S. influence. It is the Asian countries' perception of U.S. policies that have had the largest impact on the U.S. influence in the region. When U.S. policy is perceived to accommodate the region's common interests and to demonstrate a strong commitment to regional stability and prosperity, U.S. influence grows stronger.

Conversely, when U.S. policy does not have these attributes, U.S. influence declines. The U.S. image in Asia was damaged through its indifference to Asian countries' perception of its behavior during such critical junctures as nurturing the fragile APEC process that involved countries with developmental needs and dealing with the Asian financial crisis. Now, it is being perceived as preoccupied with the war against terrorism and not giving as much attention to the region as China does. Although the United States has by far the largest influence in the region, it should not take this for granted. Its influence cannot be maintained by economic and military supremacy alone. It has to be enhanced by being sensitive to and where possible furthering the region's aspirations. East Asia is going through historic geopolitical changes due to the rise of China. The region is in search of a new order to accommodate China's growing power and influence and to maintain regional peace and stability. Washington should be positive in embracing regional forums even if the United States is not formally a member because such forums would still U.S. interests.

East Asian economic integration will help reduce regional tension and lighten America's security burden. Japan's future economic prospects substantially depend on its capability to benefit from East Asian economic dynamism. If Japan becomes more open, embedded and trusted in the region, it can be a more effective and valuable U.S. ally.

As Asia adapts to a rising China, active U.S. support for improving global and regional institutions, promoting Asian development, and fostering Asian regional cooperation could enhance U.S. influence in the region and elsewhere. Seen in this light, the rise of China and the trend toward regional integration in Asia are opportunities, not threats, for both of our countries.

Thank you.

[The statement follows:]

Statement of Naoko Munakata
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Japan Visiting Scholar, Sigur Center for Asian Studies
The George Washington University

The Impact of the Rise of China and Regional Economic Integration in Asia
—A Japanese Perspective

Thank you for the opportunity to appear before this Commission. My statement before you is based solely on my personal opinion and does not represent any organization with which I am or was associated.

I will discuss the impact of China's rise from a Japanese perspective focusing on two issues. One is how China's rise as the factory of the world is perceived in Japan. This question is typically phrased as "is it a threat or an opportunity?" The other is how China's new activism in forging regional economic frameworks—particularly free trade agreements—affects Japan's regional economic policy. Both issues have a significant impact on the U.S. position in Asia.

1. China as a Threat or an Opportunity

Perception of China as an economic threat

In the early 1990s, China's rapid economic growth, combined with its external posture, generated an argument in Asia that China could become an economic and military threat. The importance of China in Japan's total trade started to increase substantially around that time and, in 1994, the bilateral trade deficit with China became Japan's largest. Nevertheless, there was no sense of urgency in Japan about the economic threat China was said to pose. It was widely believed that the level of economic development was so different that China was not going to threaten Japan's lead in the immediate future.

By the year 2000, however, the argument that China was an economic threat gained momentum in Japan. There were several inter-related factors behind this development. First, imports from China accelerated in 2000. The success of the Japanese apparel brand "Uniqlo" impressed Japanese consumers with high quality products made in China. Increased imports of items such as agricultural produce and textiles, in particular, put strong competitive pressure on politically sensitive domestic producers. Not only did the amount of imports surge, but also the composition thereof had shifted to higher value added items. As a result, imports of machinery surpassed those of textiles in 2002.

Second, Japan's foreign direct investment (FDI) to China that had started rising again in 2000, increasingly took on new and alarming dimensions. In the face of the global recession in the information technology (IT) industry, IT companies accelerated the restructuring of their businesses to drastically cut operation costs. They not only built factories in low-cost overseas sites like China but also substantially re-trenched domestic operations. The fear of hollowing out was not new in Japan. The drastic appreciation of the yen after the Plaza Accord in 1985 and the surge of the yen above the level of 80 yen per dollar in 1995 had also prompted Japanese companies to move to Asia. In those days, however, there was confidence that large corporations investing abroad would somehow be able to keep current employment at home. The situation in 2001 was different. The decade-long stagnation of the Japanese economy in the midst of intensifying global competition had significantly eroded Japanese manufacturers' commitment to maintaining domestic employment at all costs.

Another new dimension of the Japanese FDI to China was that electronics companies made high-profile investments to produce state-of-the-art consumer products such as digital televisions and digital cameras. The previous surge of FDI to Asia had taken the form of a shift of production of mature, lower value added items and thus had not broken the prevailing confidence that Japan would somehow be able to remain at the top of the regional technological ladder for some time to come. This time, however, it was feared that the shift of manufacturing operations to China of brand new items that still required significant development, if continued at the current pace, would leave little use for Japan's domestic facilities. Furthermore, the moves by the assembly makers had prompted their suppliers to produce in China as well. Therefore, there was also concern that the manufacturing shift, which had started from labor-intensive assembly processes, would continue to the production of high-tech components and precision metal fabrication, and keep moving upstream until China acquired a full-set industrial structure at the expense of Japan. This fear was reinforced by the fact that the famous industrial clusters of small and medium-sized suppliers in such areas as Ohta Ward, Tokyo or Higashi-Osaka City that had supported Japan's manufacturing competitiveness continued to erode due to the shutdown of its member companies.

Indeed, China's rise has posed a unique challenge because of the combination of the inexhaustible supply of low-cost and hardworking laborers and an abundant supply of highly educated engineers and researchers. The Pearl River Delta has a large cluster of electronics assemblers and parts suppliers. This area had initially been focused on labor-intensive assembly and gradually developed into supply of electronic components for key functions, which in turn further attracted assembly makers. The Yangtze River Delta is the gate way to China's vast domestic markets and has many high-tech companies as well as suppliers of basic materials such as steel and chemical products. In Beijing, IT companies establish R&D centers to attract top graduates from major universities.

Third, it is not just foreign companies that are thriving in China. The real challenge is that local Chinese companies are rapidly enhancing their competitiveness not just in price and attention to local needs but also in quality and technological sophistication. Chinese companies maintain a high domestic market share in major consumer durables.

China is also unique in that it has been able to rapidly develop local supporting industries. The Pearl River Delta is particularly rich in competitive local suppliers of low-cost, standard parts and components. Over time, they developed through interaction with foreign companies, particularly from Hong Kong and Taiwan. These suppliers make quick business decisions and form flexible networks. They are suitable to the electronics industry that is under constant pressure to reduce time to market that rapid technological and market changes necessitate. Many Japanese parts suppliers with limited localization of management found it hard to keep up with their pace. China's competitiveness is derived not only from inexhaustible human resources but also from the diversity of foreign companies that interact and develop agile local players, a strength that has been hard to find in Japan.

Local Chinese companies also started to establish an overseas presence, mainly through exports but also through increasingly active outbound FDI. Japanese affiliate companies that had long supplied local markets in Southeast Asia, for example, were forced to shift production to lower-cost countries including China or to stop supplying local markets and concentrate on exports of higher-value added products to developed markets. Furthermore, China's TCL international Holdings and France's Thomson SA recently created TCL-Thomson Electronics, which will be the world's largest television producer. This suggests that successful local Chinese companies are aiming at a global presence and are ready for mergers and acquisitions to expeditiously achieve that goal.

Perception of China as an opportunity

While China poses a formidable competitive threat, it also provides a vast opportunity. As the latter aspect of China's rise became increasingly apparent around 2002, Japan's perception of China became more realistic and balanced.

First, China became the fastest growing export market for Japan. After having grown about 15% against an overall export decline of more than 5% in the midst of the global IT recession in 2001, Japan's exports to China started to surge in 2002 with an annual growth rate of 32%. Their rapid growth has continued this year. Exports through September grew 36% year over year. The main export items for China's industrial markets are electronics parts such as semiconductors, basic materials such as steel and chemicals, and industrial equipment to feed production activities as well as construction machinery for infrastructure development. Automobiles and communications equipment have also been major export items for China's rapidly expanding consumer markets.

Second, the profitability of Japanese investments in China has started to improve. According to a survey conducted by the Ministry of Economy, Trade and Industry (METI) of Japan, the ratio of the profits of Japanese companies in China to those in the entire East Asian region suddenly jumped in fiscal year 2000 to around 18% from less than 5% in the previous year. Other surveys confirmed similar trends of improving profitability, albeit from a low base. These reports afforded a welcome surprise since China had been known for difficulties encountered by Japanese businesses. These difficulties contrasted with Japanese experience in newly industrializing economies (NIEs) and Southeast Asian countries, where Japanese companies had had long experience of operations and relatively stable profits. The improved profitability of local market-oriented operations is particularly significant.

Third, some local Chinese companies have recently begun to actively seek business partnerships with Japanese counterparts. In January 2002, Japan's Sanyo Electric Co. Ltd. (Sanyo) and China's Haier Group Company (Haier) agreed on a comprehensive collaboration deal that included the sale of Sanyo products under either the Sanyo or the Haier brand names, through Haier's sales network and the establishment of a joint venture in Japan to sell Haier products under Haier's brand name. In April that year, Japan's Matsushita Electric Industrial Co., Ltd. (MEI) and China's TCL Holdings (TCL), announced a collaboration agreement, under which MEI would supply Matsushita's key devices such as CRT, plasma displays and compressors to TCL and Matsushita's products would be sold through TCL's sales network. Furthermore, a growing number of Chinese companies are reported to be interested in investing in Japanese companies for the technology and distribution channels in Japan. In July 2003, a major Chinese pharmaceutical company announced an agreement with a medium-sized Japanese manufacturer of Chinese medicines to purchase the latter, the first case ever for a Chinese company to buy a Japanese one. These cases have demonstrated that local Chinese companies can actually provide Japanese companies with distribution channels for their products to be sold in China and with the capital to restructure their businesses.

These positive developments are not just windfalls but the reward for those Japanese companies that are focused on their strengths. For example, Japanese manufacturers have avoided head-to-head price competition with producers in China and

shifted domestic production to higher value added devices and materials. Successful companies have been able to compensate for the hollowing-out of lower value added operations and to boost overall sales through strong exports. The strength of Japanese companies is not just technological sophistication. Goods and services such as pop culture, convenience stores, and fashion, which had been developed for and won the hearts and minds of selective and capricious Japanese consumers, started to attract the rapidly emerging middle class in China. In addition, companies that had invested in China some time ago have learned their lessons and become better equipped, albeit with additional costs, to limit the damage caused by various problems encountered in the local business environment, such as the difficulty of collecting accounts receivable and protecting intellectual property. Thus, Japanese companies are learning to live with their Chinese competitors and are increasingly focused on how to capitalize on the opportunities that Chinese customers can offer.

In a speech at the Boao Forum for Asia held on Hainan Island, China in April 2002, Japanese Prime Minister Koizumi Junichiro struck an optimistic note:

“Some see the economic development of China as a threat. I do not. I believe that its dynamic economic development presents a challenge as well as an opportunity for Japan. I believe a rising economic tide and expansion of the market in China will stimulate competition and will prove to be a tremendous opportunity for the world economy as a whole. Since there are differences in our industrial structures, Japan and China can strengthen their mutually complementary bilateral economic relations. I see the advancement of Japan-China economic relations, not as a hollowing-out of Japanese industries, but as an opportunity to nurture new industries in Japan and to develop their activities in the Chinese market. Our integrated efforts for economic reform in both countries should advance the wheel of economic relations.”

Prime Minister Koizumi's statement captured an emerging positive atmosphere among Japanese business leaders, who took the formidable competitive threat China presented as a challenge they had to tackle in order to seize the opportunity it provided. This line of thinking gained a solid foothold in the media and the wider public as market sentiments about the Japanese economy improved earlier this year.

Challenges ahead

Unfortunately, however, there is no guarantee that this positive attitude will last forever, particularly in times of severe economic downturn. Not all companies can seize the opportunity that the rise of China offers. Some may simply have to close down their current line of business and start anew. Therefore, now is not the time for the Japanese government to become complacent. There are many business areas that have great potential but have been stifled due to regulations. Affluent and sophisticated consumers who are rapidly aging are attractive markets for health care, care of the elderly, life-long education, housing and other services that enhance the quality of life. Some of these products could find markets in Asia, where the economy is rapidly growing and the population is aging. Manufacturers suffering from a high-cost business environment would keep more operations at home if the costs of utilities, logistics and telecommunications were further reduced. Japan needs strategic moves to encourage and attract business activities of both domestic and foreign companies that are willing to invest and operate in Japan. It has to make a difference on the ground, an enterprise that requires strong political will. Japan should use the challenge that the rise of China poses to muster domestic support for this enterprise to succeed.

At the same time, there remain various problems in China that are frustrating Japanese or other foreign businesses that are trying to seize the opportunities in China. They include rampant infringement of intellectual property, insufficient implementation of WTO rules, and the lack of transparency in many aspects of the local business environment. Moreover, given the size and the level of global integration of the Chinese economy, such economic weaknesses as in the banking sector may have significant global implications, warranting closer international attention.

In my opinion, the bottom line of the issue of the rise of China is to adapt to and live with it. Japan should maximize the gain from its opportunities and minimize the loss from its problems. To do so, Japan should focus on its own strengths and accelerate structural reforms while at the same time working towards closer international cooperation to help solve China's problems.

2. China's Impact on Japan's Regional Policy

State of the game

The rise of China changed the regional landscape in two ways. On the one hand, China's new role as a link in the production network contributed to the growth of

intra-regional trade. On the other hand, China became an active player in developing institutional frameworks to promote regional integration. The first element firmly positioned China as an indispensable member of regional economic frameworks in East Asia and reinforced the second element.

China's activism toward regional frameworks, particularly FTAs, started in 2000 following earlier moves by other regional economies. In the wake of the Asian financial crisis, Japan and Republic of Korea (ROK) had started to explore an FTA as a trade policy option and both started to shift away from their single-minded dependence on the World Trade Organization (WTO). There were several factors behind their moves; concern about the growing trends toward regionalism in Europe and America had been exacerbated by the loss of confidence in Asia's economic dynamism as well as the loss of momentum of the Asia Pacific Economic Cooperation forum (APEC). Moreover, the contagion of the Asian financial crisis had impressed regional governments with their mutual economic interdependence. The crisis stirred up a sense of urgency about domestic economic reform, which they hoped that an FTA would facilitate and lock in. The two countries had quasi-government think-tanks to work on a feasibility study of a bilateral FTA between them. The ROK started FTA negotiations with Chile in 1999. Japan and Singapore studied the possibility of a bilateral FTA and announced, in October 2000, their intention to start negotiations. Japan's decision to negotiate an FTA for the first time immediately triggered reactions from the United States and China. One month later, the United States agreed with Singapore to launch FTA negotiations and China proposed an FTA with the Association of Southeast Asian Nations (ASEAN).

For its part, China, having agreed in November 1999 with the United States on the terms of its accession to the WTO and being stimulated by the regional trend towards bilateral FTAs, decided that it should also use FTAs as a policy tool. Since its proposal to ASEAN in November 2000, China has moved swiftly. In October 2001, China and ASEAN completed the joint feasibility study for an FTA, and in November 2001, China persuaded ASEAN to agree to establish an ASEAN-China Free Trade Area within ten years. In November 2002, the Framework Agreement on ASEAN-China Economic Cooperation was signed that would establish a free trade area by 2010 for the older ASEAN members and 2015 for the newer members. In October 2003, beginning with Thailand, China started to implement the so-called early harvest measures to eliminate tariffs on some fruits and vegetables.

The major factors that had prompted China into the FTA with ASEAN were diplomatic considerations. It felt the need to participate in the regional trend toward FTAs. It chose ASEAN as its first FTA partner in order to calm down the sense of threat—both economic and security—that various ASEAN countries felt towards China. China used the FTA to show its willingness to let ASEAN economies capitalize on its growth. China even offered early harvest measures for fruits and vegetables to make the FTA proposal more attractive to ASEAN and to overcome hesitation among the ASEAN members.

An FTA with ASEAN also seemed more doable than FTAs with more developed economies such as Japan and ROK. If negotiations turn out to be difficult, China and ASEAN could invoke the enabling clause for developing members of the WTO and have their FTA be exempt from the strict rule to cover “substantially all the trade,” which governs an FTA with a developed member. Japan and ROK have competitive manufacturing industries that state-owned enterprises (SOEs) in China would have difficulty competing with. The resistance from their politically sensitive agricultural sectors would also be difficult to overcome. Although China proposed a feasibility study of an FTA among China, ROK and Japan in November 2002, there is not much momentum building for this idea.

China's activism prompted Japan in turn to accelerate its moves for an economic integration agreement with ASEAN that it had contemplated since the launch of FTA negotiations with Singapore. In January 2002, two months after the China-ASEAN agreement to establish an FTA within ten years, Prime Minister Koizumi proposed an initiative for Japan-ASEAN Comprehensive Economic Partnership. The United States also strengthened its interest in the region and announced the Enterprise for ASEAN Initiative in October 2002 and the launch of FTA negotiations with Thailand in October 2003.

The Sino-Japanese “FTA race” in perspective

This situation may suggest that the classic case of “competitive liberalization” is at work in East Asia, with one preferential trade agreement prompting another to reduce the margin of discrimination of the former. At the same time, there is a growing perception that Japan and China are engaged in an FTA race not only for economic reasons but also for political ones. In other words, they seek not only to counter the trade discrimination and distortion that an FTA without them would

create, but also to compete for the dominant leadership position in the region. Many observers, including ASEAN officials, perceive that China is ahead of Japan in the game. While it was Japan that started the process of concluding FTAs in the region, China seems to be leading the process with eager and fast moves. Some argue that China poses a threat to Japan in this regard as well.

In fact, Japan and China are the exact opposite of each other in terms of their priorities and behavior. They are so different that it is odd to see them playing the same game. China's moves are driven by a political agenda of reassuring ASEAN and expanding its political influence in the region. Japan's moves are primarily motivated by an economic agenda of reducing transaction costs of production networks and other business operations in the region and of adding stimulus to domestic economic reform. China is free from messy democratic processes that would substantially consume both time and political capital and can make bold moves once there is a consensus among political elites. Japan tends to be caught up in the details and finds it hard to make bold moves in the face of strong resistance from uncompetitive but politically powerful sectors. These resisting forces in Japan anticipate that legally binding international agreements, once concluded, would be enforced no matter what, and, naturally, fight fiercely against agreements that could deprive them of vested interests. In contrast, China is still struggling to implement WTO rules in its vast territories where local officials have varying levels of willingness and capacity to enforce rules and regulations. Despite the risk of losing credibility with the business sector, China seems to enjoy the diplomatic good will that the FTA with ASEAN brings. For the time being, it does not seem to be worried about the implementation of the agreement on the ground.

These stark differences between Japan and China present both challenges and opportunities. On the one hand, differences could deepen mutual mistrust and bilateral relations could deteriorate. Japan could perceive China as engaging in a power play at the expense of Japan. China could perceive Japan as pointing out small problems and getting in the way of China's initiatives. On the other hand, differences offer them a unique opportunity for cooperation. China's fast moves prompt Japan to react so as to nullify the discriminatory effects an FTA without Japan would create. This challenge acts as a healthy stimulus to Japan to accelerate its domestic reforms. The good will that China wins provides a positive atmosphere in the region that will encourage further cooperation to build regional institutions and help Japan achieve its goals. For its part, Japan should urge China to focus on the implementation of international agreements, reminding China that the loss of credibility with the business sector is not a problem just for China but also for the entire region, given the deepening economic interdependence and China's position as a regional leader. Despite the impression at first sight of direct competition against each other, Japan and China are in fact playing complementary roles, which, if managed well, could produce great synergies in building regional institutions.

3. U.S. Interests

Does the rise of China come at the expense of the United States?

The influence of the United States will not be directly eroded by the rise of China. The peace and stability in the region maintained under the security presence of the United States have enabled active trade and investment, the primary driver of China's rapid growth. No country in sight can take over this role from the United States. The United States and other developed countries have been important export markets and sources of capital and technology. While trade within East Asia is growing faster in recent years than its trade with the world, the region is not becoming self-sufficient. Finer specialization through fragmentation of the production processes within East Asia has significantly contributed to the growth of intra-regional trade of parts and components of final goods that will eventually be exported to extra-regional markets. Although regional final demand will become more important as China continues to grow rapidly, East Asia will maintain its inherent incentive to remain open to the rest of the world.

Impact of U.S. policy

It is Asian countries' perception of U.S. policies, rather than the rise of China, that have had the largest impact on the U.S. influence in the region. When U.S. policy is perceived to accommodate East Asian common interests and to demonstrate a strong commitment to regional stability and prosperity, U.S. influence grows stronger and the momentum among East Asian countries for defensive regionalism, for example, is likely to decrease, and vice versa. Looking back at the evolution of institutional frameworks involving East Asia, there were three unfortunate developments for the U.S. influence in the region.

The first was in the mid-1990s when the United States promoted the agenda of trade liberalization within APEC. The United States successfully overcame Asian developing countries' initial hesitation about and resistance to this agenda. This success, however, did not last very long. Perceived U.S. indifference to developmental concerns and the U.S. pursuit of the North American Free Trade Agreement (NAFTA) and the Free Trade Area of the Americas (FTAA) outside APEC, which were perceived to create trade and investment diversion from Asia, bred discontent among Asian economies with the U.S. leadership in APEC. On the issue of APEC's Early Voluntary Sectoral Liberalization (EVSL), the United States tried to change the modality of trade liberalization in APEC from voluntarism with peer pressure to tariff negotiations. Despite the appearance of Japan's isolation on the issue, Asian economies, which had supported the particular EVSL package because of the choice of sectors and the flexibility available for developing members (but not for Japan), shared concerns about changing APEC into a negotiating body. These developments laid the groundwork for Asian countries' bitter reaction to the perceived narrow-minded focus of the United States' APEC policy on the EVSL agenda during the Asian financial crisis.

The second setback came during the Asian financial crisis. There is a pervasive perception in East Asian countries that the United States and the International Monetary Fund (IMF), which in itself is seen as a tool of U.S. international economic policy, exacerbated the hardship of the countries hit by the crisis. This perception, combined with the fact that U.S. hedge funds substantially profited from the massive selling of Asian currencies, hurt the U.S. image in the region. The argument goes like this: first, the premature opening of Asian capital accounts induced by the so-called "Washington Consensus" was the underlying cause of the destructive capital movements that triggered the crisis. Second, the United States was initially not forthcoming when Asian countries were coordinating a package to support currency stabilization at the early stage of the crisis. Third, the initial prescription by the IMF to induce economic contraction, which did not address the basic problem of the capital account crisis, led to a full-fledged economic crisis. Fourth, measures such as cutting subsidies on imported fuels had a significant impact on the life of the poor and damaged the political stability of Indonesia. The experience of the Asian financial crisis convinced East Asian countries that they had to protect their own interests since global institutions under the U.S. leadership could not always adequately address their interests and priorities. This conviction prompted East Asian countries to build up foreign reserves and to initiate regional cooperation to promote financial stability in Asia. In contrast, China cultivated an image as a responsible regional power by not devaluing the renminbi and by actively participating in regional cooperation.

The third came in the wake of the terrorist attacks on September 11, 2001. Since then, there has been a perception that the United States has been preoccupied with the war against terrorism and proliferation of weapons of mass destruction and that its level of policy attention to Asian economies has been substantially lower than that of China. At the same time, the perceived U.S. inclination towards unilateralism—not just in the field of security but also in such policy areas as trade or environment—alienated public sentiment in Asia. In the meantime, China won the good will of neighboring countries by expanding imports from them and taking an active role in promoting the FTA with ASEAN.

Thus, Asia's image of the United States was damaged due to America's indifference to how its behavior was viewed by Asian countries during these critical junctures.

U.S. interests in fostering Asian regionalism

Despite the recent setbacks for its image, the United States has by far the largest influence in the region. It should not, however, take its influence in the region for granted, if it is to continue to position itself as an Asia Pacific power. Its influence in the region cannot be maintained by economic and military supremacy alone. It has to be enhanced through being sensitive to and, where possible, furthering the region's aspirations.

East Asia is going through historic geopolitical changes due to the rise of China. The surge of political interest in the vision of an East Asian community suggests that the region is in search of a new order to accommodate China's growing power and influence and to maintain regional peace and stability. It is not an easy enterprise. Asian countries suffer from domestic political difficulties in economic liberalization, large gaps in developmental stages among regional economies, and mutual distrust and historical antagonism between Japan and China. Despite these difficulties, however, there is a growing consensus that, eventually, East Asian countries will come up with some form of a regional community.

The U.S. position on Asian regional forums that do not include it had been strongly negative but became more neutral under the current Administration. It has struck a markedly different note by encouraging liberalization at all levels; bilateral, regional and global. More fundamentally, however, Washington should be positive in embracing regional forums even if the United States is not formally a member because such forums would still serve U.S. interests in having East Asia more mature and integrated.

First of all, East Asian economic integration will help reduce regional tension and lighten America's security burden in the region. Economic integration will engage regional powers in stable regional interdependence where one's prosperity is in the interest of others, and make them more predictable and reliable to each other. Successful development of poorer countries in Asia through integration in regional economic dynamism will help political stability and reduce the possibility that these countries will become hotbeds of terrorism.

Secondly, Japan's future economic prospects substantially depend on its capability to benefit from East Asian economic dynamism. It is in the interest of the United States to encourage Japan, its primary ally in the region, to proactively take up competitive challenges from Asia and to promote reform of its economic structure so that it can turn Asian challenges into new opportunities.

Furthermore, if Japan becomes more open, embedded, and trusted in the region, it can be a more effective and valuable U.S. ally. Acknowledging and encouraging Japan's leadership in the region does not mean reducing U.S. power and influence in the region. Rather, it will enhance the effectiveness of U.S. alliances in dealing with diverse threats and uncertainties in post-Cold War Asia.

U.S. roles

Once Washington gains greater confidence about East Asian regional integration, the United States can take several steps to promote both its interests and healthy developments in Asia.

The first is to exercise leadership in strengthening global institutions. As the only global economic superpower, many hope that the United States will lead the world in completing the Doha WTO Agenda and will refrain from resorting to protectionist measures in its own trade policy. It can also lead efforts to strengthen international policy coordination with Beijing that China's increasing significance in the global economy warrants.

The second is to manage key bilateral relations in East Asia with constant attention. Stable U.S. relations with regional powers are crucial to increasing its awareness of the region's concerns and priorities and to fostering broad understanding within the United States that Asian integration can help promote U.S. interests.

Third, Washington can support building blocks of regional integration that can serve as a model of advanced rules beyond the WTO and reliable implementation on which to build larger institutions. East Asian countries do not have a consensus on the right sequence of FTA developments. In order to achieve a better region-wide framework, countries with longer experience of a market economy and stronger institutions should be encouraged to take the lead in developing the contents of regional frameworks. At the same time, FTAs with ASEAN members should be used to encourage integration within ASEAN. The U.S. can make a unique contribution by negotiating high standards in its own bilateral FTAs with Asian economies, as it has already done with Singapore, and developing innovative rules that can in turn be adopted by other countries.

As Asia adapts to a rising China, active U.S. support for improving global and regional institutions, promoting Asian development and fostering Asian regional cooperation would enhance its influence in the region and elsewhere. Seen in this light, the rise of China and the trend toward intra-regional economic integration in Asia are opportunities, not threats, for both of our countries.

Appendix

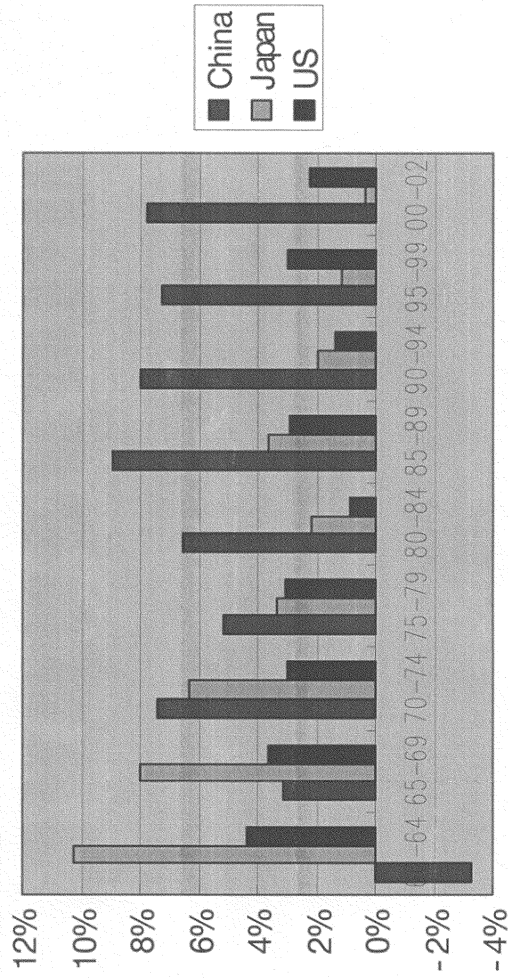
December 4, 2003

Naoko Munakata <munakata-naoko@rieti.go.jp>

Senior Fellow, RIETI

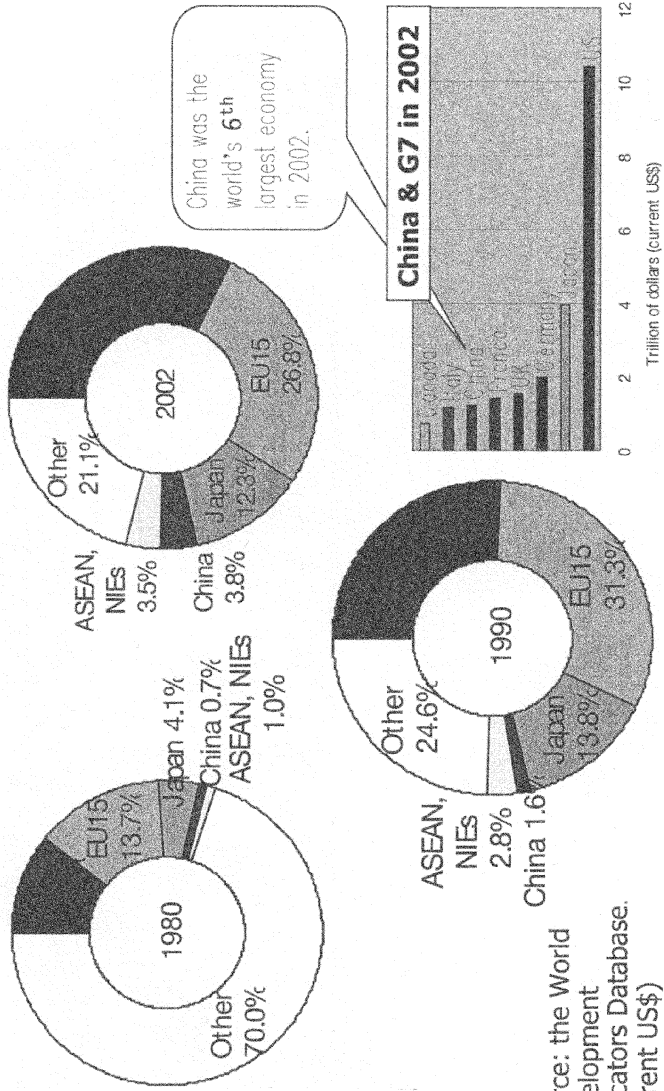
Visiting Scholar, Sigur Center for Asian Studies, GWU

China's Rapid Economic Growth



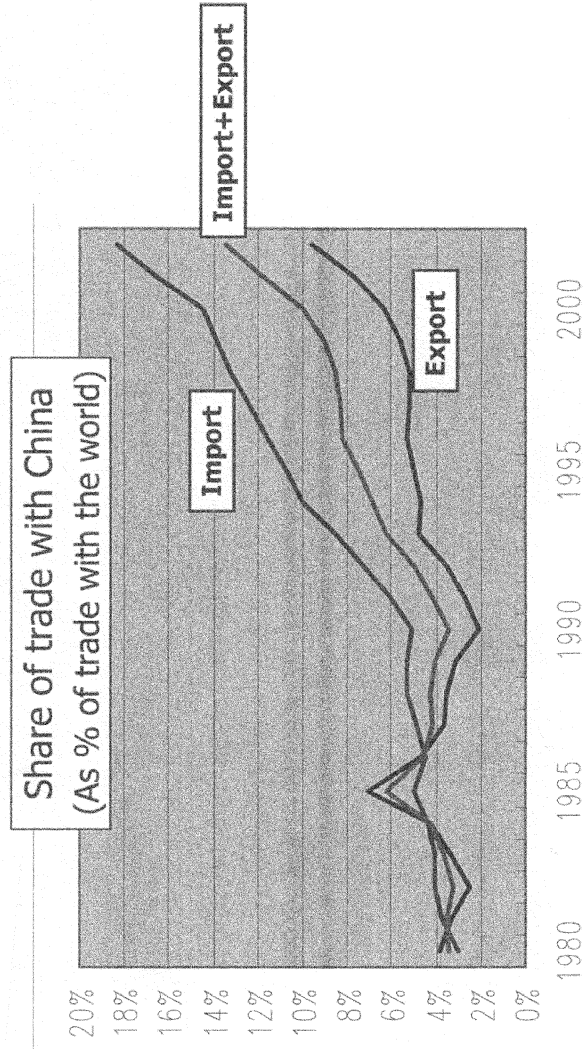
Source: the World Development Indicators Database

Share of World GDP (current US\$)

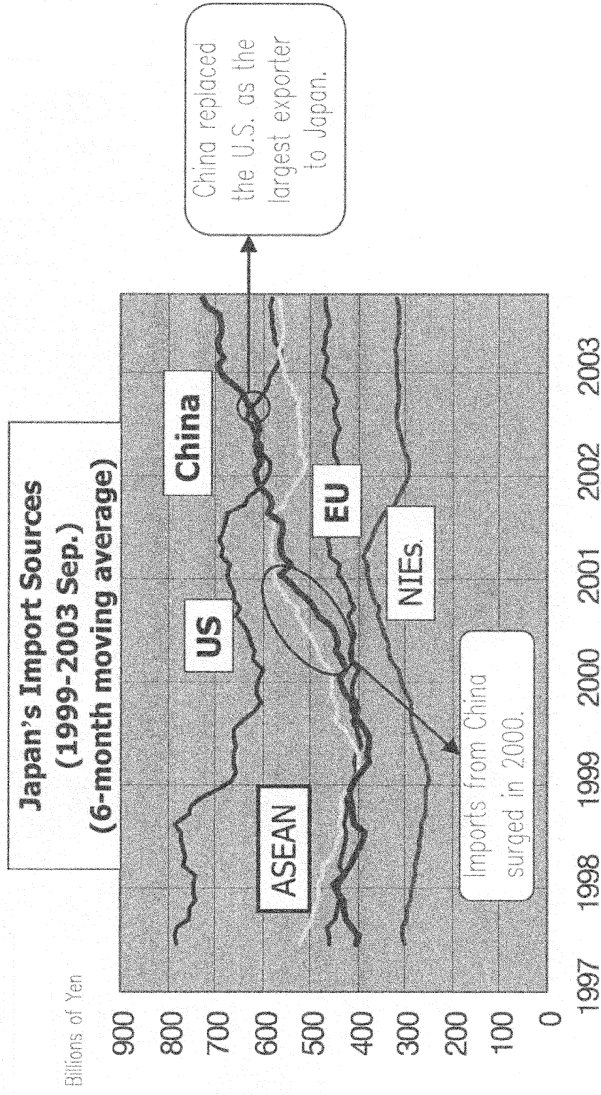


Source: the World Development Indicators Database. (current US\$)

Growing Importance of China Trade

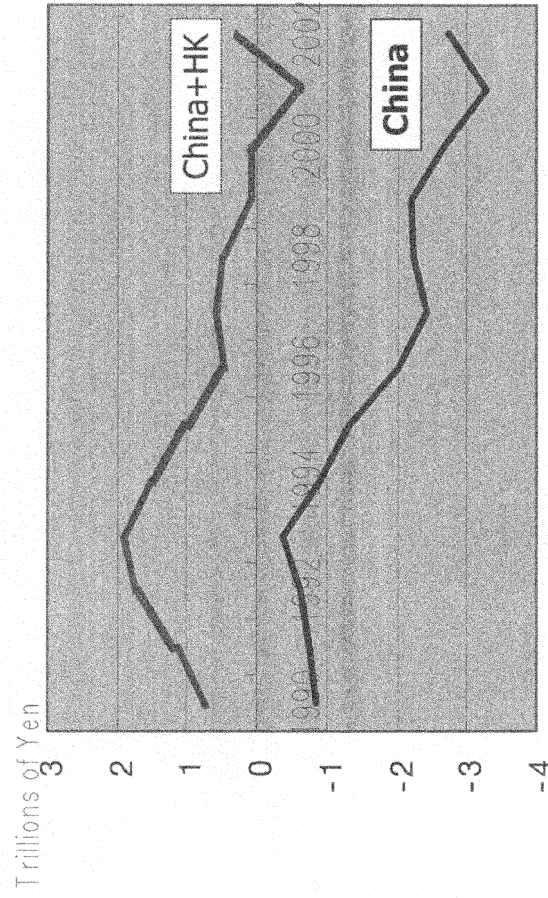


Surging Imports from China



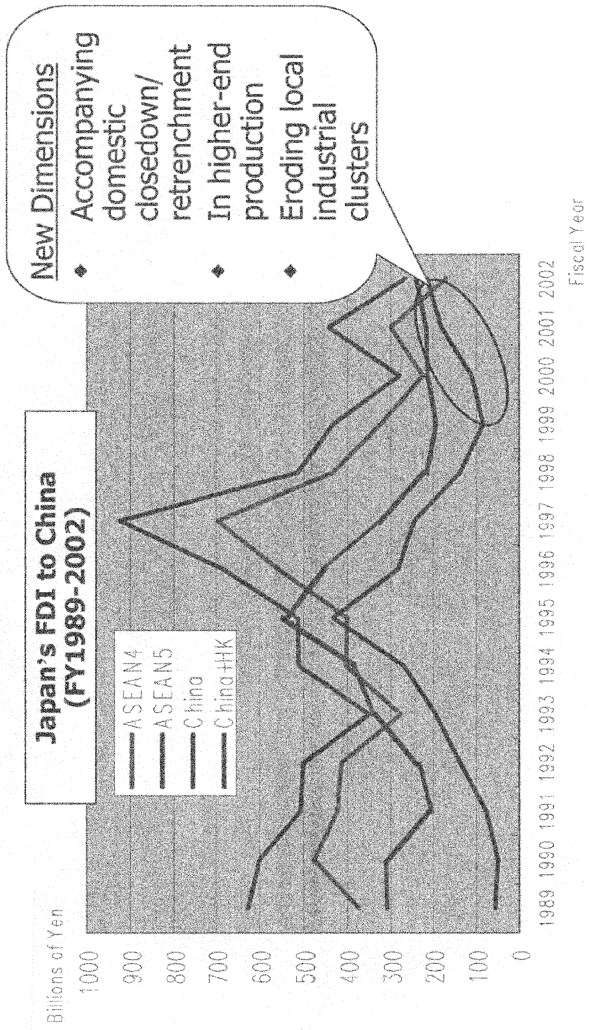
Source: Ministry of Finance, Trade Statistics *) NIEs: ROK, HK, Taiwan

Bilateral Trade Balance



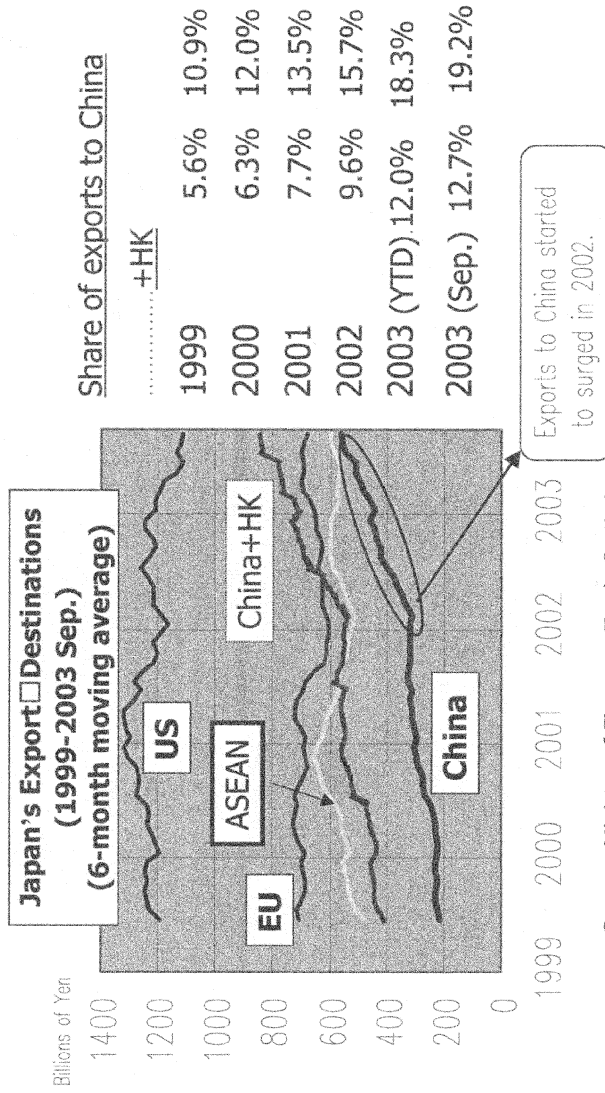
Source: Ministry of Finance, Trade Statistics

Fear of Hollowing-out



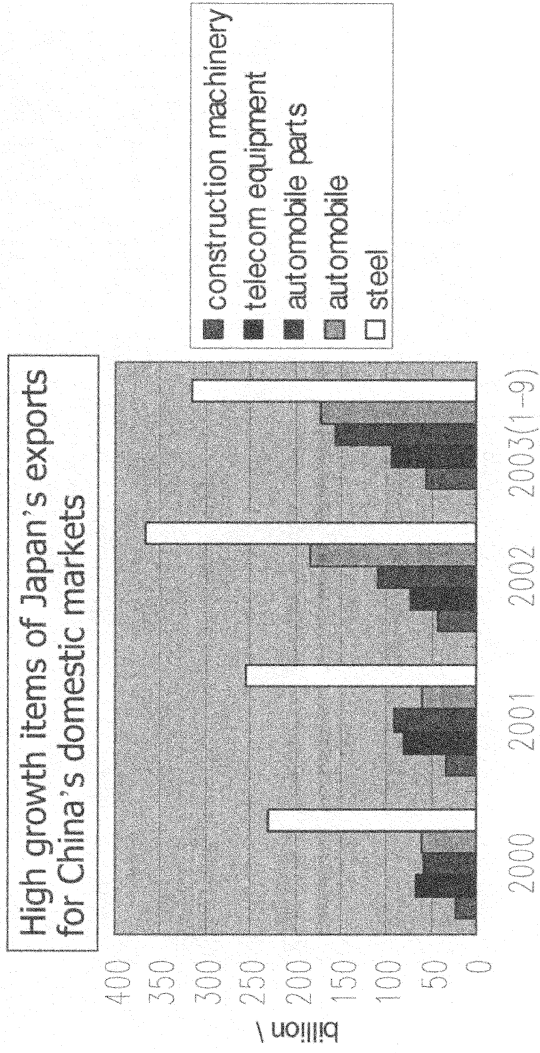
Source: Ministry of Finance, *Foreign Direct Investment*

Surging Exports to China



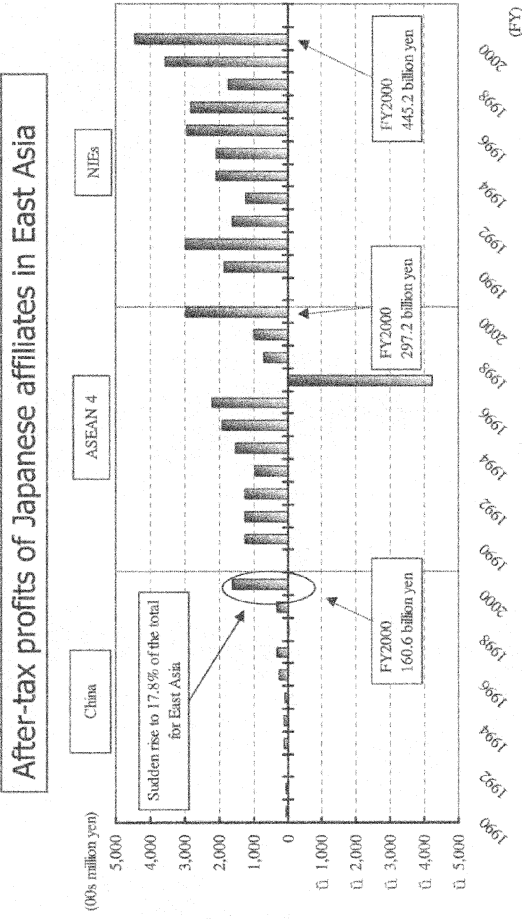
Source: Ministry of Finance, Trade Statistics

Exports for China's Domestic Demand

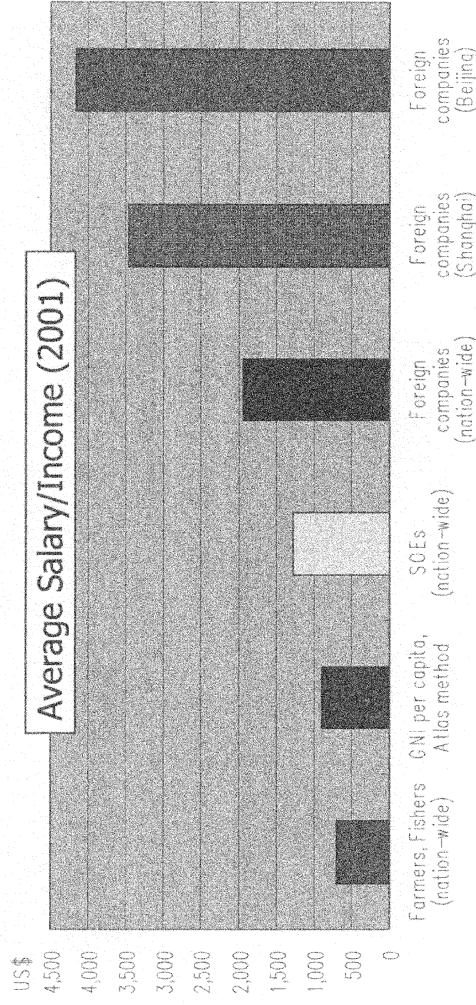


Source: Ministry of Finance, *Trade Statistics*

Improving Profitability in China



Prospects of Affluent Markets



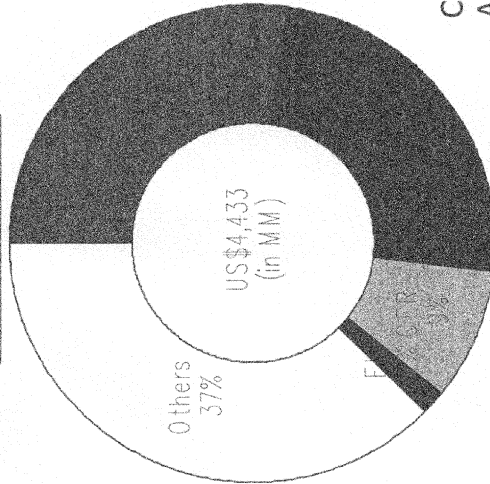
Source: World bank, the World Development Indicators Database

Japan External Trade Organization (JETRO), China Data File 2002-03 (in Japanese)

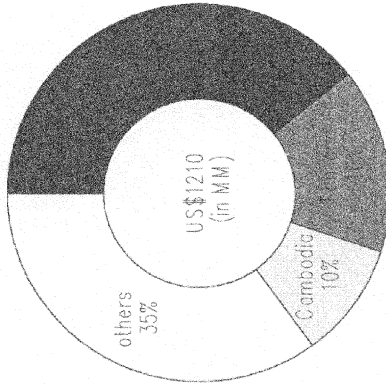
JETRO, JETRO Sensor, October 2003 (in Japanese)

Emerging Provider of Capital

FDI to the World



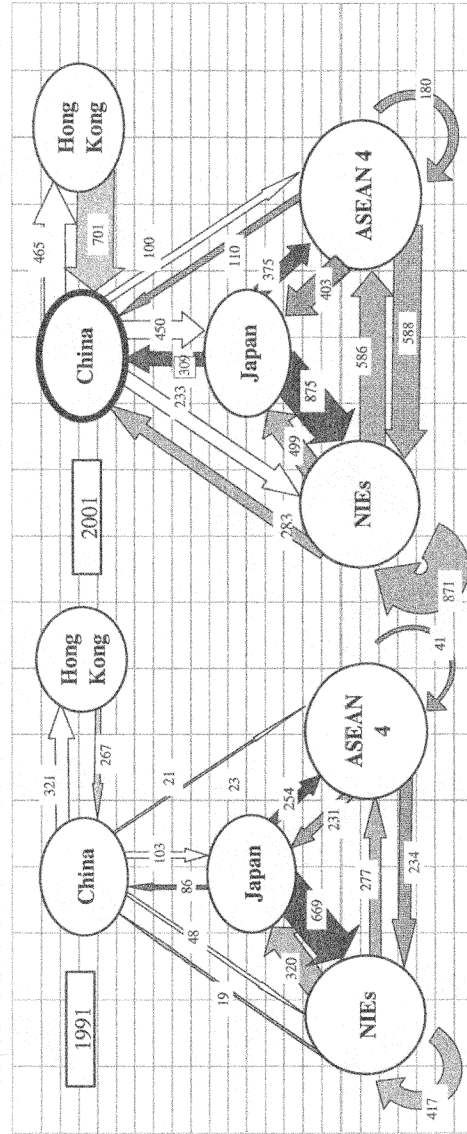
FDI to East Asia



China's FDI stock
Authorized amount, end of 2001

Source: MOFTEC, *Almanac of China's Foreign Relations and Trade*, as quoted in JETRO, *China Data File 2002/3* (in Japanese)

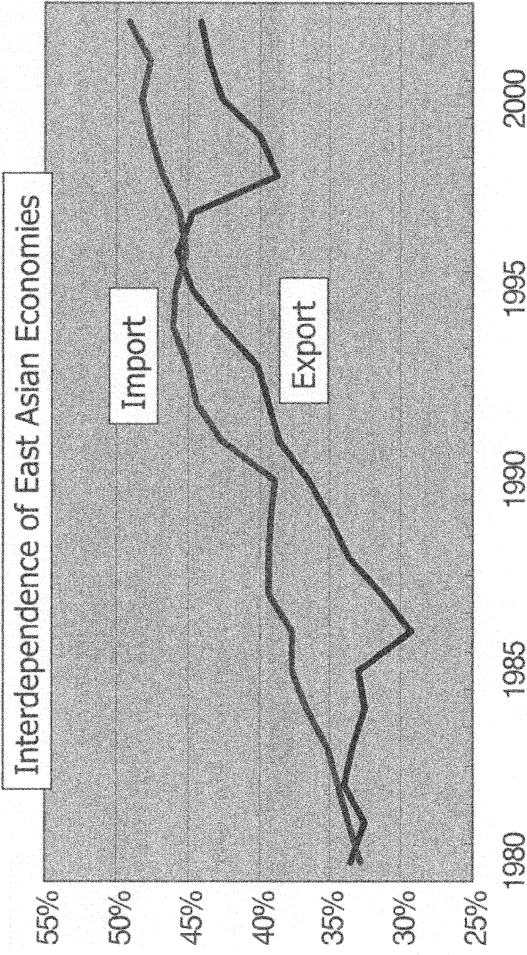
China as a New Link



Total: US\$B 333.1 Total: US\$B 702.8

Source: METI, *White Paper on International Trade 2003*

Growth of Intra-regional Trade



Source: IMF, *Direction of Trade Statistics*

Panel III Discussion, Questions and Answers

Co-Chair BARTHOLOMEW. Thank you very much, and very interesting testimony from all of you. I'm going to take the prerogative of the chair to make a personal note that Mr. Flake was born in Rehoboth, New Mexico. I suspect I'm the only other person in this room who even knows where Rehoboth is, let alone has been there, having lived in Gallup on and off for a number of years. I'm always pleased to see New Mexicans acting on the world stage.

Mr. FLAKE. I'm not sure Rehoboth exists anymore to be honest.

Co-Chair BARTHOLOMEW. I think it's still there in a very small, small way, but anyway, thank you.

Co-Chair DREYER. Has it been hollowed out?

Co-Chair BARTHOLOMEW. There you go. Perhaps it has been hollowed out. I think actually I'll start, Mr. Flake, with a question for you, but if the other witnesses have any thoughts on this, I would be interested in hearing from them. What does China's increasing economic relationship with South Korea mean for China's relationship with North Korea and what kind of an impact is it having? How do you see it playing out?

Mr. FLAKE. This is one of the issues I've addressed in the paper as well in greater length, but to be honest at this point, there's no contest. For a long period of time, there was this deep contest for legitimacy between North and South Korea, but at this point, in every possible measure, China-South Korean relations are much closer than they are with China's relations with North Korea, and it's very much played into the current crisis on the Korean peninsula, and as much as one of the earlier Commissioners, I believe the Vice Chairman, expressed some skepticism about the current Chinese proposals, the very interesting thing here, the dynamic, is that they were very much lobbied towards that position by our South Korean allies.

And it's in many respects, in fact, some very disturbing respects, I think it's quite arguable that the Chinese position on the North Korea crisis and the South Korean position on the North Korean crisis are much closer than our own positions in the U.S. with our South Korean allies.

Now, there's a great concern on the Korean peninsula and China, and they share, they basically share the same belief that the overriding priority is the avoidance of war, the avoidance of conflict in the Korean peninsula, and so they are united in their efforts to keep or maintain the stability on the Korean peninsula.

What it does mean in the long run, though, however, to get directly at the heart of your question, is that when push comes to shove, China goes with South Korea. There really is no question for that. That just depends on how things play out. But if North Korea misplays its hands and if North Korea, you know, moves further down the line of provocations that it's been going on alarmingly in the last year or so, China's interests are much more closely aligned with South Korea than they have been for a long time with North Korea.

Co-Chair BARTHOLOMEW. Do you think that Beijing then would view Pyongyang as an economic liability?

Mr. FLAKE. No question. Now, at this point, more than just an economic liability, an economic, political and security liability, but

at the same time Beijing's overriding priority in this and in almost every realm remains stability, stability, stability, economic development, economic development. So as long as they can preserve the status quo, they would be happy.

But I think as this crisis continues to develop, China is increasingly of the mind that, you know, they're going to have to do something. In fact, they have and quite remarkably in the last year played a much more active role than I think they're comfortable with in prodding North Koreans to come to the talk.

Now they're clearly not where we'd like them to be, but I'm of the mind that as North Korea miscalculates or I would argue continues to miscalculate, that the Chinese will be forced further into our corner, and here's the great irony, and this tells you how skillful the Chinese have played this, is that both the South Koreans and the Americans view the Chinese position as being closer to their own camp.

In other words, if you look at how the security situation develops further, the Americans tend to think that when push comes to shove, the Chinese will be with us, whereas obviously as I mentioned earlier, in the current context, the South Koreans are much closer.

Co-Chair BARTHOLOMEW. Okay. Thanks. Dr. Lincoln, any thoughts on it?

Dr. LINCOLN. Just to add that from the Chinese perspective, North Korea stands in the way of further economic development in the Northeastern part of China, Heilongjiang Province, the old Manchuria. More than a dozen years ago, the United Nations proposed a large development project along the Tumen River which divides North Korea from Russia and then runs up into China, and it's principally the North Koreans that are the stumbling block on that proposal. So again I think that to the extent that the Chinese think in terms of the gains from economic growth and development, North Korea is a problem for them.

Co-Chair BARTHOLOMEW. And since you've raised those provinces, is there any evidence that the influence of North Korea might be making it difficult for Beijing to pursue economic reforms in state-owned enterprises in the three provinces that share a border with North Korea?

Dr. LINCOLN. That's beyond my limited knowledge of China.

Co-Chair BARTHOLOMEW. Okay. Mr. Flake, any?

Mr. FLAKE. I would be very skeptical of that type of a linkage. I mean, you know, the pursuit of those reforms has their own set of difficulties. There's very little in the way of heavy industrial complex close to the North Korean border. The city of Shenyang, probably about four or five hours drive north of the border, you know, is really a large part of the rust belt, the traditional rust belt of China, and they have some severe problems there. But I don't see any direct link between either the security situation there or the relationship with North Korea that would be an inhibiting factor in that process.

Co-Chair BARTHOLOMEW. I actually have a couple more minutes. Sorry, this is my first time co-chairing. We're working out the process up here. One of the trends that we've sort of been hearing about today is about 9/11 as a benchmark in terms of Chinese in-

creased activity or prominence, and influence in the region. The U.S. perhaps not paying as much attention as it was before. These trends that you identify, do you think that they've been going on for a number of years pre-9/11? Do you think that 9/11 is a major factor if only because the U.S. has shifted its focus so much to terrorism or is this something you think we would have been seeing anyway—for any of you?

Dr. LINCOLN. Well, let me start with one comment, that in terms of economic outreach, it at least goes back to the decision of the Chinese to actively pursue membership in the WTO. I'm not sure exactly when that process began, but certainly by 1994–95. Also, during the Asian financial crisis, the Chinese discovered that they gained some recognition from the United States by following an exchange rate policy that we perceived as being beneficial, by holding the value of their currency.

Co-Chair BARTHOLOMEW. Okay. Mr. Flake, thoughts?

Mr. FLAKE. Yes. I am much more inclined to be introspective on this issue than to look to China as kind of the bogeyman for our problems in the region and problems with our relationship. In Korea, in particular, right now, and again this isn't the focus of this panel, there are some very deep-seated and serious problems with the U.S.-Korean alliance, to the point that as someone who has been focusing on Korea for the last 15 years, I doubt that we're going to see another five years of the alliance just because the schisms are so deep, but I think it would be wrong to look at China as the origin of those problems.

And that there are some fundamental changes that have taken place within Korean society itself, and of their perceived interests and, of course, I think 9/11 was a very key turning point in terms of our willingness to accept risk and our perceptions of our interests and so that's the divide, not China.

Co-Chair BARTHOLOMEW. Okay. Ms. Munakata.

Ms. MUNAKATA. Yes. I think in Asia the perception that the United States was paying less attention to the region had been a factor even before September 11. Even before Asian financial crisis, United States was perceived as only promoting liberalization of Asian markets and not paying attention to their developmental concerns. That was not a serious concern, however, because the Asian economies were in good shape and the United States provided growth opportunities through markets, technology and capital.

I think after the Asian financial crisis, Asian countries felt that except for China, the United States had lost interest in Asia. The United States started to focus on the WTO accession negotiation with China, and did not pay attention to the rest of Asia.

In my opinion, the perception that the United States was not paying enough attention to Asia became more prominent after September 11. The United States was primarily focused on the issue of terrorism.

Co-Chair BARTHOLOMEW. Okay. Thank you. Dr. Dreyer.

Co-Chair DREYER. Yes. I guess this is primarily for Mr. Flake. I am not a Korea expert by any means, but as I reflect on what you were saying, I noticed you had a very optimistic view of Chinese-

South Korean relations, and I wonder if there aren't some other factors in there that you would be willing to consider?

For example, somewhere you said something about a remarkable turn by Koreans toward traditional, maybe you said ancient, cultural roots, and it strikes me that often Koreans define their culture in juxtaposition to Japan's influence, and they certainly don't feel part of the Chinese empire, or a vassal state of the Chinese empire. Much of this tilting toward Chinese culture is really an assertion of, it seems to me, traditionally Korean nationalism as defined by opposition to Japanese influence.

And as for the larger number of Korean students studying in China than the United States recently, I think the underlying factors are not determined so much by cultural affinity so much as that China is (a) nearer, and (b) cheaper. It's also important just having students from another country study in your country doesn't mean they're life-long friends or going to agree with you over the long term. And finally the business of the Chinese-Korean community as a factor helping out in trade, is yes, it does, but it also brings certain problems with it.

We have read, for example, of alleged tour groups of Chinese citizens of ethnic Korean origin who check into hotels in Seoul and then disappear into the population and scams in which Chinese-Korean women turn up married to South Korean gentlemen, all of whom are 80 years old or older, and it doesn't really look like a romantic match so much as a way to get out of China, and incidents like these cause certain frictions.

And so wouldn't you say that these are at least a minor counterpoint to the optimistic picture you gave?

Mr. FLAKE. No. They're all very valid. In fact, the optimistic picture is the attempt to kind of summarize an eight-page paper in a few seconds.

Co-Chair DREYER. Yes, sure. I understand.

Mr. FLAKE. But there are some points I'd kind of like to build on—

Co-Chair DREYER. Please.

Mr. FLAKE. —that you mentioned. First and foremost, I think you're exactly right, that the current view of China is a bit romantic on Korea's side. And it tends to be viewed very much in an anti-Japanese prism, but I would also take it a step further. It tends to be viewed in an anti-American prism. In other words, Korea is a country who has an identity problem—right—and one of the biggest things that digs at the root of them is the fact that they lost their independence to the Japanese during the period of Japanese occupation without a shot fired and then went straight from that to U.S. military rule and this close alliance with the United States.

And so there is a line of thought that the Koreans are never going to really stand up on their own until they can kind of step away from that relationship, and the most recent of those is, of course, with the United States, and so there is an entirely different trend, which again is beyond the purview of this Commission, of very serious rise of anti-Americanism in South Korean right now, and that's again a further reflection of what's going on there.

But I will say, however, that I remain optimistic about long-term prospects for U.S.-South Korean relations, and it's based on not

just the reliance and the traditional kind of older brother/younger brother relationship, but on the dramatic democratization of South Korea and the effect of decades of South Korean students coming here.

South Korea has probably the highest percentage of U.S. educated Ph.D. elites than any other country in the world.

Co-Chair DREYER. Taiwan.

Mr. FLAKE. Perhaps, yes. But a remarkable number, so the point is that the underlying values of democracy, market liberalization, the rule of law, you know, free press, there are strong underpinnings, where as Korea continues to interact with China, they continue to realize that there are some very real differences there despite the cultural and historical ties there.

So I would put a very important caveat on the relationship with the China, that there are inherent limits built into that relationship unless China continues on its current path of opening and reform, gradual though it may be. That is an inherent limit built in there.

And the question of the students—you're exactly right in terms of cheaper, closer, but I do think there's a lesson for the U.S. to be said there too. The same is true with tourism. The same is true with students. The harder it gets to get into the U.S. and to deal with the U.S., the more we're going to lose the hearts and the minds of our traditional allies because, now, why do you want to deal with this humiliation of going to the barracks that we call the U.S. embassy in downtown Seoul, you know, when you can just go to China, yes, and just hop on for a couple of bucks and go in a ferry?

So there is a very important question of our national interest in terms of what we have to do to keep the hearts of our allies there.

The question of the Korean Chinese in terms of immigration, again, these are all very, very real problems. I would actually throw an even larger light. These are some fundamental problems that are tied into the continuing division of the peninsula which haven't been addressed. For example, you know, right now the South Korean constitution guarantees any North Korean refugee, you know, automatic citizenship in South Korea, but not to ethnic Koreans born and raised in China, and those lines are very amorphous, and so it's going to get a lot muddier before it gets clear.

Co-Chair DREYER. Thank you. Anybody else? Dr. Lincoln.

Dr. LINCOLN. If I could just add a comment that I think reinforces Gordon's points. Just as Korea is opening up more to China, it's also made some progress in its relationship with Japan. As I'm sure you know, they had a pretty tortured relationship with Japan since the end of World War II. When I first went to Seoul in the mid-1980s, it was not possible to find any Japanese brand name electronic products on the shelves of stores because there was a prohibition on the import of them.

Those prohibitions are gone. I think Korea now accepts Japanese pop music and Japanese film. They will start negotiations of a free trade area with Japan next year which may or may not succeed, but the fact that they are actually willing to sit down and negotiate one is a big step forward for them, in considerable contrast to the drift in U.S.-Korea relations.

Co-Chair DREYER. Munakata-sensei.

Ms. MUNAKATA. Well, I agree with Dr. Lincoln's assessment. I think the Korea-Japan relationship has improved substantially since Kim Dae-jung's visit to Japan in the autumn of 1998. Since then, the two countries have studied the idea of an FTA, and are finally going to launch negotiations most likely this month. It's also quite interesting to note that Korean movies, and dramas are very popular in Japan. It's a positive development in the bilateral relationship.

Co-Chair DREYER. Thank you.

Co-Chair BARTHOLOMEW. Chairman Robinson.

Chairman ROBINSON. Thank you, Madam Co-Chair. I was intrigued, Mr. Flake, by the discussion on China's attitude toward what the Commission as a whole views as a North Korean crisis, rather than a problem. At least I think that's the majority view. And of course, China has stepped up to the six-party talks and there has been a good deal of activity on the diplomatic front. I agree with all that. And certainly the U.S. has embraced this as a constructive set of steps. Some would suggest maybe more than is deserved.

On the other hand, as you know, there's immense Chinese economic leverage in the mix, 100 percent of the fuel, 40 percent of the food. These exports are the centerpiece of North Korea remaining an ongoing, viable economy, and yet that leverage has not been used to date. There were a few days where symbolically fuel shipments from China were curtailed. Despite some signal sending along those lines, no meaningful, in my opinion, use of Chinese economic leverage has yet been in evidence despite the fact that 8,000 spent fuel rods have already been reprocessed by Pyongyang. If we believe published reports, North Korea is fabricating or in a position to fabricate a nuclear weapon a month with the available plutonium, et cetera, so that we'd be talking about a nuclearized North Korea with an arsenal of perhaps over ten weapons by as soon as this summer with ever longer range ballistic missiles being developed and deployed.

That said, the situation I think we'd agree is becoming considerably more dangerous. Do you see a point in the next 12 months or beyond, a circumstance where China will get the wake-up call that this is not just a diplomatic event, that they're going to have to reach into their economic kit bag and use some of the serious levers that they have available to them? That's my first question.

Mr. FLAKE. That's an excellent question. Let me first just state kind of a little bit about China's influence over North Korea. Now I've been long of the opinion that China tries to have it both ways, that we tell them that we think they have great influence over North Korea, they deny all along that they do, thinking that we will assume that they do. In reality they don't, because the Chinese influence over North Korea is negative influence. It's the ability to pull the plug, and that influence carries with it consequences, very real consequences for China's number one priority: stability and economic development, right?

And as a result, the Chinese basically give North Korea nothing more than they absolutely must, and the North Koreans know that, and as a result, the North Koreans give the Chinese no credit for

it. And they spit in the Chinese faces just because they know the Chinese assistance is coming because of Chinese interest; right.

And the effect of that has been that China has really been reluctant to use that negative influence with the exception of very recently, and one kind of symbolic three-day cutting off is an indication, I think, of things to come, and in this I differ actually with a lot of the China specialists, if you will, who think, oh, China would never do that just because it's against the basic fundamentals of Chinese ideology in terms of interference in the foreign policy of other countries, but as I mentioned earlier, I think China is increasingly viewing North Korea as a liability in every front, and that when push comes to shove, they will.

And let me kind of paint a different scenario. I had a meeting two weeks ago in South Korea with two different prominent South Korea National Assembly members, both very close to the U.S., leaders of two different parties, and they both had the same concern: the U.S. is giving too much to China. The U.S. is giving too much of a role to China in the six-party talks, and the worry was that the Chinese were going to somehow take over this process, they would then rule Northeast Asia and the U.S. would be cut out of that.

I have far less concern about that because I have a far more pessimistic view of the six-party talks because my presumption is that the U.S. intent in the six-party talks has been explicitly stated not a negotiation, these are talks. Our intent is building a multinational group to put pressure upon North Korea, and so we are going through the motions of six-party talks essentially to bring the Chinese along.

And I don't think the Chinese are as far off as some people would realize. In February 12 of last year, China voted affirmatively at the IAEA to refer North Korea to the U.N. Security Council. And right now, they're trying to buy as much time as possible and block the ultimate conflict, you know.

But if North Korea does something really stupid, tests another missile, tests a nuclear weapon, you know, there are a lot of things that North Korea could go to go that one step too far, and it's difficult to know, you know, what China will do, but my guess is that when push comes to shove, particularly if North Korea is seen as a provocateur, that China will take those difficult steps that you're talking about and move from the realm of the diplomatic to the symbolic because in the end the people who make the decisions on these issues, you know, the Wen Jiabao's and the Hu Jintao's, have no love lost for North Korea and they're looking at China in a very different light than their predecessors did in terms of, you know, a global power, a concern about global issues, and global responsibilities.

Chairman ROBINSON. Do Ms. Munakata or Dr. Lincoln have a view on that subject?

Dr. LINCOLN. I'll pass.

Chairman ROBINSON. Okay. Thank you.

Co-Chair BARTHOLOMEW. Vice Chairman D'Amato.

Vice Chairman D'AMATO. Thank you, Madam Chairman. I think this is an interesting discussion. What I'm getting from it, and I want to get your confirmation both in what you're saying about the

dynamics of the Korean peninsula and what you also, Ms. Munakata, are saying about U.S.-Japanese relations, what I'm getting is that the United States is leaving too open a field for Chinese diplomacy here, and that American energy is at a too low a level in the region.

And that the Chinese are being given opportunities that are only available because the field is open to them. And the comment that your two Korean legislators make is along the same lines.

I've got two questions. First, have you thought about the kind of measures that we should take to reinvigorate American diplomacy? Perhaps you were talking about an attitude shift that is less concentrated on the development of a U.S.-China relationship and more concentrated on shoring up, reinvigorating our traditional alliances and friendships in the region. In other words, perhaps we need to rebalance the level of effort by the United States. Do you have any suggestions as to how one would do this?

My second question is more specific, and that is do we have a vigorous inter-parliamentary exchange program between the Congress and the Korean legislature, Mr. Flake?

Mr. FLAKE. We do.

Vice Chairman D'AMATO. Is that one area that we can use to help reinvigorate our relations with South Korea?

Mr. FLAKE. We do have a rather vigorous inter-parliamentary exchange system, but like most of these around the world, they tend to be driven from Korea, and you can only get rather passing interest, you know, from our side here. But it does exist and there are, you know, on a periodic basis new proposals, new formats coming out of the Korean side.

I'm very much, coming from an organization that's named after Mike Mansfield, who kind of lived half his life in Asia, it seems, in terms—even when he was in the Congress—and am a very strong proponent of the more contact that we can have on the legislative front, the better. So I wouldn't say by any means or any stretch of the imagination that the exchanges that we have on inter-parliamentary level right now are sufficient. They certainly can be a lot more, particularly given what I see to be the root of this problem. This goes to your question in terms of our invigorated diplomacy.

And that is just, you know, a widening gulf between, you know, U.S. and South Korean perceptions, views and most importantly threat perceptions, and again we haven't discussed it here, but I would argue in the conclusion of the paper that I submitted is that really despite all this topic here, almost everything hinges on what I would consider to be the hinge of history in Northeast Asia, and that is how the question of North Korea gets resolved.

And this is a situation that could completely blow up and totally affect our relationship with China in a positive or negative light. So if we hold together with China on this, it could be an area of cooperation which impacts, you know, positively our relationship for the future, but if there is a schism on this, the results, I think, could be disastrous, and the gap and the perception I'm talking about between the U.S. and South Korea is that over the last, you know, 35 years, the average South Korean, you know, viewed

North Korea through the realm of the propaganda that came from the military dictatorships.

And as South Korea opened and democratized, had a free press, they kind of threw out the baby with the bath water, and you've had two now successive administrations in South Korea who are very vested in keeping their own dialogue open with North Korea, and as a result, there has been no negative words coming out about North Korea in the South Korean press from their own government, and so what you have is a South Korean threat perception about North Korea going through the floor, whereas in the U.S., post-9/11, our recognition of and our threat perception about North Korea has gone through the ceiling.

And that really is in my mind the crux of the divide that we're facing right now between South Korea, and so right now, every time we in the U.S. express our concern about what's going on in North Korea, the nuclear program or whatever, we're being viewed in South Korea as warmongers, because walking down the streets in Seoul two weeks ago, you would have thought that North Korea was somewhere in sub-Saharan Africa. It's not a country 30 kilometers north of you. It's just, you know, it's our poor brothers that we do have a responsibility to help, but the threat perception just isn't there.

So I think that's kind of the key. I think there is an awful lot of effort that needs to be taken in terms of us getting and doing a much more effective job at expressing our concern to the South Koreans because I think it's probably true in Japan and in China and definitely true in South Korea is they don't understand how fundamentally 9/11 has changed our country. They don't get it.

And, you know, I think obviously there is some change that has to take place on our place, but the articulation of that change has not filtered down to Asia, and I think that's key for all of these ongoing relationships.

Vice Chairman D'AMATO. That's very interesting. Is it more important for us to build consensus with South Korea on how to proceed in the peninsula than with China?

Mr. FLAKE. I would argue both. In other words, I'm actually, you know, one who is rather critical of the failure of the Bush administration to engage North Korea early on, but think, giving how far gone the problem is right now, that it is essential that we keep this multilateral coalition, you know, the six-party talks, and China, Russia, South Korea, Japan, and the U.S. firmly together, because whatever happens, whether North Korea collapses, whether there's a war, whether miracle of all miracles, they comply, it's going to be contingent upon our ability to keep that multiparty process together because if we are split on this, then when things really, when the rubber hits the road, the implications I think are far reaching for the future.

Vice Chairman D'AMATO. Thank you very much. Did you have something to add?

Ms. MUNAKATA. I think that there are three levels at which the United States can take measures to improve its image in the region. The first is to strengthen the global institutions. The United States defines itself as a Pacific power, but above being a Pacific

power, it is a global power. If it ceased to be a global power, it would also cease to be a Pacific power.

Therefore, it is very important for the United States to concentrate on strengthening global institutions both in security and trade areas. I think Asians are looking to the United States for global leadership.

The second is to pay constant attention to its key bilateral relations in Asia. If the United States maintains strong bilateral relationships with Japan, Korea, China, it can help shape the development of regional forums by aligning its interests with those in the region. Third, Washington can support building blocks of Asian integration that can serve as a model. Japan and China are pursuing different agendas through FTA's. Japan is more concerned about the economic aspects whereas China is focusing its efforts on strengthening its political position. The United States should support Japan effort to actually implement FTA's. China is not really capable of making things happen on the ground because of the inability or unwillingness of the local authorities.

Therefore the United States can really assist Japan in its efforts to promote the healthy development of regional institutions.

Vice Chairman D'AMATO. Thank you. Mr. Lincoln.

Dr. LINCOLN. I was actually going to give a yes and no answer in typical two-handed economist fashion. On the yes side, as has been said by others on this panel, the reaction of the United States and the IMF in the wake of the 1997 Asian financial crisis left a bad taste in the mouth of many governments around the region.

That experience did kind of open the field for greater thinking about regional behavior with us out of the room. That tendency has been reinforced by some of the unilateralism that governments in the region perceived, particularly in the opening phases of the Bush administration. For example, the Kyoto Protocol may be a bad agreement, but the way in which the administration went about walking away from the agreement certainly bothered the Japanese. After all, it had the name of one of their own cities in the name of the agreement.

But this unilateralism bothered others around the region as well. I would qualify that, though, to say this was not just leaving the field open to China, but also leaving the field open to Japan. If we had been having this hearing ten years ago, the focus would have been what have we done that has left the field open for the Japanese to dominate Asia? And the Japanese are still there. They are after all a major power in Asia—and represented at this table, so it's not as though we have a unipolar power structure within Northeast Asia.

The Japanese still count for something. On the other side, maybe it's time to point out or remind everyone the existence of APEC. We do have a regional institution on the economic side that includes the United States, Australia, New Zealand, Canada, Taiwan, and others, that provides us with the opportunity to be a player in regional discussions on economic issues. I'm quite concerned that we have allowed the APEC process to atrophy in both the Clinton Administration and the Bush Administration.

Vice Chairman D'AMATO. Thank you very much.

Co-Chair BARTHOLOMEW. Commissioner Wessel.

Commissioner WESSEL. Thank you. I appreciate all of your time this afternoon. Let me follow up, if I could, on an issue that's been raised once or twice I think, primarily by you, Dr. Lincoln, about the currency issues and the response after the '97 crisis. We now have U.S.-Chinese currency issues as probably the forefront of our trade concerns right now.

How does that play with regional players now? What are the issues relating to some of the other countries in the region vis-à-vis China and their currency manipulation? I know that there are questions about Taiwan's manipulative practices. How does that fare with South Korea, with Japan and others, and I'd appreciate any light you can shed on that, with all the panelists.

Dr. LINCOLN. Okay. Well, I guess I can speak mostly to what's happened with Japan. I've actually found it rather amusing that all this American policy attention is focused on the remimbi and the manipulation or the attempt to keep it at a fixed rate by the Chinese government when, in fact, the Japanese Central Bank has spent far more money than the Chinese have to try to hold down the value of the yen.

From my standpoint, there is competition between American and Japanese firms in terms of what we manufacture at home and export to one another, far more than there is between what we manufacture at home and what the Chinese ship to us.

So I just find it rather curious that we spend all the time arguing about the Chinese and don't pay much attention at all to the Japanese. That's a deliberate choice by the administration, and I hear informally from my friends in the administration—that this is due to the fact that Japan is our friend and ally on Iraq.

Commissioner WESSEL. I believe the last currency manipulation report by the Administration failed to recognize manipulation by any country—

But how does this work? I understand clearly with Japan. How does this relate to South Korea and others? I'm not an expert on the currency practices of each of these countries? Is there a competition in the region among others as well?

Dr. LINCOLN. Competitive devaluations, you mean?

Commissioner WESSEL. Correct.

Dr. LINCOLN. Or preventive measures against appreciation?

Commissioner WESSEL. Correct.

Dr. LINCOLN. There has been a bit of that argument on South Korea over the last six months which puzzles me because just looking at the data on the Korean exchange rate, it has been going up against the dollar. So I'm not quite sure why this argument has been made, but I'd defer to Gordon.

Mr. FLAKE. Yes, I really haven't focused on this too closely, but I know that the Koreans are rather ambivalent about the intention focused on China, because they're always listed as number two and three on that list when they come out in terms of currency manipulation.

But given the increasing trade between Korea and China, they're also concerned, as you might imagine, on the possible impact of whatever China does on their own trade with China. And so, like I say, it's something that they really haven't come out with kind of a hard position one way or the other on, but they're concerned

about, and there's a considerable degree of ambivalence, as you might, just because the uncertainty factor there.

Commissioner WESSEL. Do you have any views on the question of whether there should be float or just a repeg? There are some—I think Dr. Bergsten, for example, believes there should be a competitive revaluation, but that it should be at a stable rate so that China has some ability to plan for the future? Any views on that vis-à-vis the region as well?

Dr. LINCOLN. I guess I would agree with Fred Bergsten. The lesson we learned in 1997 is that when countries open up without having really established a robust domestic financial framework, a set of viable financial institutions, they can get into trouble. And so not being an expert on the Chinese financial sector, they may not be ready quite yet.

Certainly, a flexible exchange rate is a direction we want them to go, and I think it is right to put pressure on them saying eventually they should get to the point of moving to a float. But for what needs to happen this year, probably not; simply revaluing the currency would be sufficient.

Mr. FLAKE. Since the most attention I've paid to currency valuation has been North Korea's decision to increase the value of the North Korean won last—I think any statement I make would have the same weight as something coming out of North Korea. So I'll leave it at that.

Commissioner WESSEL. Thank you.

Co-Chair BARTHOLOMEW. Commissioner Wortzel.

Commissioner WORTZEL. Thank you very much. Dr. Lincoln or Ms. Munakata, I have a question on Japanese official development assistance to China because I find it interesting that today you have all of this direct investment, a lot of direct investment. 20 years ago in 1978, it might have been useful to have ODA going in there, but what is Japan getting it for today? Is it a viable foreign policy tool today? And would Japan do better to use that as a means of influence? Cutting it off as a means of influence?

I'd also, Ms. Munakata, you have painted a picture culturally of a Korean peninsula that would be extremely comfortable which China. Use any description you wish, with China as more of a regional hegemon, with China as an overarching major power that provides a security umbrella, and serves as a market.

If that's the case, it seems to me that China would not necessarily care whether it was a united or reunited Korean peninsula or a separate Korean peninsula. Regardless of the outcome, China retains a fairly subservient buffer against what it perceives to be its real security threat historically and that's Japan.

Is that a fair characterization?

Ms. MUNAKATA. Well, let me address your first question about Japan's ODA to China. Given the extraordinary fiscal situation in Japan, there are several arguments regarding what to do with the ODA to China. Against this background, the pledged amounts of ODA have substantially decreased for two consecutive years, 25 percent from fiscal year 2000 to 2001, and again a 25 percent decline from 2001 to 2002. I would expect similar reductions in the future. Also, Japan has shifted the priority from things like the development of infrastructure to the protection of the environment

protection and the implementation of international rules that Japan feels would also be a benefit at home.

And then at the end of the day, I think Japan and China have to graduate from the donor-recipient relationship and to one of being equal partners. We somehow need to recognize the importance of this equal partnership, which is more suitable as China becomes a great power in the region.

Thank you.

Dr. LINCOLN. I'd just add a couple comments to that. Japanese development assistance in total has been falling since about 1995.

Co-Chair DREYER. To China or overall?

Dr. LINCOLN. Overall. It's down on the order of 35 percent since its peak. This is in yen terms, in terms of what it's actually costing the Japanese government. ODA to China, I think, held up longer, but as you've just heard is now dropping quite sharply. This is driven by, in fact, your concerns, Mr. Wortzel, as to what Japan is getting from providing aid. There is a belief that while it might have been useful 20 years ago when foreign aid was being ramped up, China is not as poor a country as it was then. There are also some rather troubling military developments in China, and officials wonder why Japan should be putting money into a country that's building up its military. So I think there is a major shift underway at the present time.

Co-Chair BARTHOLOMEW. Is that aid primarily tied aid?

Dr. LINCOLN. No. Most Japanese aid has now been untied. That was a big problem in the '80s. It's not supposed to be a problem now. Maybe the official numbers err on the direction of being untied, but certainly there is a trend—

Co-Chair DREYER. A lot of it for environmental concerns; right? A lot of it for environmental concerns because Japan is very much concerned with Chinese pollution because it affects Japan.

Dr. LINCOLN. Right. Yes.

Mr. FLAKE. Just two quick responses. I think I probably should add some nuance to the picture of a kind of a Korea comfortable with China, because there is a rather sharp divide still within Korean society, and it does fall on generation lines. I mean the older group still very much thinks of these things strategically and thinks if you're a shrimp among whales, and you've got these two big neighbors, the real advantage is to have a strong relationship with a superpower who is far away—right—who is not right next to you and who doesn't have that direct influence.

But I would say that I think that the demographics are really tilting away from that with the coming generations in South Korea.

As to the question of a buffer, you know, and whether China would need it or not, I think that there has been also here a rather dramatic development in terms of China's perceived need for a buffer. I mean the logic on North Korea for a long time was that China didn't want unification because they wanted a buffer between it and South Korea.

Right now, I guarantee you, Beijing has no fear of South Korea; right. They're really not worried about it. In fact, I would even go so far as to say I don't think Beijing really feels the need to have a buffer between it and Japan, you know. The fundamental changes within China are such that, you know, at least on a secu-

rity level, or the fear of influence, I mean given the openness of Chinese society and the penetration of the internet and the penetration of communication, there is just not that awful much for them to buffer against. And definitely not the Korean peninsula. That wouldn't be a factor, at least nearly not to the degree it was ten years ago.

Co-Chair BARTHOLOMEW. Commissioner Dreyer, you have a comment?

Co-Chair DREYER. Yes, I just wanted to add to what you said to that with regard to the buffer idea, that the Chinese, if you talk to them about this, and if they're being frank, they will say, those Koreans, they're very *lihai*; they're very fierce. They fear a united Korea, because they perhaps there would be two of them ganging up on China, which they don't want.

But, of course, they can't come out and say, "We don't want a unified Korea, because that would have ramifications for the Taiwan they hope to unify with." End of comment.

Mr. FLAKE. Can I just make a brief rejoinder to that? This was actually a very interesting point of discussion with the Chinese in that conference that I mentioned that I had in Seoul two weeks ago because, you know, the whole question of unification, again, has dual implications. If it's successful, then it could actually aid, provide a case for the unification with Taiwan or aid their system there.

But there is—you're right—a deep-seated ambivalence that has more to do with regionalism, not regionalism, but borders and border questions and ethnic created minority in China. I would still say that those concerns and the fear of unified Korea, you know, pale in the face of the trend which is towards a much more arrogant nationalist younger generation in China that sees itself as *Zhonghua*, the central kingdom and the world comes to us. Their level of confidence is breathtaking.

And as such, in that context, I just don't see that as a major inhibitor that would actually lead them to try to prevent unification of the Korean peninsula.

Co-Chair DREYER. Except that I don't think that they truly believe that a successful unification is (a) in the cards, and (b) that if it did, it would take so long that it's just not going to be a lesson for Taiwan. So I think they're not being candid with you there.

Co-Chair BARTHOLOMEW. Okay. I'm going to step in. We have two more Commissioners who have questions. We have a Commissioner who wants a re-question. I understand that the panelists are here for our next panel. If it's okay with them, and they don't have time constraints, we'd like to finish this one out and then go ahead and move on to the next one.

Commissioner MULLOY. Thank you.

Co-Chair BARTHOLOMEW. Commissioner Mulloy.

Commissioner MULLOY. Your comments on Korea remind me—was it Khrushchev who said he loved Germany so much, he always wanted two of them?

And historically that didn't happen. So history has a way of moving. Dr. Lincoln, I know you have a Ph.D. in economics from Yale, and I wanted to direct my question to you and then either Mr. Flake or Ms. Munakata, if you want to comment.

Let me give you a series of facts. We have now a \$500 billion trade deficit. We have about a \$2.8 trillion international debt accumulating quite rapidly, about another \$500 billion each year. My understanding is 60 percent of our trade deficit is with our Asia trade, probably around that percentage.

We know that Japan and, as you noted, China, Korea and Taiwan and others are all intervening in currency markets to maintain undervalued currencies against the dollar. When we raised this issue with China at APEC, all of the Asian countries lined up and supported China against our intervention.

So here's what I'm saying. And now Chairman Greenspan and others are telling us this is not only politically unsustainable, this is economically unsustainable for our economy to continue to run in this fashion. So at some point, it's got to change, whether it's going to be a catastrophic economic event of some sort or whether it's going to be a political event.

But at any rate, whatever is going to happen, I don't think it's going to be resolved by lots of new U.S. exports into Asia. That's my sense. That it will more likely be resolved by a lot fewer Asian exports into the United States. If you watch the political situation in this country, and you see what's going on in terms of increasing resistance to globalization and free trade among the populace, not yet among the elite opinion makers, but among the population, what will be the consequence of this? I think it is inevitable that we're not going to be the open market for Asia that they've become used to for the last 25 years or 30 years and they all have had export-led growth strategies: What will this mean for U.S. influence in Asia?

My sense is these trends which I see historically and economically inevitable are going to mean a much lessening influence in Asia because they're not going to need us as the big market anymore or they won't have it, and that will mean our political influence diminishes? Do you quarrel with that or would each of you comment on that scenario for me?

Dr. LINCOLN. Sure. I certainly would not quarrel with the view that if we were to move in a more protectionist direction, as a means of reducing imports, that that would lead to a diminishing of our influence in Asia and probably other parts of the world. I think the world has looked to the United States to be the leader on the drive to make global markets more open, and for us to be perceived as walking away from that would not sit well and with further regional discussions, free trade agreements and what not, that it would not include us.

I'm not quite so sure, though, that that's the direction we're going to move. Maybe I'm being optimistic.

Commissioner MULLOY. Well, let me just—

Dr. LINCOLN. Yes.

Commissioner MULLOY. Even without saying that we go protectionist, just the economic forces at work here—

Dr. LINCOLN. Oh, okay.

Commissioner MULLOY. —mean that we cannot continue to run these huge trade deficits.

Dr. LINCOLN. Right.

Commissioner MULLOY. So something is going to happen, but we're not going to take as many imports.

Dr. LINCOLN. Okay. If that something that happens is currency realignment and if that manages to happen reasonably naturally and without sudden jerks, then I'm not so sure that it decreases our influence in the region. It certainly may reduce the rate of growth of our imports from the region, but so long as governments throughout the region perceive that as a natural economic outcome, I'm not sure that it really affects their policy perception about the United States.

So I would be reasonably comfortable with that outcome and agree that, in fact, something has got to happen. I will tell you that in economics, there is no theory that tells you what level of current account deficit or cumulative foreign debt is dangerous for a country.

Nevertheless, there are levels that begin to—

Commissioner MULLOY. Five percent of GDP is worrisome; isn't it?

Dr. LINCOLN. Five percent of GDP is pretty high.

Commissioner MULLOY. Yes.

Dr. LINCOLN. And it does lead many economists including myself to wonder how long can that go on before the lenders that we're borrowing that money from become concerned about the debt levels and demand higher interest rates in order to keep the lending going. Then there will be a currency adjustment as the flow of capital slows down.

Commissioner MULLOY. Okay. Can I sum up what I think I heard? You're saying if this happens through exchange rate changes that could help, that would be one thing. But if we don't get those changes and it happens through a protectionist impact here, that would have a quite different dramatic effect?

Dr. LINCOLN. Right.

Commissioner MULLOY. Okay. Could Mr. Flake?

Mr. FLAKE. Just very briefly, and I'll just look at this through the Korean prism. I mean I think there's no question that it does decrease the U.S. influence in the region, and a perfect example is what's happened in the last ten years with Korea. I mean Korea was always very dependent on the U.S. market, and a downturn in Korea, you know, the Koreans always say the U.S. gets a sniffle and they get pneumonia; right?

But the one thing that has kept the Korean economy afloat in the last ten years is the fact that the China market has grown so dramatically, and as they've diversified, now between Japan, China and Korea, then the EU is number four, you know, that has actually enabled them to be less dependent on the U.S., and my presumption is with less dependence, there's less dependency. Of course, the security situation is above and beyond that and how that plays out will be a very determinant factor.

I will also just point out on a more of a ideological level, though, however, that one of the fundamental things that's driven kind of the antipathy towards the U.S. worldwide is the presumption of an increasing gap between U.S. ideology, you know, the core ideas of market liberalization and openness, which have been most attrac-

tive, and which most people in the world have seen as kind of our banner or beacon in our actions.

And whenever there is a discrepancy between what we say and what we do, you know, the world is extremely attune to that. And so that's a danger for the future as well.

Ms. MUNAKATA. Actually I think if domestic demand grows in Asia, then Asian economies are relatively less dependent on Asia on U.S. markets. If this happens it could lead to a subtle change in U.S. influence in the region.

Commissioner MULLOY. Yes.

Ms. MUNAKATA. That will happen regardless of the process, be it through exchange rate adjustments or a recession in the United States. Protectionism would add to the decline of U.S. influence. So I think there are several elements that affect U.S. influence.

One is sheer economic power. Another is more political, or symbolic, so to speak. Protection certainly damages the symbolic aspect.

Commissioner MULLOY. Yeah.

Ms. MUNAKATA. But I think the U.S. power is not just represented by the size of its markets. The United States provides technology and capital, represents the notion of a market economy, and ensures peace and stability in the region. Although I think it's not going to happen in the immediate future until the region becomes confident that it needs no more external help, the U.S. will maintain its influence.

If China becomes a full market economy, and at the same time achieves a more liberal political system, I think that would be due to the success of the U.S. policy. While it's ironic, if the U.S. strategy would succeed in the area, that's when United States would have to start worrying about the decline of its own influence.

Commissioner MULLOY. Thank you.

Co-Chair BARTHOLOMEW. Commissioner Becker.

Commissioner BECKER. Thank you. That last comment of yours about a strategy succeeding. Whose strategy?

Ms. MUNAKATA. U.S. strategy.

Commissioner BECKER. Okay. I want to take the question just a little bit in a different direction. When Mr. Tkacik offered his testimony, I don't know whether any of you were in the room at the time, but he most emphatically stated that the Asian countries were being hollowed out by China. He mentioned South Korea. He mentioned Japan and he mentioned Mexico, and then he mentioned the United States.

So when we talk about these win-win situations, and how things are going to level out and work well—and I listened to you both. Mr. Lincoln, your written testimony put down the idea that the Asian countries were being hollowed out. I'm standing here in America on what I think is a very slippery slope. We run a trade deficit here that's astronomical with China alone, and it's reaching \$130 billion this year and growing.

The exports from the United States in comparison to the imports, the gap keeps growing bigger and we're being flooded with imports. Foreign direct investment into China is at extremely high levels, and this is relocating plant facilities from the United States owned by the multinationals into China.

Some of the companies, I'd hesitate to identify them as U.S. companies or China companies, are headquartered here in the United States. Their banking is in the Cayman Islands, but they're using China as an export platform. I would hesitate to say where this is going to end and what's going to happen with all of that.

But that's sort of my question to you. Just for the sake of argument, say nothing changes—let's say the next decade is just like the last decade, let's say we keep running higher and higher imports into the United States, exports from China. Let's say the trade deficit continues to grow at the levels that it's growing now. Let's say the foreign direct investment stays the same or keeps increasing like it does each year with plant locations, and moving from the United States to China, what do you see for America?

Where do you see this will take us? What picture would you form in your mind of America ten years from now? Or 15 years from now?

Dr. LINCOLN. Personally I see an America that can be quite successful in this. I see an America being quite successful, though perhaps not if the size of our global current account deficit were to continue at five percent or more than five percent of GDP a year. I think we are beginning to move up into somewhat worrisome territory on that.

And so my scenario for a successful America ten years from now is one in which there will probably be some depreciation of the dollar against a basket of all the currencies of countries that we trade with.

But on the other aspects of your question, I'm not particularly concerned. I'm an economist, and if you look at economic history, we've watched every industrial nation in the world grow and develop and shift. I went to Yale. The key industry in New Haven, Connecticut 100 years ago was the carriage industry. They lost big time because none of those companies moved into automobiles.

Commissioner BECKER. Mr. Lincoln, if I could interrupt you one second on this because this is very near and dear to me. We've lost over three million jobs in the United States, and it's not the industrial base now. It's the high tech jobs in this country. We're losing it across the board. Everything that can be transferred, everything that can be moved, everything that can go over the Internet or by telephone and everything that can be made physically into product is going out of this country.

When Mr. Tkacik said Mexico was also being hollowed out, President Fox about nine months ago held a news conference and said over 5,000 plants had moved out of Mexico into China. I mean that they were stripping all the industrial base out of Mexico.

These were companies that came from the United States and from Europe and from Asian companies because of the free trade agreement in the United States. Now you're having another move to the lesser-developed countries. So it's not just making things, it's even thinking.

I have a radiologist that runs a scan on me every so often. It's being done from India, I found out. It's not being done from the United States. My doctor doesn't do that. They don't do that anymore. Everything that can go out is gone. Forgive me for interrupting you.

Dr. LINCOLN. Well, in response I'll go back to my New Haven example. Certainly the loss of jobs from New Haven to Detroit was every bit as painful as from the United States to another country.

Or, my roots are in Massachusetts. And believe me where my relatives lived in Massachusetts was a very depressed area for many years, because the textile industry moved to the South. It took many years to get over that. Was that a problem of unfair competition from the South? Well, maybe. The southern workers were not unionized, but it was also a mistake on the part of Massachusetts not to put in place better policies to find other things for people in the state of Massachusetts to do. I think that's really where the issue is for the United States.

The lesson of economics is that if you have a bunch of people who are willing to work, you can find something for them to do. And that interacting with other groups of people who have found interesting things that they can do is usually to the benefit of both parties.

And so our task is to redeploy our labor force to do things that we do best, and if we can do that, we'll be okay. Even on something like direct investment, just as American companies are moving things out of this country, for virtually every dollar of foreign direct investment that we make elsewhere in the world, there's a dollar of foreign direct investment coming into the United States because foreign companies see opportunities here, reasons that they want to be in this country.

So I understand the concerns. I'd like to say I'm as concerned about the loss of jobs in this economy over the last several years as anybody, but I think that's primarily our fault and not the fault of our trading partners. We need to solve the job losses with domestic policies that train people, create jobs, and provide a better macro economic environment, with a smaller government deficit, and a smaller current account deficit. Those are the kinds of things I think we should be focused on.

Commissioner MULLOY. I need to comment on this because I can't let it go. The dollars coming into this country are not for new investment for the most part. We had this debate at another hearing. But what we understand they're coming in to buy existing. So, in other words, instead of a company being owned by Americans, it may be owned by non-Americans, and that's what the investment is. We're selling off ourselves to pay for imports that we're no longer paying for through exports, that we're selling off assets to pay for the current account deficit.

Co-Chair BARTHOLOMEW. Okay. And I'm sorry. I'm going to have to step in at this point. Mr. Flake and Ms. Munakata, if you have some thoughts on that, would you mind providing them for the record, and we can go ahead?

Chairman Robinson.

Chairman ROBINSON. Thank you. I think this is the last question, and I apologize for running over a bit. I would address this to Ms. Munakata, if that's possible. China has been engaged in what some might view as an alarmingly robust military buildup over the past several years.

Japan has, in recent years, engaged in a number of important military procurements of its own. For example, the decision to import ballistic missile defense systems like the PAC-3 and SM-3,

aerial refueling tankers, 767 AWACs, a decision to go proceed with an indigenously manufactured maritime surveillance and patrol aircraft, and a whole list of other important assets.

That's a positive development in my view from the perspective of defense burden-sharing in the Pacific with the United States and also an appropriate response to the Chinese offensive military buildup as well as an evermore dangerous situation on the Korean peninsula.

As you know, Japan has been very reluctant to publicly reference that most of these military procurements are directed toward a China threat in the future as opposed to the shorter term North Korea crisis.

Do you see that political reluctance to state openly the principal threat to Japan continuing indefinitely or is there some prospect for change there?

Ms. MUNAKATA. I personally think from the perspective of the general public, the North Korean missiles flying over their heads really changed their perception of the threat. This fear has brought about increasing political support for the trends you have just described. I'm not a security expert, but my personal opinion, is that China is certainly building up and modernizing its military capability. However, we are not sure how they are going to use this military capability. That will depend on the relations between China and Japan, and the role of the United States.

Rather than being focusing on the threat, especially at the diplomatic level, I think Japan should just focus on how to improve the relationship with China and then reduce China's incentive to maintain an aggressive posture in the region. At the same time Japan, as an independent country, should just work on its own self-defense capabilities.

Chairman ROBINSON. And very quickly, Mr. Flake, Dr. Lincoln, any thoughts on that question? No? Thank you very much.

Co-Chair BARTHOLOMEW. Thank you very much. You have been very generous with your time and your thoughts. We really appreciate it and we look forward to further discussions with you.

We're going to—instead of taking our usual break between panels—move right into the next panel because we're running half an hour behind.

[Whereupon, a short break was taken.]

PANEL IV: RELATIONS ON CHINA'S BORDERS

Co-Chair BARTHOLOMEW. We're going to move forward with our next panel. Thank you very much for your patience. We always like it when dialogue is going on, but it sometimes means that our schedule gets thrown off. So our second panel this afternoon will look at China's relations with its other Asian neighbors.

We will hear from Dr. Wang Gungwu—I hope I pronounced that correctly—Director of the East Asian Institute of the National University of Singapore; Dr. David Steinberg, Director of Asian Studies at Georgetown University; Dr. Blaxall, I believe you'll be next—Dr. Martha Blaxall, Visiting Scholar at the School of Advanced International Studies of Johns Hopkins University; and Dr. Rollie Lal, Associate Political Scientist at the RAND Corporation.

With no further ado, we'll move forward. Dr. Wang, please.

**STATEMENT OF WANG GUNGWU, Ph.D., DIRECTOR
EAST ASIAN INSTITUTE, NATIONAL UNIVERSITY OF SINGAPORE**

Dr. WANG. Thank you. I sent in a little paper, which summed up some of the most straightforward issues, which involve China and Southeast Asia, not just immediately but over a period of time, because I thought we needed a bit of a perspective.

Now, I would like to just take what I consider to be a couple of major points, which look further afield. For example, I thought it would be important to put in context where Southeast Asia stands with China, for example, relative to some of the other areas that have been covered by this Commission.

It is important to think of China as they think of it themselves, as a country with potential enemies all around it. Certainly, historically, they've had enemies coming mainly from overland, for a long, long time, thousands of years, and that remains I think still very much in the historical consciousness. So in a sense when we talk about the middle kingdom, one interpretation has been that the middle kingdom means how proud of their glorious civilization that they have been, but another meaning of it, of course, is that they are right in the middle and surrounding on all sides are people who are in their eyes barbarians in the past, but now just people who might potentially threaten China in one way or the other.

In that background, Southeast Asia has been the least of their worries over the centuries. In fact, they've never had any problems in Southeast Asia. Their main problems have been from the West and from the North with tribal confederations of one kind or the other for the last 2000 years, and many of these confederations have actually succeeded in conquering in the early stages parts of China, but eventually the whole of China on two occasions, the Mongols and then the Manchus more recently.

I put that in perspective because Southeast Asia was an area which was of no great interest to the Chinese except possibly some trade coming in by sea, and never having had any enemies from the south, they were pretty complacent about it for a long time and paid very little attention despite the fact that we do know that they had the capacity in the 15th century to send a series of naval expeditions right through the Southeast Asia area into the Indian Ocean to the coast of Africa, and then did nothing more about it. They withdrew altogether, and stopped all those expeditions, and then paid no attention until the Europeans arrived.

And even then, they were pretty complacent right up to the 19th century, and it was not until the 19th century that they found themselves for the first time meeting an enemy coming by sea, and to that extent, Southeast Asia was a kind of a discovery for China. And this discovery was far too late. By the time they thought about Southeast Asia, Southeast Asia was actually colonial territories of a number of European powers, and the British had broken into China and China has been a weak and divided country for about 100 years.

So, in 1949, when the Communists won, their heritage was still very much a land heritage. Even the victories within China were actually won over land and nothing to do whatsoever with water, with the sea, and the whole coast of China was already, in any case, not Chinese. I mean as they saw it, the whole coast of China

was dominated by other people's navies. So this is the context in which to look at Southeast Asia, it seems to me.

And what I think we should bear in mind is that when China looks around, all the really troubled areas are still in the old places. In Northeast Asia, of course, because of Manchuria, Korea, that's overland. Japan is a little far away but still close enough to that part of that world which is one of the areas, which used to trouble them.

And then more so in the West, although it may not appear to be terribly dangerous to China right now, I think we have to take into account China's consciousness of this very long land border right across Russia, Outer Mongolia, to all the "stans." I think there are six stans, I think I count, Kyrgyzstan, Tajikistan and so on and so forth.

And they also discovered something that they never thought about before the 19th century, which was how vulnerable Tibet could become. I don't think the Chinese cared much about Tibet before that, but following what the British were able to do across from India and the Russians through Central Asia, I mean this great game that they used to talk about between the British and the Russians, the Chinese learned that Tibet was very vulnerable. Of course, once upon a time, the Tibetans were very fierce people and did attack China before they were tamed by the Lamaist Buddhism, but that fact was sort of reinforced by the possibility of a threat over the Himalayas.

This had nothing to do with India. Actually it had to do with the British Empire at the time, but insofar as the British left and India took over the responsibilities of that part of the world, then at least the Chinese were awakened to the fact that Tibet was a vulnerable area that they should bear this in mind.

And I think this has made them aware of Tibet and want to hold on to Tibet in a way that historically they had never thought of doing before. Again, to put into context, Southeast Asia then is an area from which they have never been threatened before, and the one time that they were threatened was by sea, which was a very bad period for China. They learned a lesson. They would never neglect Southeast Asia again.

But still it is a friendly place and when you look around the China's neighbors today, where all the trouble spots are, I think the Chinese would have to conclude that Southeast Asia is the friendliest neighborhood that they've got and that they should do their utmost to keep that area friendly and away from anybody, any country who might possibly use that area against the soft underbelly of the China coast, the southern China coast.

And to that extent, I think they are trying their utmost to ensure at least the one area where they have always felt relatively safe, to make sure that one area remains a friendly area towards China, while they can then focus their attention on areas which are much more troublesome, whether it's Central Asia or Northeast Asia, and potentially I suppose Tibet in the very, very long run. I think these are I think major concerns for China, and I think that Southeast Asia can be better understood in that context. It's not an area of primary security risk to the Chinese. No threat to China, but an opportunity to have that area friendly towards China is something

they couldn't possibly miss, and they want to be assured of that so that they can concentrate elsewhere.

Now how are they doing that? I suppose it does help to take into account that the Southeast Asians have been somewhat neglected by everybody for a while. They had a lot of attention when they were first decolonized after 1945 to about 1975 when the Cold War was fought partly in Southeast Asia, and Americans were very interested.

But then the Vietnam War ended, the Americans basically lost interest in the region, that's how it's perceived in Southeast Asia, and they began to make their own arrangements with China.

And ever since 1975 with diplomatic relations, they've also tried to find their way out of this problem. The main approach has been to unite all of Southeast Asia under the umbrella of the Association of Southeast Asian Nations, well, a kind of unity of strength. If the ten states could really unite, then they would feel safer with a powerful China next door.

That, of course, did take awhile to happen, and during that period of time, Southeast Asia was doing extremely well. Economically, you may recall that the economies of at least half of the countries in Southeast Asia developed very rapidly, and there was a great deal of optimism as to how Southeast Asia would develop, and the net result was that a certain overconfidence perhaps about rounding up the four new members of Indo-China, those Indo-China states, and Burma to join ASEAN at a time when the rest of Southeast Asia was doing so well, that the countries felt they could be helpful to these countries.

It just turned out that in 1997, the financial crisis hit them so hard that this has been a major problem for them. The gathering of the ten states into this association hasn't worked out as well as all that. The major casualty of the financial crisis was, of course, the fall of Suharto and the problems that that has created for Indonesia have almost paralyzed ASEAN states for the past few years.

Indonesia is the largest country in the area and Indonesian leadership had provided a lot of the impetus for ASEAN development. When Suharto fell, and there was tremendous difficulty about leadership in Indonesia, that led the ASEAN network association to really stumble very badly. In that context, many of those leaders found that China was actually playing quite a positive role.

The Southeast Asian countries didn't feel that they were getting much attention from the United States or Japan or anybody else at the time, but China was relatively friendly, and China's growth seemed to have helped them over this difficult period. Of course, there are arguments about precisely to what extent the Chinese helped them and to what extent, in fact, China's growth is actually costing the Southeast Asians in terms of the foreign direct investments going to China that should have gone into Southeast Asia had their economies not failed.

All that argument is still continuing, and we don't have to know the answer to know that the Southeast Asian countries nevertheless felt that China's growth was not only just something to be afraid of, but also possibly something to take advantage of and that provided an opportunity for them to pick up again.

It is in that context I think the Chinese initiatives of the last few years have fallen on very, very happy ears indeed, and the news that the Chinese are genuinely or seem to be genuinely interested in their welfare and to try and gain their friendship, and to try and reduce their fears of China's growth, I think has been very well received.

So there has been a coming together which the Chinese have taken full advantage of, and indeed has offered more, a series of initiatives to strengthen the image of China as their friend next door ready to support them when necessary and so all these moves about free trade agreements, signing of the Treaty of Amenity and Cooperation, all these things I think have been step by step getting closer to the Southeast Asians.

And that, if I may conclude, has been a tremendous boost to ASEAN. The uncertainties, the paralysis since 1997, the very depressed mood; the feeling that ASEAN needed to be reinvented and so on suddenly has picked up. We now come across people who are genuinely hopeful that the interests, the involvement of China and the way China's moves have led to Japan paying new interest, and the Koreans, South Koreans have been very keen, and this has also affected how India sees ASEAN, and how Australia and maybe United States may pay more attention to ASEAN.

All this I think has led the ASEAN countries to look upon China's moves as being generally very, very positive to them, and they are going to take full advantage of it to ensure that nobody neglects them in the future.

Thank you.

[The statement follows:]

**Statement of Wang Gungwu, Ph.D.
Director, East Asian Institute, National University of Singapore**

"China and Southeast Asia"

When the People's Republic of China (PRC) was established in 1949, most of Southeast Asia was in the throes of decolonization. Several of the countries in the region had new leaders who looked to the Soviet Union and China to provide support against any effort to enable the colonial powers to remain. They feared that these colonial powers would seek to perpetuate their control over the region's economic and strategic centres by leaving power in the hands of dependent and anti-communist nationalists. Others, however, were determined not to let the communists take over when their countries became independent. Southeast Asia had clearly become one of the arenas where a global struggle for power between the capitalists and communists was being fought.

By the 1960s, the divisions were clear. The commitment of the United States to defend former French Indo-China and hold the line in Vietnam was largely seen as a war to prevent the region from going communist and more specifically to stop the PRC from advancing southwards into Southeast Asia. The United States decision to send troops could not prevent a communist victory, but two other events had profound results for the region. They were both the result of power struggles. The first occurred in Indonesia in 1965 when an attempted coup ended with the removal of the neutralist President Sukarno from office and the installation of a military leader, General Suharto, who was a staunch anti-communist. The other had its roots in the breakdown of Sino-Soviet relations in the early 1960s, but emerged as a deep internal struggle within the PRC when Mao Zedong launched the Great Proletarian Cultural Revolution that nearly destroyed the Chinese Communist Party.

Although this did not stop the Vietnamese armies from winning the war against the United States, the two events cleared the way for a coalition of anti-communist forces in at least six of the ten countries in Southeast Asia. These were Indonesia, the Philippines, Thailand, Malaysia, and the two small states that did not in the end become part of Malaysia, Singapore and Brunei. Indonesia's break in diplomatic

relations with the PRC, however, marked the turning point. That made possible the coming together in 1967 of five of those countries (Brunei joined later) to form the Association of Southeast Asian Nations (ASEAN).

The PRC was greatly distracted by numerous problems at the time. Soviet and Vietnamese suspicion if not hostility towards what Mao Zedong was doing to the communist cause was one. China's own paralysis as different factions fought one another to the bitter end in both domestic and foreign affairs was another. And then there was the near-destruction of China's urban industrial economy that left the people poorer than ever. The formation of ASEAN in the midst of these troubles as an anti-communist coalition that sided with America and its allies was anathema to the Chinese leaders, but they were helpless to do anything about that.

This is the context of China-ASEAN relations for much of the next decade. It began to change when the United States responded in 1972 to the growing divide between the PRC and the Soviet Union, but little progress was made in Sino-ASEAN relations until after the end of the Vietnam War. Following the establishment of diplomatic relations by three of the ASEAN members, Thailand, the Philippines and Malaysia, the foundations were laid for a new understanding. The United States military withdrawal from mainland Southeast Asia, the death of Mao Zedong in 1976, the reaching out of ASEAN towards the three now independent Indo-China states, as well as the start of bilateral trading relations between China and the core ASEAN states—all happening within a couple of years—marked a new realism in the region. But nothing could have prepared anyone for the dramatic economic reform program initiated by Deng Xiaoping in 1978.

The ASEAN states remained suspicious for years after these reforms were systematically implemented. Chinese diplomacy at the time was still dominated by a post-Maoist rhetoric that did not fit the language of ASEAN discourse. ASEAN efforts to admit the three Indo-China states as new members were interpreted by some of the Chinese leaders as moves to make the organisation a bulwark against China. Most of all, China's historical claims to sovereignty over most of the islands of the South China Sea were threatening to several ASEAN countries and this remained for another two decades a sensitive issue in many of the meetings between Chinese and ASEAN officials.

But underneath the surface, profound economic changes were occurring that eventually overcame some of the initial fears about a resurgent China. It had begun with the flow of Japanese, U.S., Taiwan and Hong Kong investments to each of the ASEAN countries during the 1960s and 1970s and with the productive way many of its businessmen responded to the new opportunities. After the end of the Vietnam War, the flow was augmented by new capital from South Korea and various countries of Europe. The fact that the investments in export-led industries made with the Japan model in mind were so successful created confidence and creativity in economic activities that the nations of Southeast Asia had never before experienced. Whether or not PRC's economic reforms after 1978 played a part in promoting the later stages of this growth-centred environment is not clear. Certainly, the increased attention that China paid in the 1980s to developments in Cambodia and Myanmar enabled Chinese leaders and their diplomatic corps to enter into closer relations with their counterparts in the region. It was inevitable that better understanding should follow after that.

No less important was the easing of suspicion in each ASEAN country of the economic role of its population of Chinese decent. That these people of Chinese origin were knowledgeable about China, and were welcomed by the Chinese authorities to invest in China, helped to improve the flow of trade with Southeast Asia. It soon became clear that this relationship would become a growth area that would greatly stimulate economic development within the region itself. On its part, China began to pay more attention to the quality of diplomatic exchanges. A new generation of Beijing officials was encouraged to think afresh about the countries that bordered the country's soft underbelly.

A notable shift in attention occurred in the aftermath of the Tiananmen tragedy of June 4, 1989. When the rich Western countries turned away from the Beijing regime, China were grateful that its neighbours were not condemnatory but ready to deepen their economic links further. This was also the time when the Soviet Union collapsed and the Cold War ended. For the region, this was followed closely by the resumption of official relations between Indonesia and China which, in turn, enabled Singapore to establish formal diplomatic ties—an act that completed the normalization of China's relations with the whole region. The role of that island republic had been recognised by Deng Xiaoping after his visit there in 1978, but a fuller flowering of that relationship had not been possible earlier. There is reason to believe that Singapore was able more directly than before to help Sino-ASEAN relations move to more comfortable levels. The boldness of Singapore's Suzhou Indus-

trial Park proposal was much appreciated even though both sides encountered more difficulties in implementation than expected. Many lessons were learnt there that, if anything, accustomed more Southeast Asians to observe the Singapore experience and think beyond simple trading.

China's extraordinary economic growth is only 20 years old and the completion of the ASEAN Ten project to include Vietnam, Laos, and Myanmar, and finally Cambodia, even more recent. Close relations between China and this enlarged and renovated ASEAN simply had not been possible much before the year 2000. Yet it is now clear that events beyond the control of either side helped to promote a closer relationship even before ASEAN had completed its enlargement. This was when the financial crisis hit the region in 1997 and brought a decade of the rapid development of the original five members of ASEAN to an unexpected stop. It no longer matters whether China's decision not to devalue the renminbi did in fact soften the blow to the region. What mattered was that China, unlike many Western and Japanese banks and multinationals, was perceived to have been helpful and caring at a time when the region badly needed support.

Since 1997, while Southeast Asia fought to overcome economic stagnation, China has sustained an annual growth rate that averaged 7–8%. Foreign direct investment (FDI) to China did not grow but was still healthy, valued about US\$40–45 billion annually. During the same period, FDI to all the ASEAN countries combined dropped sharply for three years running and then held the line at about US\$15 billion per year, about one-third that of China. More significantly, China has been gaining rapidly in the export of manufactured consumer goods to the United States, Japan and Europe. In comparison, the growth in ASEAN trade in these products have slowed greatly where it has not actually declined.

The trend that characterises the past six years is clear. The momentum is with China and all ASEAN members know that. There are many different views in the region as to what this means for the region in the future. The impact on the region's economy is growing. How are the members of ASEAN taking it? ASEAN is an association, not a community, of nations. It has only recently expanded to include four countries whose economic and political systems are quite different from those of the founder members. The earlier members have been successful in minimizing diplomatic and security problems among themselves, but they have been far less successful in the area of economic cooperation. The new members will not make the task of regional integration easier, especially when at least three are much closer to China and are still being influenced by their historical links.

There are now two sets of developments that deserve the closest attention. China's economic power may be alarming to some ASEAN members, but it is also seen by China's smaller neighbours as offering opportunities for them to ride on that growth. The initiatives taken since 2000 by China towards ASEAN, especially those linked to Free Trade Agreements and the readiness to be the first from outside the region to sign the Treaty of Amity and Cooperation, have had ramifications. They have aroused Japan, South Korea and India to act in response, and have spurred ASEAN to speed up its efforts at economic cooperation. At the same time, recalling that ASEAN had always cooperated more readily on diplomatic and security matters, their leaders have moved towards negotiating some kind of security community. In the context of the post-9/11 global developments in which China and older allies like the U.S. and Japan appear to be on the same side, this is likely to advance quickly and prove to be a fruitful step forward.

In short, ASEAN is now more ready to revive its efforts towards some kind of regional integration in the longer term than they have ever been. It is also now prepared to make moves towards a larger regionalism of East Asia that it had been wary about in the past. Again, it is China's new position on this matter that has made the difference. Since the mid-1990s, the steps taken towards ASEAN+3 (that is, China, Japan and South Korea), followed by China's push for ASEAN+1 (with China alone) meetings, have galvanised the region and beyond. China's success has not been limited to economic pressures on ASEAN members to perform better, but also to persuade them to think big and beyond its original box.

The biggest challenge is whether ASEAN can shape itself to act as an effective community while so many changes are going on at the same time. External pressures to increase cooperation are coming at it fast and furious while the realities on the ground are not necessarily pushing its members in the same direction. On the one hand, its older seaward-looking members are further away from China and perhaps more confident of extra-regional support for their relations with China. On the other, the members on the mainland can deal with China overland, or by ancient river routes that are being modernised, and these relationships have different political and strategic implications for the region. At the same time, advances in communications technology will provide new avenues for a larger regional role for

ASEAN. Nevertheless, its members would still have to conduct their relations with China at several levels. Below that of the ASEAN network itself, there will continue to be profitable local trading links and a wide range of bilateral connections. These latter have been established by China with each respective government and each would feel the pressures of specific local and national interests.

The picture as a whole has to be multi-layered. Above that of ASEAN would be the several regional groupings that ASEAN supports, the most prominent being that of Asia-Pacific Economic Conference (APEC). But, given the size of that group, it is understandable why ASEAN is simultaneously attracted to the much more manageable concept of a East Asian region. It is towards this East Asian "community," emerging from the regular meetings of ASEAN+3, that China seems to be moving its neighbours forward. As long as ASEAN remains as one more or less united player and, as long as a Northeast Asian equivalent (an Association of Northeast Asian Nations, or ANEAN) is not in sight, the prospect of a comfortable relationship emerging between China and Southeast Asia looks promising.

Co-Chair BARTHOLOMEW. Thank you, Dr. Wang. Dr. Steinberg.

**STATEMENT OF DAVID I. STEINBERG, Ph.D.
DISTINGUISHED PROFESSOR AND DIRECTOR, ASIAN STUDIES
SCHOOL OF FOREIGN SERVICE, GEORGETOWN UNIVERSITY**

Dr. STEINBERG. Thank you very much. It's an honor to testify before the Commission. I'm delighted to see that attention is being paid to China in Southeast Asia because it has been ignored for so long, except for the interest in terrorism, which has been a single focus of the United States.

Four hours ago, a senior Southeast Asian official said China has done everything right in Southeast Asia and Japan has done everything wrong in Southeast Asia. And he commented that, as Dr. Wang has said, that the attitude of Southeast Asia toward China is very benign and China regards Southeast Asia as an area where they can expand their influence in contrast to the other parts of their periphery.

China deals with Southeast Asia in two different ways, bilaterally in an individual country basis, and of course, multilaterally through ASEAN. Bilaterally, the most important country not because of the extent of Chinese investment in any dollar terms is Burma because of its strategic importance and because it penetrates that country in a far greater degree than China penetrates any other country, although Indonesia, of course, has far greater Chinese investment.

For several reasons, the Chinese concerns in Burma should be a worry to the United States because of the potential of Indo-Chinese rivalry, based on the war of 1962, and because China has access to the Bay of Bengal through Burma. It has access to the northern or the western part of the Straits of Malacca. It has built a great deal of infrastructure, and has lent them a large amount of money.

The problems of Burma have spilled over to our treaty ally Thailand, which again should be of great importance to the United States, and that has often been neglected. China has put forward its best foot forward on Southeast Asia and it's been exemplified by their attitude towards ASEAN. As Dr. Wang has said, they've signed the Treaty of Amity with ASEAN, which Japan has not yet signed, strangely enough.

It has signed a protocol with ASEAN on a Declaration of the Conduct of Parties in the South China Sea, which puts in abeyance, or at least will for awhile, any disputes about the South China Sea oil and gas reserves. It, as Dr. Wang also said, is going

to have an eventual free trade zone with ASEAN, and China is a member of the ASEAN Plus Three and the China Regional Forum.

When the Multi Fiber Agreement ends on December 31, 2004, there will be likely a hollowing out of hundreds of thousands of textile jobs all throughout Southeast Asia into China which should be of concern to the United States because it could lead to political instability in some of these areas.

Chinese trade to the region has expanded markedly, and we must remember that there are about 30 to 40 million Chinese or people of partial Chinese extraction in the region, and there are natural ties for trade and commerce with these areas.

China no longer claims that these are citizens of China, but the relationship is very important. Chinese economic role in Southeast Asia, as we all know, is very, very important, and in Indonesia especially, where three percent of the population, the Chinese, have about 70 percent of the capital according to the academic studies. This creates all kinds of problems when we talk about, as part of U.S. policy, the privatization of industry, for example, because the chances are the Chinese would buy it, thus exacerbating income differentials.

In Indonesia, the Chinese have been exceedingly busy. The bilateral trade in 2002 was \$8 billion, and \$2 billion a decade ago. Chinese investments in Indonesia were 6.8 billion as of July 2003, and only 282 million in 1999. China has gone after energy resources in Indonesia. It has signed in 2002 an \$8.4 billion contract to supply liquid natural gas for 20 years to Fujian Province, and they've done some other memoranda of understanding on various power plants.

So in 2002, they also signed an Indonesia-China Energy Forum. China is expanding its influence there. Chinese influence also in Cambodia and Laos has been very important as well, and there are some figures in my written testimony on that.

But the most important avenue of Chinese advancement has been Burma, and this is the reason that over U.S. objections, ASEAN admitted Burma in July 1997 to try and modify Chinese influence there. A Japanese former general has said to me that if China can import oil and gas to Southwest China through Burma and not go through the Straits of Malacca and the South China Sea, that is not in Japan's national interest.

So there is a question there of some rivalry. Burma is beholden to China for military equipment, at least \$1.8 billion, if not more, of military equipment since 1988. They have built and expanded and rehabilitated railroads, roads, dams, irrigation systems, ports and airfields as well—and they have done this on the Bay of Bengal, which is of great concern to India because actually India tests its missiles in the Bay of Bengal and for China to have potential listening posts and monitoring stations on the Bay of Bengal is of concern to India.

That is why India has changed its policy toward Burma which was once very antithetical to the regime in 1988 to one of friendship to try and counter Chinese influence. Chinese influence is also grossly undercalculated in the international trade and investment figures, because Chinese investment basically does not go through the board of investment in Burma.

In the overland trade, there's a great deal of smuggling, and great undervaluing of commodities. If you go to the border, I was there a couple of years ago, everything is conducted in Chinese yuan, not in Burmese currency, which is unstable.

There are supposedly one or two million illegal Chinese immigrants into Burma. Mandalay, the seat of Burmese culture, is, according to the Australian Foreign Ministry, 20 percent Yunnanese and Lashio, the most important city north of Mandalay is half Chinese. So we have a real problem, I think, there, and with the sanctions that the United States has imposed on the country, I think this has increased its dependence on China.

Now, this anecdotal point that I mentioned in my written testimony about the paramilitary training of males. Officials told me, you're being trained so that we can have a holding action against the United States when it invades, until China comes to our assistance. This sounds ludicrous to any American, but the Burmese are very fearful of the United States. And when you talk to them that the U.S. has really no national interest in doing anything against that country in terms of military action, they say, well, Grenada and Panama, Kosovo and so forth, and they'll give you a list of six or seven of these invasions.

And they are prepared to believe the worst. Another point here I think is that the sanctions have had social effects that have been deleterious. They have hurt the regime somewhat. They have hurt the population more. We have cut them off, in essence, and isolated them. We try and open up other countries such as North Korea, China, Vietnam, but we have done the reverse in Burma, I think we have, according to a Member of the Congress, a policy of regime change in Burma, and I don't think that policy is going to work.

That is something that one should really consider. We may feel very good about this policy because it is, in fact, a moral policy, but at the same time, if it's not effective, then I think we should consider what the United States ought to do in terms of the national interests, which are multiple in that country while we have a one strand policy of human rights. And human rights ought to be a strand in any of our policies but one of a number of strands as we've seen in our policy toward China and Vietnam.

Thank you very much.

[The statement follows:]

**Statement of David I. Steinberg, Ph.D.
Distinguished Professor and Director, Asian Studies
School of Foreign Service, Georgetown University**

China's Role in Southeast Asia

It is a great honor to be asked to testify before this Commission on the subject of China's role in Southeast Asia. It is a topic of great potential importance to the United States, but one that I feel has been neglected, and thus I am delighted to see that this Commission is interested in it. Although the U.S. concentration on the threat of terrorism in that region, and especially in Indonesia, is a critical issue facing both the United States and the Southeast Asian countries, the new and expanded role of China is a subject about which we should be aware. This is not necessarily to argue that the Chinese role is inimical to U.S. interests, but there are disturbing signs about a new state of equilibrium in the region in which China will play a dominant role and for which the U.S. may not be prepared and in which the U.S. may play a less important part than our national interests may dictate with two treaty allies in that region (Thailand and the Philippines).

In connection with this testimony, I would like to insert for the record three documents on China and Southeast Asia in which I have been involved. These are:

1. *China and Southeast Asia Roundtable*, which I chaired, a part of the Stanley Foundation's 44th Strategy for Peace Conference October 2003.
2. 'Southeast Asia Looks North: New Dynamics with China,' a draft chapter in *Georgetown Southeast Asia Survey 2002-2003*, published in May 2003, of which I was co-editor.
3. *Strategic Rivalries on the Bay of Bengal: The Burma/Myanmar Nexus*. Conference I organized on Sino-Indian relations, February 2001.

United States relations with China have recently been exceptionally good. The U.S. designation of a Uighur separatist organization in Xinjiang Province in west China as a terrorist group has pleased the Chinese, who obviously have been concerned that separatist fundamentalist or terrorist Muslim movements in Central Asia could spread to Xinjiang. China has been most helpful, even essential, to attempts to solve the North Korean nuclear crisis. Taiwan straits issues have been quiescent of late, although there is evidence that they may well heat up before the Taiwan Presidential election in April 2004.

In Southeast Asia, Chinese behavior has been the most benign in recent memory. Its approaches are twofold: regional, through dealing with the Association of Southeast Asian Nations (ASEAN), which now includes all ten countries of that region, and bilaterally. Bilateral relations should be of most importance to the United States in Burma/Myanmar because of several reasons: the extent of Chinese economic and military penetration of that country; the potential of Burma as a pivotal element in any potential Sino-Indian dispute; the Chinese access to the Bay of Bengal and the Malacca Straits; and the spill-over effects of mismanagement and abuses in Burma that affect our treaty ally, Thailand. It seems evident that other ASEAN states have also been concerned about the Chinese influence there. That China is on a campaign to present its best image was evident in Hu Jintao's 2002 visit to Singapore and Malaysia. In a sense, China may be trying to recapture the 'soft power' status it traditionally held as the cultural center of East Asia.

China has engaged in an extensive campaign to downplay the disagreements over the potential sovereignty of the oil and gas reserves offshore in the South China Sea. Previously China has claimed this area as its territory, but it or portions of it have been claimed by all the neighboring Southeast Asian nations. China has signed a protocol with ASEAN, the Declaration on the Conduct of Parties in the South China Sea, that, although not resolving the disputes, has put them on hold and indicates a desire for an amicable settlement of the dispute sometime in the future. Chinese interest in expanded energy resources is indicated by the China National Offshore Oil Corporation acquiring assets in Indonesia. China has indicated it would support an eventual free trade zone in ten years that would include all of ASEAN and China, although some ASEAN member states feel they might be swamped by Chinese industry. China is a member of the ASEAN Plus Three group, as well as a member of the ASEAN Regional Forum. China will likely benefit disproportionately when the Multi Fiber Agreement ends after December 31, 2004, at which time businesses that have invested in textile production in the low-wage states of Southeast Asia to evade quotas will move their factories to China. This is likely to exacerbate urban unemployment, especially among women, in many Southeast Asian nations, and could have internal political overtones there.

Chinese trade with Southeast Asia has expanded markedly: at about 75 percent a year between 1993 and 2001. Population and thus business links between the 30-40 million Chinese in Southeast Asia of Chinese or partial Chinese extraction are critical, now with overseas Chinese reinvesting in the mainland at heightened rates. Although China no longer claims that these millions of overseas Chinese are citizens of China (a position of previous Chinese governments and in the earlier period of Communist rule), the bonds between and among them prompt ease of business transactions, giving them important roles in those societies. For example, the Chinese population of Indonesia of three percent own 70 percent of the capital. The Chinese position in Malaysia has been dominant economically, although the Malays hold political control.

The Chinese role has become important in Cambodia and Laos, where Chinese trade is said to dominate, and although previous Chinese-Vietnamese relations were strained to the point of border conflict, Chinese trade has become important in Vietnam as well. In Indonesia, Chinese imports were \$2.2 billion in 2001, and in Burma \$1.8 billion or about 23 percent of all imports. Chinese imports to Cambodia and Laos had doubled between 1999 and 2001 to \$169 million and \$49.4 million respectively.

The most important avenue of Chinese advancement in Southeast Asia is Burma/Myanmar. The Chinese presence has become ubiquitous. Although the Burmese are a highly nationalistic people who certainly do not want to see their state or their economy dominated by any foreign group, and who believe they can handle Chinese influence, there are disquieting signs. Burma is beholden to China for its military rearmament, have received at least \$1.8 billion in military assistance equipment. Burmese are trained extensively in China as well. The Chinese have built, expanded, or rehabilitated a wide variety of infrastructure throughout the country, including road, railroads, dams, port facilities, and airfields. Whether there are Chinese naval bases or port facilities on the Bay of Bengal is a question, but it is evident that the traditional trade routes from Yunnan Province in Southeast China by road to Bhamo in Burma's north, and then down the Irrawaddy River to the Bay of Bengal gives the Chinese potential access to an area that India has long considered its strategic reserve. Chinese-built infrastructure is close to the western reaches of the Malacca Straits, the most important natural waterway in the world and through which Japanese and Korean oil and products are shipped, and which is the U.S. lifeline to Diego Garcia, our base in the Indian Ocean on which we depend for some of our Middle Eastern activities.

International figures on Chinese trade with Burma are grossly undercalculated. The overland trade is undervalued and smuggling is rife, and most Chinese investment does not go through the Myanmar Investment Commission and is thus unreported in international figures. Chinese illegal immigration is widespread, and there are estimates of between one and two million recent Chinese immigrants into Burma. Mandalay, the seat of Burmese culture, is said by the Australian Foreign Ministry to be one-fifth Yunnanese Chinese, and others say that Lashio, the most important city north of Mandalay and the terminus of the old Burma Road, is now half Chinese. Chinese penetration into the Wa areas on its southern border with Burma is extensive, and a UN survey indicated that instruction in primary schools was primarily in Chinese. China has recently granted \$200 million in economic assistance to Burma and additional funds for technical assistance. Japan is greatly concerned over China's preeminent position in Burma and has attempted to use its foreign assistance program to counter Chinese predominance. Burma was enabled to join ASEAN in July 1997 over strong U.S. objections, but one factor in ASEAN interest in having Burma join was that it might lessen Burmese dependence on China.

That dependence has grown as a result of U.S. sanctions and those of other states. Burmese have remarked informally to visitors and among themselves that they can withstand sanctions, which are hurting the common people—especially women—as State Department testimony indicated, because they can rely on China. There is anecdotal evidence that in the one-to-three month para-military training now required of males from 18 to 50 years old, some Burmese officers when queried as to the usefulness of the training indicated that it was to allow the Burmese to conduct a 'holding' action against the Americans until the Chinese come to their aid. The Burmese military have officially written that the interest that the United States has in 'regime change' in Burma is that Burma is the weakest link in the U.S. containment policy toward China.

There is no doubt in my mind that sanctions and other U.S. actions have intensified Burmese reliance on China to the detriment of U.S. strategic and national interests. The U.S. has a one strand foreign policy toward Burma—human rights. It should be a part of any policy, but it should be considered along with other U.S. interests, which include our strategic concerns, trade, and investment, narcotics issues, the effects of war and economic underdevelopment on the outflow of refugees and illegal workers into Thailand, causing great concern for our ally. We should also consider that the Indian Foreign Minister a couple of years ago pronounced China as the primary potential enemy of India. From Delhi's vantage point, with China to the north, and Pakistan—a close Chinese ally—to the west, and Burma infiltrated by China to the east, there is considerable concern, which is why India changed its policy toward the military from antagonism to friendship to try to counter Chinese influence. It is not insignificant that India tests its missiles in the Bay of Bengal, and Chinese tracking stations on Burmese soil would enhance their capacity to monitor such tests. This is a volatile region.

The U.S. sanctions regime may make both the Congress and the Administration feel morally good, but it is most unlikely to achieve its objective, which is regime change. That does not mean that pressures should not be brought on the military to reform and democratize within a reasonable period, but rancorous public statements simply require a vociferous negative reaction from the Burmese government, which should be quite expected. Sanctions succeed in further cutting off Burma, and making reliance on China more extreme. This is not in either the U.S. or Burmese

national interests. We are, I am afraid, engaged in a policy that both will not work and will cause harm to U.S. national interests and the Burmese peoples.

Co-Chair BARTHOLOMEW. Thank you, Dr. Steinberg. Dr. Blaxall.

**STATEMENT OF MARTHA O. BLAXALL, Ph.D.
ECONOMIC CONSULTANT
SCHOOL OF ADVANCED INTERNATIONAL STUDIES**

Dr. BLAXALL. Thank you very much for having me here today. I would like to begin by pointing out a few facts about Central Asia. The five countries that I'm talking about are five of the six "stans." I'm not talking about Afghanistan.

They are not five homogenous countries, but there are similarities amongst them. First of all, their existing geographic borders were established by Stalin based principally on the location of the different ethnic groups residing in the region. That is one of the reasons that the borders within Central Asia make little sense.

Secondly, they were industrialized entirely during the Soviet, period and the industrialization model that prevails both in the industrial sector and in agriculture, is one of a centrally planned economic system.

Thirdly, these countries are characterized by authoritarian political regimes. They are all pretty much run by the secretaries of the Republics' communist parties that were in power at the time of the end of the Soviet Union.

As a result, the transport systems in the region are directed towards Moscow, which was the economic center of the Soviet economy. Only in the last few years have there been new roads and new railroads that are directly link together different parts of the region, thereby allowing it to become more of an economic whole within itself.

These are all Muslim countries, but they are all secular Muslim countries with zero tolerance for Muslim extremism.

One major difference among the republics is in their natural resource endowments. Kazakhstan, as we all know, has proven reserves of 15 billion tons of oil and two billion cubic meters of gas. Turkmenistan has the fifth largest natural gas reserves in the world. Uzbekistan is the eighth largest natural gas producer and one of the top three cotton producers in the world. The Kyrgyz Republic and Tajikistan, the two poorest countries in this part of the world, have hydropower, and they are both looking for ways in which they can sell their hydropower to their neighbors, and certainly for the Kyrgyz, China is an obvious market.

These two countries are also the only two countries with surplus water, and water is one of the scarcest resources in Central Asia. China is interested in the possibility of accessing water from these countries for Xinjiang Province in the West. None of these countries is wealthy. Kazakhstan is the richest, with per capita gross national income (GNI) at about 1,500. By comparison, Tajikistan's per capita GNI is at \$180, and that of the Kyrgyz Republic at about \$290, placing them among the poorest countries in the world. We have two countries that are becoming more middle income countries, but of course, if we look at the distribution of income within these countries and not just at the aggregate per capita numbers, we find very large numbers of poor, rural people.

Let us look at how this poor Muslim, natural resource rich region relates to its towering neighbor, China. The most important issue, of course, is the availability of large supplies of oil and gas within the Central Asian Republics and China's energy security concerns. As was pointed out by the previous speaker, China is looking all over the world for energy, and from the Chinese perspective, Kazakhstan is a natural partner in this regard. Not only is China a major market for Kazakhstan's oil, but is also an investor in the country's energy sector to ensure that Kazakh oil continues to flow to Western China. The absence of pipelines and good roads is a barrier to more rapid growth of Kazakh oil exports to China, but these barriers will be resolved, and as oil production in Kazakhstan becomes large enough, Chinese investment will increase.

At an aggregate level, official Chinese exports to Central Asia in 2002 were \$800 million and its official imports were \$1.3 billion. Actual Chinese exports should be increased by another billion, roughly speaking to include the shuttle trade in consumer goods to Central Asia, and, in particular, to Kazakhstan and the Kyrgyz Republic. Total trade therefore is about \$3 billion at this point in time, which is a huge increase if one takes into account the fact that in Soviet times the border between the Soviet Union and China was virtually closed.

In general, China sells consumer and manufactured goods, and the Central Asia republics sell unprocessed natural resources. Even so, the increased trade with China has had a positive, modernizing effect on the Central Asian republics in that the Chinese market demands a higher product quality than these countries have been required to meet for Soviet or post-Soviet markets.

A third theme is national security. Both the Central Asian republics and China are engaged in a common war against Muslim extremism and terrorism. China, of course, is adamantly opposed to any manifestation of Uyghur separatist aspirations and associates any such manifestations with Muslim extremism and terrorism.

The Central Asian republics are equally concerned about terrorism, particularly as it is used to challenge their authoritarian regimes. Uzbekistan, as you probably know, has the most notorious record in this respect.

The Shanghai Cooperation Organization evolved out of this common concern about terrorism and Muslim extremism, with all of its founding members recognizing that a regional approach to these issues was the only possible way to succeed. China has been a leader in the evolution of the original Shanghai Five, established in 1996, to the current Shanghai Cooperation Organization, which now includes Uzbekistan as well as three other Central Asian republics, Russia, and China.

The Shanghai Cooperation Organization is highly important to China for several reasons. For one thing, China can pursue its key strategic goals of political stability, greater regional economic cooperation and energy security through the Shanghai Cooperation Organization. It helps to assure greater border security, and in so doing, to reduce drug trafficking with its HIV toll. Similarly, the Shanghai Cooperation Organization legitimizes China's policy of clamping down on any evidence of Uyghur separatism, as China is able to justify repressive measures as part of a collective effort

against Islamic extremism. The Shanghai Cooperation Organization also allows China to work with the Central Asian republics on economic and military matters so as to and can counterbalance the growing U.S. military presence in the region, and to do so in a multilateral context that neither offends nor threatens the United States.

Russia also finds the Shanghai Cooperation Organization a convenient and useful multilateral entity for some of the same reasons, but from the Russian perspective, it also allows Russia to maintain its historical involvement in the region without threatening the sovereignty of the newly independent former Soviet Republics. At the same time, while Russia is prepared to tolerate Chinese economic inroads in Central Asia, it is obviously concerned that China not use the Shanghai Cooperation Organization to gain undue political or cultural influence with the region.

Thus the multilateral approach to Central Asian security and economic cooperation that the Shanghai Cooperation Organization facilitates serves the interests of both Russia and China in counterbalancing the growing economic, military and political presence of the United States in the region. At the same time, however, the organization serves as a collective partner with the U.S. in attacking the joint enemy, militant Islamic terrorists.

Moreover, from the Russian perspective, the U.S. presence counterbalances Chinese efforts to strengthen its military or diplomatic cooperation with Central Asian republics. So in a sense, the Shanghai Cooperation Organization facilitates a strategic balance among the three major powers—the U.S., China and Russia—with respect to Central Asia.

Finally, how does China's growing economic strength affect America's interests in Central Asia? There is certainly a common purpose with respect to combating Islamic extremism and terrorism that threatens the political stability of the region and access to the region's oil and gas supplies. Everybody agrees on that point—the U.S., China and Russia.

The most recent military exercises within the Shanghai Cooperation Organization, as well as U.S. military bases, are directed to this goal, and all of the countries involved currently choose to see the situation as complementary rather than competitive.

But, as another speaker has pointed out this afternoon, the U.S. does care about democracy, and as political change takes place in the "stans" over the next decade, which it is likely to do, we may see chinks appearing in the wall of solidarity between the members of the Shanghai Cooperation Organization—particularly Russia and China—and the United States.

The Chinese, in particular, may want to maintain more authoritarian regimes in order to keep up the pressure on the Muslim extremism and ensure political stability. The U.S., on the other hand, may want to push for greater democracy.

Secondly, it is to the advantage of the Central Asian Republics—Kazakhstan, Turkmenistan and Uzbekistan—to have multiple markets and a competitive situation for their exports, as this allows them to negotiate the best prices for their energy supplies. This is also in U.S. interests. And, as Kazakh oil exports increase, they will expand the volume of non-OPEC oil in world markets, which

is also a positive development for the U.S. Great quantities of Kazakh oil being shipped to China is also in the best interest of the United States, since it will lessen Chinese demand for oil from sources that are more convenient for the U.S. to import from. China is less likely to explore oil supplies from Africa and Latin America if it can realize significant imports from Kazakhstan.

Finally, we must not lose sight of the fact that U.S. and western technologies are needed now in Central Asia and will continue to be needed for the foreseeable future. Kazakhstan is not likely to choose Chinese investors over U.S. or Western investors without taking into account what the implications of that would be for their own modernization programs.

Let me conclude by saying that while we should be vigilant regarding China's and Russia's goals and actions in Central Asia, we should not have as our primary motivating policy countering their actions in the region at this point in time. At the same time, we should continue to press for political reform, democratic approaches, and market-based economic systems that will best contribute to the Central Asian countries long-term stability. And we should also provide help on how they can best use their royalties from oil and gas investments for poverty alleviation and economic development purposes, because it is not clear that they know exactly what to do on these issues.

This demands a long-term commitment towards Central Asia on the part of the U.S. In this regard, we should welcome Chinese and Russian initiatives that are consistent with our long-run objectives and we should not respond in a knee-jerk fashion that labels any such initiative a threat to U.S. interests.

[The statement follows:]

**Statement of Martha O. Blaxall, Ph.D.
Economic Consultant, School of Advanced International Studies**

Economic and Political Implications of China's Growing Economic Power on Central Asia

Madam Chairwomen and other Commissioners, I am Martha Blaxall, an independent consultant who has worked as an economic development specialist for more than 30 years. I have been involved in economic and regional development issues in the Central Asia region of the former Soviet Union for the past decade. Most recently, I was a Visiting Fellow at the Central Asia Caucasus Institute at the Nitze School of Advanced International Studies at Johns Hopkins University, and Director of the Central Asia project at Yale University's Center for the Study of Globalization. My research has focused on regional trade issues in Central Asia, including trade between the Central Asian Republics and China. I am pleased to be able to contribute to this hearing on China's economic and political impact on its Central Asian neighbors.

It is important to point out at the start that China has differing relationships and interests with the five former Soviet Republics that comprise what we refer to as "Central Asia." These differences, to a large extent, are reflected in the economic and political realities that shape each Republic's policy towards establishing closer economic ties with China. China interacts more with Kazakhstan and the Kyrgyz Republic, both of which share common borders with the People's Republic and have significant economic and political ties with China. Uzbekistan is interested in China as a possible export market and as an ally in the war against Muslim extremism in the region. Tajikistan, though an immediate neighbor, and a market for Chinese consumer goods, has little to sell to China and is too heavily dependent upon the Russian military to envision major security ties with China. Tajikistan does see China as an ally in the war against heroin trafficking from Afghanistan, however. Turkmenistan, while a major source of natural gas, a commodity in great demand in the development of China's western provinces, is not a major economic or political

player in China's diplomatic initiatives towards Central Asia at this point in time, despite China's interest in Turkmen gas.

In general, the Central Asia Republics (CARs) are still emerging from the Soviet legacy of Central Planning. In all five states the government retains at least some ownership—and in many instances control—of the major industrial sectors. Kazakhstan has encouraged foreign investors to become major partners, particularly in the energy sector, and its fiscal and monetary policies are supportive of foreign investors' interests. But even here, both domestic and international political considerations, rather than economic or market-based factors, are more likely to affect investment decisions and policies. Uzbekistan still retains a multi-tier foreign exchange rate regime with non-convertibility and government control over access to foreign exchange. There is greater market freedom in the Kyrgyz Republic, but even here there are many barriers for foreign businesses. Turkmenistan has become an autarkic dictatorship in which economic and political decisions are made by its President, Saparmurat Niyazov, who prefers to be known as Turkmenbashi, the father of all Turkmen. As a result, the country's modernization has more or less come to a standstill.

These countries are also burdened with a transport and economic infrastructure that was put in place to implement the Soviet centrally planned economic system. Railroads, pipelines, roads, and, until recently, telecommunications networks, still operate around Moscow as the "hub" of economic activity. The World Bank and the Asian Development Bank have begun to invest in new roads and railroad lines that will allow the CARs to become an economic region by themselves, and to trade more effectively with China. However, traditional trading relationships and transport routes have allowed Russia to remain one of, if not **the** principal trading partner for all countries in Central Asia.

In Soviet times, Central Asia was a source of raw materials and unprocessed agricultural commodities that were sent to Russia for further processing and distribution. This legacy has meant that the Central Asian countries have been struggling to evolve from colonial-style economies that export low value products and import finished goods. Their economic policies are focused on attracting the foreign investors and new technologies that will result in more value added production. The region also needs technology-related investments and technical assistance that will facilitate the transformation away from the old Soviet models to more market-based models that will attract foreign investors and generate desperately needed economic growth. Except for Kazakhstan and the Kyrgyz Republic, however, they have been reluctant to decentralize economic decisionmaking and allow private firms, rather than government agencies, to determine prices and production quantities for much of their export sectors.

As a result, their economies have suffered enormously since independence. After the disastrous economic implosions that followed the collapse of the Soviet Union—the Kyrgyz Republic's economy shrank to about 30% of its Soviet-era level, for example—economic recovery began to occur in Kazakhstan with the growth of the energy sector in the mid to late 1990s. Uzbekistan suffered less during that decade due to its conservative approach towards privatization and public debt, but its economic base continues to struggle, and the U.S. Military expenditures related to the Khanabad base have been an important contributor to Uzbekistan's economy in the last two years.

At this point in time, only Kazakhstan has a per capita income greater than \$1,500. The Kyrgyz Republic and Tajikistan have GNI/capita of less than \$300, which makes them among the poorest countries in the world. Table 1 displays the GNI/capita for Central Asia and China for 1998 and 2002, as well as their respective infant mortality rates. None of these countries is wealthy now, although Kazakhstan is on the verge of sustained economic growth. Turkmenistan's numbers are highly suspect, since the average Turkmen is at a subsistence level.

Two other factors are important in setting the stage for Central Asia's relationship with the PRC. First, the enormous oil and gas reserves in Kazakhstan, Turkmenistan and Uzbekistan are potential sources of energy for China. Kazakhstan has more than 15 billion tons of oil overland and in the Caspian Basin, at least 2 billion cubic meters of gas, and the capacity to reach 1 million barrels of oil per day in the very near future. Turkmenistan has the fifth largest natural gas reserves in the world, but its exports are hostage to a wholly Russian-controlled pipeline system. Uzbekistan, though not now a large exporter, and the eighth largest natural gas producer in the world, is energy self-sufficient. Yet all of these countries are geographically landlocked, with no access routes to the West or the Far East except through Russia. This makes them entirely dependent upon friendly relations with their neighbors, including each other, for transport corridors to markets, or for pipeline transmission of oil and gas. Not only does this leave each country vulnerable

to instabilities in neighboring states, but also to terrorist acts that can damage or destroy existing transport routes.

China's Economic Relations With Central Asia

It is becoming increasingly clear that China views closer relations with its Central Asian neighbors as an important strategic objective. China is cultivating institutional and cultural ties with the region and expanding its security relationships, principally through its leadership of the Shanghai Cooperation Organization (SCO). On the economic front, China has increased both its exports and its imports with the CARs, and has explored and realized several major commercial and infrastructure investments.

While China's trade with Central Asia is still relatively small, officially-recorded imports and exports have more than doubled since the late 1990s. In 2001, for example, China officially exported \$0.8 billion of goods and services to the CARs and imported \$1.3 billion. This was a tiny fraction of China's total trade (less than one percent in both cases), but it equaled almost eight percent of Central Asia's exports and more than five percent of the region's imports. If unofficial and unrecorded trade is also included—mostly the \$1 billion in consumer goods that is shuttle-traded across the Xinjiang borders with Kazakhstan and the Kyrgyz Republic—China's growing importance as a supplier of consumer goods becomes evident. China's principal competitor is Russia.

Kazakhstan is, by far, the most important trading partner for China within Central Asia. While China exports manufactured products to Central Asia, its imports from the area are mostly raw materials, with petroleum products from Kazakhstan being the largest single item. Kazakhstan's exports to China in 2002 reached nearly \$1 billion, three-quarters of the total CAR exports of \$1.3 billion, and China has become one of Kazakhstan's top five bilateral trading partners. Recognizing the importance of its growing trade with Kazakhstan, then President Jiang Zemin was quoted in the Chinese press in 1999 as having said that "Kazakhstan had become China's second largest trade partner after Russia within the CIS." President Hu Jintao reinforced Kazakhstan's priority in China's foreign policy by visiting Kazakhstan during his first trip abroad in June 2003.

Expanded trade in raw materials and commodities offers growth opportunities for the Kyrgyz Republic and Uzbekistan. For the Kyrgyz, hydropower offers an opportunity to export electricity along the border with China. Uzbekistan's exports to China are growing, but reached only \$50 million in 2001, with short cotton fiber being the primary export. Uzbekistan could also export chemicals, mineral fertilizers, horticultural products, non-ferrous metals and natural gas, as well as cotton lint and other cotton products. For China, exports of consumer goods, particularly to Uzbekistan and the Kyrgyz Republic, could expand further, particularly in processed foodstuffs, food processing equipment and technology, and some electronic goods. Better roads and a railroad between China and Uzbekistan would contribute substantially to realizing these opportunities. Asian Development Bank funding for these investments is now becoming available.

China's status as a major trading nation and locus for foreign investment has probably had less of an effect in Central Asia than elsewhere in Asia. Countries like Singapore, Korea, Thailand, the Philippines, Taiwan, and even Indonesia, have been losing market share in the United States and the EU to Chinese-made goods that these countries formerly manufactured themselves. Since none of the CARs had ever gained market share in the major Western markets, they have not suffered from competition with Chinese goods. Russian exporters, however, continue to compete with Chinese products in the former's traditional markets in Central Asia.

One positive effect on the CARs that stems from increased trade with China has been an improvement in the quality standards applied to export-related goods. China, in general, demands a higher quality product than these countries were required to meet for Soviet or post-Soviet markets.

One negative impact, however, relates to China's insatiable demand for copper. Chinese copper imports have been growing at about 30 percent annually as China upgrades its power grids and installs telecommunications cables throughout its western regions. This has led to smuggling and unrecorded trade of illegally obtained copper supplies. In the Kyrgyz Republic, for example, copper equipment has been stolen from the Kyrgyz electricity grids and sold to markets in Xinjiang, negatively affecting electricity production and distribution in Kyrgyzstan.

Energy Trade and Investment

China's rapid economic growth, and its emphasis on the "development of the west," including Xinjiang Province, are having a significant impact on energy developments in Central Asia and Russia. The Commission's recent hearings dealt in

great detail with China's energy needs, and that information need not be repeated here. Suffice it to say that China is about to surpass Japan as the world's second largest oil importer, and is expected to import more than 200 million tons of oil annually by 2015.

Kazakhstan, along with Russia, is the closest available source of energy in the quantities needed by the Chinese economy. This has spurred China to explore major investment opportunities in Kazakhstan's energy sector, and to investigate the feasibility of constructing major pipelines from Western Kazakhstan to Xinjiang Province. CNPC has made a large investment in the Kazakh oil firm, AKTOBER-MANAIGAZ, and there is a joint CNPC/KazMunaiGaz effort being explored to construct a pipeline from Atyrau and Kenkiyak, with a 1,300 kilometer second stage planned from Atasu to a rail junction at the Kazakh border. China also attempted to become a partner in one of the major U.S.-European-Kazakh oil production ventures on the Caspian Sea but was excluded by the existing partners. Since the Chinese tend to take into account economic, as well as energy security issues in their investment decisions, they have deferred the potential pipelines from Western Kazakhstan to Xinjiang until there is enough production to meet the 400,000 barrels per day (bpd) volume that will make this pipeline commercially viable.

China's Vision for the Shanghai Cooperation Organization (SCO)

The Chinese see the opportunity to satisfy several of their strategic economic and security goals through a strengthened Shanghai Cooperation Organization. Originally conceived in 1996 by China, Russia, Kazakhstan, the Kyrgyz Republic and Tajikistan as a cooperative effort to ensure regional security, the original "Shanghai Five" evolved into the "Shanghai Forum" at a meeting in Dushanbe in July 2000. The Forum agreed to cooperate in fighting terrorism and Muslim extremism from both domestic and foreign (Afghani) sources. At this meeting, which Uzbekistan attended as an observer, a proposal was put on the table to consider economic, as well as technical cooperation. Uzbekistan has subsequently joined the group, which has evolved further into the Shanghai Cooperation Organization with headquarters in Beijing, and secretariat support provided by the PRC. China's Ambassador to Russia, Zhang Deguang, has been appointed the Executive Secretary.

Chinese leadership has contributed to the institutionalization of the SCO and an energized program in several areas of key importance to the Chinese leadership. It offers China a framework within which it can pursue its key strategic goals of political stability and greater regional economic cooperation. The new SCO military initiative against terrorism and Islamist extremism provides a regionally-acceptable justification to clamp down on Uyghur efforts to promote a separate state in Xinjiang. It also helps to assure border security and to reduce drug trafficking, one of the most important reasons for skyrocketing increases in HIV disease throughout Central Asia and Western China.

Further, from the Chinese perspective, the SCO counter-balances the growing U.S. military presence in the region and allows China to avoid voicing its concerns about a long term U.S. military presence in its backyard; a stronger SCO in which China has a dominant role is a non-threatening way to assert Chinese influence in Central Asia that does not overtly confront U.S. military or political objectives. A recent article in a well-known Chinese journal commented how the SCO helps China to maintain "restraint" towards the United States, despite America's "ever growing unilateralism" and the "formation of a power structure like the Roman Empire."

Finally, the SCO offers China a framework within which it can pursue its energy security goals. A Chinese Commerce Ministry Trade Institute publication in August 2003 stated that "The greatest economic benefit that China can achieve in the Shanghai Cooperation Organization is the acquisition of the energy resources needed for our country's sustainable economic development and the exploitation of the Organization's role as an Eurasian continental bridge." The article then goes on to say that increased Chinese investments in Central Asia not only help China to achieve its economic objectives but also to satisfy certain political goals as well. Stronger economies in the CAR contribute to regional stability. Further, China's economic support can only enhance China's image as a true "partner" in contrast with the "double-sided nature of the U.S." or the limited capacity of Russia to provide real economic assistance.

Russia and China: Impact of China's Growing Economic Strength

Russia has responded pragmatically to recent strategic changes in Central Asia, seeking to maintain both its significant economic and political position and its military presence in order to neutralize China's growing economic and diplomatic initiatives and America's military inroads. Along with China, Russia was a driving force

in the establishment of the SCO, and has a great deal at stake in its success. The SCO reflects, in part, improved Russian-Chinese relations that have led to border demilitarization, expanded trade, and the June 2001 “Good Neighborly Treaty on Friendship and Cooperation” that was the first such treaty between the two countries in several decades, partly in response to concern about U.S. policies.

Beijing became concerned, however, in the post 9–11 period, that the U.S.-Russia Treaty of Moscow and the creation of the NATO-Russian Council would shift Russian priorities away from the SCO to European matters. Such a move would weaken China’s relative position in the Beijing-Moscow-Washington strategic triangle.

Despite Chinese concerns, it would appear that the Russian-China relationship vis-à-vis Central Asia will remain solid, particularly as long as the United States continues its proactive military position in the region. There is substantial bilateral trade—about \$12 billion this past year—between the two countries that has benefited Russia substantially as the Chinese economy has grown. There is the prospect for major Chinese investment in the Russian oil industry in the central and western part of the country. And there is the joint policy of zero tolerance towards Islamist and separatist movements that is a primary motivating force behind the Shanghai Cooperation Organization. As long as Chinese inroads in Central Asia remain economic, rather than military, it is likely that the two countries will see a commonality of interests that will strengthen their cooperation. The SCO will serve as a mechanism through which that policy can be translated into visible steps of a military and economic nature. The multilateral approach to Central Asian security and economic cooperation that the SCO facilitates serves the interests of both Russia and China in counterbalancing the growing economic, military and political presence of the United States in the region. (Certainly the Russian base at Kant, in Kyrgyzstan, offers Russia the symbol it needs to reassert unilaterally its military influence in the region.) At the same time, however, the SCO can also serve as a collective partner with the U.S. in attacking the joint enemy of militant Islamist movements. And from the Russian perspective, the U.S. presence in the region also counterbalances Chinese efforts to strengthen its military or diplomatic cooperation with the Central Asian Republics; Chinese military interests in Kyrgyzstan to bolster its campaign against Uyghur separatists in Xinjiang is a case in point.

How Does China’s Growing Economic Strength Affect U.S. Interests in Central Asia?

American policy towards Central Asia seeks to combat Islamic extremism and terrorist activities that could threaten the political stability of the region and U.S. access to Central Asia’s vast supplies of oil and gas. The U.S. also asserts its support for more rapid movement towards democracy and market-based economic systems, but it has subordinated these universal American foreign policy objectives to its anti-terrorist campaign and American firms’ access to energy.

The fact that China and the U.S. have a meeting of the minds on the anti-terrorist objective has minimized potential diplomatic conflict between the two countries in their respective Central Asia initiatives. The U.S. military presence in the region, as well as the Chinese-led SCO military exercises have been directed to the same goal and are viewed as complementary rather than competitive. Over time, however, this shared interest may come into conflict with other U.S. objectives.

For example, it is likely that political instability will characterize the transition from the current post-Soviet authoritarian regimes in Central Asia to the next set of political structures. Should there be “velvet” revolutions similar to those that occurred in the then Czechoslovakia or in Georgia last month, U.S. support for the new regimes would undoubtedly be forthcoming, as long as democratic principles underlie the ideology of successor government leaders.

China’s concerns may be different, however. The Chinese fear instability within the CARs because of its potential to generate greater pressures for Uyghur separatism in Xinjiang. The existing autocratic regimes can be counted on to suppress any domestic opposition from Muslim extremists or other nationalist groups; more democratic regimes may be more tolerant of minorities’ claims for recognition, and by the same token, more willing to support Uyghur nationalist ambitions in Xinjiang. The Chinese are probably more aware of these potential policy divergences than the U.S., and are using the Shanghai Cooperation Organization as a vehicle to suppress Islamic terrorism and any associated separatist movements.

Chinese concerns in this area go way beyond Afghanistan, the Islamic Movement of Uzbekistan, or any of the other existing Islamic organizations, whereas American interests fall short of condemning the legitimate nationalist aspirations of the Uyghur people. The U.S. decision to categorize a key Uyghur nationalist movement as a terrorist organization was undertaken to gain Chinese support for U.S. foreign policy elsewhere in the world, and did not necessarily represent an unwillingness

to recognize some kind of legitimate minority status for Uyghurs within the PRC. What happens in Central Asia as the current regimes evolve into the next stage of political rule may affect U.S.-Chinese diplomacy in this regard.

The area with the greatest potential for problematic competition, however, is access to the region's oil and gas supplies. It is clear that the Central Asian countries benefit from multiple markets for their oil and gas. The one country that has only one outlet for its exports, Turkmenistan, has little leverage on the prices it negotiates with its Russian buyers. Kazakhstan and Uzbekistan are aware of this situation, and the former, in particular, intends to maximize the number of players investing in and buying its vast oil supplies and to retain the freedom to pursue the best deal offered by any of the players. Kazakhstan's foreign minister told The Asia Society in September that "as far as pipelines are concerned, our policy is clear and simple: have as many export routes as possible." This means that the Kazakhs are likely to pursue actively additional Chinese investments in oil field development and pipeline construction.

Should the U.S. be concerned? To the extent it is advantageous for these countries' economic growth to have diversified markets for their oil and gas, U.S. interests are well served. The U.S. gains, as well, if supplies of non-OPEC sources of oil are expanded through Chinese investments. Also, if China is able to obtain greater quantities of petroleum products from its neighbors in Central Asia, sources closer to the U.S. in the Middle East, Africa and Latin America will become more available to the United States.

U.S. influence in the region will remain strong in any case. American and European business practices, cutting edge technologies and capital base are attractive to, if not essential, for Central Asia to realize its full potential in the energy sector. Neither Russia nor China can provide the expertise and funding needed to exploit these vast resources. Furthermore, the Central Asian nations view the U.S. presence as a positive counterweight to Russia and China, and American involvement will continue to be a priority for these countries' foreign investment strategies.

The U.S. should remain vigilant towards Russian and Chinese goals and actions, but countering these actions should not be the principal motivating factor in U.S. policy towards Central Asia. It is equally important that we continue to press for political reform, democratic approaches, and market-based economic systems in order to promote the kind of economic and political governance that will best contribute to the long term stability of these countries. We should also provide assistance in the use of oil and gas sector royalties for poverty alleviation and economic development in order to create the broad-base of economic and political support that can withstand the threats from Islamic extremism and endemic corruption.

These latter goals demand that the U.S. remain committed to the growth and development of the Central Asian Republics for the long term, perhaps well beyond the time period needed to stamp out Islamic terrorism coming from Afghanistan or other parts of the region. We must continue to support realistic, sustainable, economic assistance programs that bring about real gains for all segments of the population. In this regard, we should welcome Russian and Chinese initiatives that are consistent with our long run objectives and not respond in a knee-jerk fashion that labels any such initiative a threat to U.S. interests.

Table 1 Poverty Indicators in Central Asia and China: Per Capita Incomes and Infant Mortality Rates

	GNI/Capita		Infant Mortality Rates (deaths per 1,000 births)
	1998	2002	2001
China	790	940	31
Kazakhstan	1,350	1,510	81
Kyrgyz Republic	350	290	52
Tajikistan	180	180	91
Turkmenistan	530	1,200	69
Uzbekistan	620	450	52

Source: World Bank

Co-Chair BARTHOLOMEW. Thank you, Dr. Blaxall. Dr. Lal.

STATEMENT OF ROLLIE LAL, Ph.D.
POLITICAL SCIENTIST, RAND CORPORATION

Dr. LAL. Thank you. Thank you, Madam Chairman and Commissioners, for giving me the opportunity to speak with you today. What I'm going to do is summarize briefly some of the key aspects I see of the economic and security relationship between China and India and South Asia.

Today, what we're seeing in Asia is what I would consider a somewhat remarkable shift in relations between India and China. Both of these countries are actually moving closer together in a change that may change Asian security as a whole.

Indian Prime Minister Vaipayee's visit to China, to Beijing, earlier this year produced some agreements that are helping to resolve their long-standing border dispute, increase trade and decrease distrust. Another factor that's working in this direction is the growing economies of both China and India. But while the probability of war between both China and India is increasingly low, what we can also see is that economic competition exists and tensions from both China-Pakistan relations and, as Dr. Steinberg mentioned, China-Burma relations could still cause friction between these countries.

China has had a profound economic impact on India in the past. China first set an example for India in the 1980s with its economic reforms which were very successful and propelled China very quickly to economic success, but India took the cue and did not implement reforms until about a decade later after an economic crisis. So one of the effects of this is that as China's economic growth has moved forward, it has decreased China's incentives to have conflict with India. As India has followed in its steps with liberalization and reforms, it has come to the same conclusions.

Domestic issues in both countries are also pushing them in this direction right now. Both countries are facing serious internal problems, both ethnic unrest, separatism and income disparities and also integrating the economies with the world economy.

It appears that territorial disputes are not furthering the agenda very well on that front. In particular, for China, as mentioned earlier today, the high tensions with Taiwan are giving it reasons to resolve some of its other foreign disputes. Also, the separatist movements in Xinjiang and Tibet are pushing it in this direction, draining its resources to looking at internal issues rather than external.

The difference for India is that India's domestic problems, although they did include the ethnic unrest and separatism, India's main domestic problems that it's trying to focus on at this time are its domestic economy. India is trying to match China's economic growth rates. Growth rates in India have averaged approximately six percent per year for the last decade, but it needs to be much faster than that in order to eradicate poverty and raise living standards in a real way.

Also, tensions with China and Pakistan have posed a serious economic hurdle for India in the past by both deterring foreign investment and draining budgetary resources. Both countries are also coming to the conclusion rapidly that a breakthrough in relations is likely to lead to greater trade opportunities.

A decade ago, bilateral trade between China and India was approximately 300 million per year. It's now standing at about five billion and by 2005 it's expected to double to approximately ten billion per year, still a small sum for China's trade relations, but the rate of change is rapid and in a positive direction.

These changes mean greater interdependence over time between China and India. However, it also means that there will be greater competition. India wants China's high growth rates and competitiveness, particularly in the consumer goods sector. In the past, Indians have been very worried about cheap Chinese goods flooding the Indian market and the possibility of hollowing out of their own domestic manufacturing sectors.

But in the last few years, we're seeing again a difference. Indian businesses are not looking at China more as a model for foreign investment and manufacturing success. On the other hand, what we're seeing is that China is hoping to copy India's success in information technology. Media reports right now in China are showing that businesses there are now increasingly worried about India's competitiveness in microchip manufacturing in particular.

Chinese analysts are saying that because India's salaries are lower, costs there are cheaper making their goods more competitive. So in a very strange turn of events, what we're now seeing is that the Chinese are asking if their market is likely to be flooded by cheap Indian goods, though they've still got a way to go before that happens.

On the side of security relations, what you can see is that China and India have had a tense past. Again, as mentioned by Dr. Steinberg, China and India fought a border war back in 1962 that India lost leaving both countries extremely suspicious of one another. Although diplomatic relations were reinstated after 1976, both sides had thousands of troops on their disputed order in the years since then.

In '98, India's nuclear tests were interpreted by China as directly aimed at China, and then the Indian Defense Minister statements basically stating that China is the main threat of India did not make the situation any better.

However, now, both countries are making statements saying that the remaining border disputes are not actually worth a military conflict or war. India's decision earlier this year to formally accept Tibet as a part of China and China's flexibility on the issue of Sikkim as a part of India are moving this process forward more rapidly.

And it's also important, I believe, to not underestimate the U.S. role in this situation and relationship. The idea of the U.S. being able to use India to contain China has provided Chinese strategists, I believe, with a real reason to warm relations with India. A closer relationship between China and India could make it difficult for the U.S. to bring India into an effective containment strategy.

We can see the shift in their security relations most concretely in their new military cooperation. The first military exercises took place between China and India last month in November of this year. Both countries took part in a joint naval search and rescue exercise off the coast of Shanghai.

Having the militaries work together in this way is very important in their bilateral relationship, though it is not that significant militarily in terms of the countries, the other countries in the region. They are most likely to work as a type of confidence building measure and decrease the probability of conflict.

Now, moving to China's relations with Pakistan a little bit, China, as you probably know, has had a very close relationship with Pakistan, both during the Cold War and during the 1990s. China's military assistance to Pakistan including the possible transfer of the nuclear and missile technology to Pakistan has been a serious problem in India-China relations over the years.

However, now China is emphasizing more a balanced strategy towards South Asia. The shift may actually be a result of India's rising importance in Asia, but it could also be partially the result of some other factors that are Pakistan-centric.

Pakistan's transfer of nuclear technology to North Korea may have placed China in a somewhat difficult position in Northeast Asia and with the international community where China is, of course, expected to some extent to help defuse the situation.

In addition, whereas Pakistan's past support of fundamentalists groups was not really a priority for the Chinese, reports now show that the number of Uyghurs that have been trained in Pakistan could have caused some problems for China in Xinjiang. As a result of this, the issue has effectively become a liability for Pakistan in its relations with China.

However, despite these problems, it's important to note that the strong historical relationship between China and Pakistan is unlikely to just disappear very rapidly. Military cooperation is continuing between the two countries and China may also want to maintain close ties with Pakistan in order to keep a sort of hedge against being surrounded by hostile powers in Asia in the future.

In conclusion, I would just like to note that close relations between China and India, in particular, do have some far-reaching implications for U.S. foreign policy. For India, while maintaining close relations with the U.S. will remain the number one priority, keeping good ties with China is apparently a more increasingly important priority for them as well.

Close relations between these two countries, of course, also means that it's very difficult increasingly to play India off against China, but at the same time a more secure India does make a more stable partner in Asia and a less volatile situation in Asia as a whole.

Thank you.

[The statement follows:]

**Statement of Rollie Lal, Ph.D.
Political Scientist, RAND Corporation**

China's Economic and Political Impact on South Asia *

Thank you Madame Chairman and Commissioners for the opportunity to speak before the Commission today. After decades of tensions, India and China are moving

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closer in a shift that is affecting the strategic realities of Asia. A recent visit to Beijing by Indian Prime Minister Vajpayee has produced a promising set of agreements to help settle the long-standing border dispute, increase trade, and decrease mutual distrust. A critical factor in drawing the two countries together has been their growing economies. However, while the probability of military conflict is increasingly low, bilateral economic competition could be the source of possible friction in the relationship.

Implications of China's Economic Power

China's economic growth and liberalization has affected India in significant ways. China set a positive example for India in the 1980s by liberalizing its economic system and transforming China into an economic success story. However, the lessons of China's modernizations were implemented by its neighbor a decade later, after an economic crisis forced India to reform its bureaucratic economic system. China's economic growth and wealth has also decreased the incentives for it to engage in conflict with its neighbors, increasing its initiatives to make peace with India. Similarly, India's liberalization and growth has led its leaders to accept the same conclusion.

China and India are currently addressing their challenges with very similar programs that are meant to propel their economies and strengthen their militaries. Both countries face the threat of growing income disparity, ethnic unrest, and separatism and both China and India are focused on modernizing and developing their economies to integrate more closely with the rest of the world. Minor disputes over territory do not further this agenda well. For China, high tensions with Taiwan provide a good reason to resolve old quarrels with India. In addition, China has concerns with internal security. Separatist movements in Xinjiang and Tibet continue to absorb much of its attention, and reflect problems that China is facing regarding its ethnic composition. Rising unrest from unemployment and gaping inequalities in income distribution between regions are exacerbating these ethnic divides. Securing its external borders and relations with neighboring countries allows China to focus on these growing internal problems.

Indian policymakers are more confident than their Chinese counterparts regarding their ability to deal effectively with domestic ethnic and economic forces. In fact, they overwhelmingly state in interviews that the unity of the Indian state does not hinge upon keeping Kashmir, whereas in the view of most Chinese policymakers, a separation from Taiwan could mean the end of China as we know it.

Rather than worrying about the country disintegrating, India is trying to refocus its national efforts on economic growth in order to match China's success. Indian growth rates have averaged 6% in the past decade, but growth needs to be even faster to eradicate poverty and raise living standards. Conflict and tensions with neighboring China and Pakistan have posed a large economic hurdle for India in the past, impeding foreign investment and absorbing critical budgetary resources. Moves by Vajpayee's government to foster ties with Pakistan complement the recent initiatives in China, and could eventually lead to a significant demilitarization of India's northern borders.

A breakthrough in relations with China is also likely to mean a tremendous growth in trade between the two countries in coming years. Whereas a decade ago, trade volume was a paltry \$300 million per year, it has now increased to \$5 billion, and growing. Trade estimates for 2004–2005 are closer to \$7 billion, and trade is expected to reach \$10 billion by 2005–2006. These changes mean a boost to the Indian economy, and greater interdependence between the two economies.

Of course, the field for competition has also shifted to economic interests. India eyes with envy China's rapid growth rates and competitiveness in the consumer goods sector. For years, Indians were worried that cheap Chinese goods were flooding the Indian market and threatening domestic manufacturing. In the past few years, however, businesses are looking to China more as a model for attracting foreign investment. The difference in FDI to the two countries is stark, China drew an estimated \$52.7 billion in FDI in 2002, whereas India attracted only \$5.5 billion. Indian businesses realize that much effort is needed to match China's performance in this arena, including added attention to education, infrastructure, and less bureaucratic entry and exit procedures for businesses.

China, for its part, is hoping to emulate India's success in the information technology arena. In China, recent media reports indicate that concerns are rising regarding India's increasing competitiveness in microchip manufacturing. Chinese analysts argue that because India's salaries are lower, costs are cheaper, thereby mak-

and private sectors around the world. Rand's publications do not necessarily reflect the opinions of its research clients and sponsors.

ing Indian products more competitive. Language is also a factor in China's concerns. Businesses in China fear that U.S. businesses will prefer Indian products because of the Indian facility with English relative to their Chinese counterparts. In a strange turn of events, the Chinese population is now asking whether their market is likely to be flooded with cheap Indian goods. With common strengths and export markets, trade competition is inevitable. But competition on economic terms is beneficial for both countries.

Security Relations

Both countries fought a border war in 1962, leaving a sense of suspicion and tension between the two countries in the following years. Diplomatic relations were reinstated in 1976, but both sides have retained thousands of troops along their disputed borders for years. Complicating matters further, India's 1998 nuclear tests were initially interpreted as a hostile maneuver aimed at China. The situation was exacerbated by the Indian Defense Minister's statement claiming that China was India's main threat. Since then, both countries have slowly come to the understanding that their national interests can be compatible. When asked, leading officials and scholars in both countries state that remaining disputes on borders are not worth a war. As the populations of these two countries comprise a total of a third of the world, this is no small achievement. Furthermore, India's decision to formally accept Tibet as a part of China, and China's decision to show flexibility on the issue of Sikkim in recent discussions has helped to ameliorate relations.

The U.S. role in Asia is undoubtedly a significant factor in China's strategic calculus with regard to India. Calls within the U.S. to work with India to contain China have provided Chinese strategists with a reason to warm relations with India. A closer relationship with India is beneficial to China in that it precludes the U.S. from being able to co-opt India into a containment strategy, whereas the existence of tensions between China and India would provide an ideal opportunity for both the U.S. and India to work together in containment.

China and India's growing economies and trade ties have also had considerable influence on improving their security relationship. Both countries have come to the understanding that economic cooperation is the key to the future, and closer diplomatic and security relations must follow.

The shift in relations has been manifested most recently in the first bilateral military exercises between China and India that took place in November 2003. Both countries engaged in a joint naval search and rescue exercise off the coast of Shanghai, a significant move in their relationship, though limited in its military significance. Working together in the military arena will undoubtedly decrease the possibility of miscommunication and misunderstanding, making conflict less and less probable. The joint exercises also serve as confidence building measures between the two countries militaries. However, the exercises do not mark the beginning of a security alliance by any means. China and India will take time in deepening their security ties. Trust will need to be built through expanding economic interdependence, political agreements, and further military cooperation to create a mature and stable relationship.

China and Pakistan

China's relationship with Pakistan has also been shifting in recent years. During the Cold War and the 1990s, China maintained a close relationship with Pakistan, to India's disadvantage. China's military assistance, including the possible transfer of nuclear and missile technology, to Pakistan has been a persistent irritant in Sino-Indian relations. However, China has in recent years emphasized its intent to pursue a balanced foreign policy towards India and Pakistan, a change from the past policy that was markedly in Pakistan's favor. This shift is likely a result of India's growing significance as an economic and military power in Asia. However, other issues are increasingly affecting China's relations with Pakistan. Revelations of Pakistan's transfer of nuclear technology to North Korea have placed China in a difficult position vis-a-vis the international community and North Korea. China finds that it must now scramble to defuse the situation in Northeast Asia created by North Korea's nuclearization. In addition, whereas Pakistan's support for fundamentalist groups was previously not a priority to China, reports now indicate that the numbers of Uighur separatists trained by Pakistan has created problems for China in Xinjiang. As a result, the issue has become a liability for Pakistan in the bilateral relationship. Nonetheless, the strong historical relationship between the two countries is unlikely to disappear. Military cooperation continues, and China may want to maintain close ties with Pakistan as a hedge against being surrounded by a hostile U.S., Japan, and India in an unknown future. However, cooperation with Pakistan will increasingly be tempered by the current trend of warming ties with India.

Implications for U.S. Interests in South Asia

The implications of closer Sino-Indian relations for U.S. foreign policy are far reaching. Although India's close relations with the U.S. will remain a priority, maintaining positive ties with its large neighbor will probably be increasingly important to ensure future security. A warming of ties between these two countries also means that the U.S. needs to understand that China, India, and Japan could work cooperatively in the future, and attempts to play off India against China may be unlikely to bear fruit. At the same time, a more secure India will mean a more stable partner for the U.S. in South Asia, a less dangerous Asian dynamic, and a more attractive destination for U.S. investment in the future.

Co-Chair BARTHOLOMEW. Thank you, Dr. Lal. Commissioner Dreyer, you're up first.

Panel IV Discussion, Questions and Answers

Co-Chair DREYER. Okay. Thank you. Dr. Steinberg, I certainly share your opinion, that the United States cannot have a human rights-centered policy as the only string in its bow. And I was amused at your statement that China has done everything right and Japan has done everything wrong. And yet about five years ago, Japan actually extended aid to Burma with the explicit purpose that Burma should not be isolated too closely with China, and there was a lot of criticism of that at the time. So Japan in this case did what you think is the right thing took a lot of flak for it.

And I was wondering, as you talked, what would be your policy recommendation for the United States to engage Burma? Obviously, we cannot be seen to be backtracking on, you know, we don't care what happens to Aung San Suu Kyi, as if we no longer care about her and give the impression that the SLORC, now known by a new name is not so bad after all, and that sort of thing. So how do we get ourselves out of this box we've put ourselves in?

Dr. STEINBERG. Well, we've put ourselves in one. They, of course, put themselves in their own box. I mean we have to say that first. And they have been totally oblivious to what kinds of actions would improve their own situation. They've missed every opportunity they could take at no expense to themselves to improve their situation.

The problem is this: now that we have sanctions, and as I say, I've been in favor of military sanctions but not the economic sanctions, now that we have sanctions, we cannot simply stop the sanctions now, because that would be a reward for no action. That's quite clear.

We can do something, perhaps with the executive order, if they in fact took some significant steps to improve, and I have in my visits to the people in Burma, and to the Burmese ambassador here, have said that you need to take some significant action so that there can be some amelioration of the situation.

The first action they could take would be a clear explicit timetable for the quote "roadmap" that Prime Minister Khin Nyunt has set forth. They've been reluctant to do that according to them because the opposition would sabotage that roadmap, and I said that's a price you may have to pay, but it's better to take that chance than to not have a roadmap because nobody believes that this is going to really happen.

I think it will happen, but I don't think the military will give up complete control. I think they will have veto power over any future government, civilianized or not. Now what should the U.S. do?

We have engaged in a position where we've asked them for unconditional surrender. We've said basically: recognize the May 1990 elections and then we'll talk to you, which means get out of power and then we'll talk. They're not about to do that.

We need to save face, everybody's face. Face is not Asian. Face is universal, and it's our face, the administration and the Congress's face. It's the NLD'S face and Aung San Suu Kyi's and it's the military as well.

Every time we publicly lambaste them, they have to have a nationalistic reaction. Prime Minister Khin Nyunt, whom I saw just before he was made Prime Minister in August, said we will have to fight against—I mean, stand up to the Americans, not fight physically but stand up because we can't be put upon this way with the sanctions and the Executive Order freezing assets.

What we need to do is to have a concerted policy. Getting Japan in there is very important because Japan in the past has had more access to the country than any of the industrialized states.

And so therefore we need a concerted policy. Prime Minister Koizumi has been very strong recently in contrast to earlier Japanese positions, since the May 30 incident where many people were killed in central Burma, but right now we need to have to have this very quiet intense dialogue with staged steps: if you do this, and we specify what that is, we will then, let's say, stop freezing assets. If you take a second step, we will nominate an ambassador or do whatever, and then the final step would be getting rid of sanctions at some future date when you say, okay, you have a date for a free election, and that free election is certified by appropriate people, that in fact it was free.

So I think we need to do that, but right now we are not looking at the process. We are looking at the product. The product is change of regime. What we need to look at is the process of how we get a regime to be more democratic, and that's what is lacking right now.

Co-Chair DREYER. Thank you.

Co-Chair BARTHOLOMEW. Dr. Steinberg, I was not going to take the time just yet, but it's interesting given your discussion of how much influence China has in Burma. Would it not be an option that we would or should or could ask that the Chinese government use some of the leverage they have with the Burmese government in order to address the issues that are of concern not just to this nation but also to other nations around the world?

Dr. STEINBERG. I agree completely and Senator Lugar did an op-ed piece a couple months ago where he talked about this. I met with the Chinese charge' in Rangoon in the first week of August. He wouldn't see me last year, but he did see me this year. And I said it is in China's national interest that you do something about this regime and get them to reform.

You think that Burma is in your geopolitical interest, which I admit it is, but an unstable government, wars on the border, narcotics trade and HIV that infiltrates into China, this is not in your interest. The only way this is going to change is if you put pressure on the regime to change. I said I hear that there is a high level delegation going to Beijing the end of August. He said how do you know that, and I said, well, Burmese friends tell me things.

And they did go, and I said that is the time for you, the Chinese, to tell the Burmese, you've got to reform. And I think the U.S. Government is interested in this as well, and I think that is a very important avenue we should pursue, yes.

Co-Chair BARTHOLOMEW. Thank you. Chairman Robinson.

Chairman ROBINSON. Thank you. I have two quick questions, one for Dr. Lal concerning China-Pakistan relations. I don't think we need to revisit the nature of the military and strategic relationship between the two. It's pretty clear where China stood on supplying Pakistan's nuclear program as well as missile development and you mentioned that this type of military cooperation is still continuing. Perhaps it's of a different character or slightly lower key than the earlier dangerous transfers that are a matter of record.

I'm curious if that's the case because it strikes me that if you have China shipping components for ballistic missiles, or offering assistance of any kind to Pakistan's nuclear weapons program, you are obviously dealing with the vital national security interests of India. All of the confidence building measures, all of the efforts to improve Chinese-Indian relations it strikes me are more than offset by the potential consequences of these kinds of irresponsible Chinese transfers.

Is that a reasonable assertion and what's your view of the character of the military transfers today? Are they as troubling as they have been in the past? Thank you.

Dr. LAL. I think that's a very important comment. I would have to agree with you to a large extent that China's military cooperation with Pakistan at this time is still continuing, and, yes, that is a very troubling aspect for India, particularly because of the missile components and missile capabilities, which is Pakistan's main capability of wielding any destruction on India really at this time.

However, having said that, I would have to say that it doesn't completely negate the confidence building measures happening on China and India on the other side, simply because one of the largest hot spots for China and India in the past was their own border dispute.

So I think what's really happening, one thing that India was very concerned about in the past was the two front problem, the northeast border and the northwest border possibly being attacked at the exact same time, thereby putting its military in a very difficult situation.

So what's going on right now is I think the Indians are probably somewhat pleased that they can demilitarize to some extent over time possibly the northeastern border and focus more on the northwest. Of course, Chinese assistance to Pakistan does still make it extremely volatile, and I think I would have to agree with you in the sense that that will probably be the long-standing issue between China and India in the future right now is waiting for that to be resolved.

Chairman ROBINSON. Thank you. And Dr. Steinberg, I was also interested in an elaboration on a couple of comments you made. First, if you have a chance to explain a little bit more about the nature of the overland route of Chinese energy imports through Burma, as a way of avoiding the vulnerabilities of the Strait of Malacca. What kind of scale are we talking about, and is this in the

strategic category? Could this become a very important energy conduit for China?

And the second related question on China-Burma military cooperation. You mentioned that Chinese listening posts are already in place on the coast of the Bay of Bengal. We've heard various reports of other military infrastructure that China has put into place in Burma. Do you have any information as to the scale and substance of that dimension? Thank you.

Dr. STEINBERG. On the question of the overland route, it won't be operational in the foreseeable time. It's not like having a pipeline to the oil supplies of Central Asia. But the idea has been that Bhamo, which is on the Irrawaddy River, which is navigable, oh, I don't know, 800 miles up from the Bay of Bengal or so, 70 miles from the China border, which was the old mule station for the entry into China from the South, now China would move supplies down through Bhamo and then by cargo and container down the Irrawaddy River and then across the Arakan Yoma to the port of Kyaukpyu which they are developing, and that's a deep water port on the Bay. That would be very important. Now this would be significant but it wouldn't challenge any of the other major routes of supply.

But it is important, and the other part of this is that China needs Burma and Southeast Asia for its trade because Southwest China can't compete with the east coast of China in shipment of goods and export of goods. The costs of shipment are just too great.

On the military side, it's a little more complex. I cannot say what is happening except that the modernization of the Burmese army has been by China. They have significantly increased its capacity. The Burmese have increased its military from 186,000 approximately in 1988 to 400-450,000. The target is supposed to be half a million, which, with the demilitarization of much of the Vietnamese army, would make it the largest army in Southeast Asia, a labor intensive army as opposed to, let's say, a Thai army which is a capital intensive on a U.S. model.

Chairman ROBINSON. And in my remaining seconds here, the Burmese deep water port that you referenced, does China have any naval presence there or plan such a presence?

Dr. STEINBERG. Not that I know of, but there have been reports of a capture of a Chinese fishing vessel off the Andaman Islands which is a major Indian defense port which is close to the Cocos Islands which is a Burmese one north of that. This supposedly fishing vessel was full of electronic hearing gear, so we assume.

Co-Chair BARTHOLOMEW. Commissioner Reinsch.

Commissioner REINSCH. Thank you. I don't want to weigh into Burma, but I do want to thank Dr. Steinberg for his comments on the negative aspects of unilateral economic sanctions. I think you are right on target. In my organization, we call them chicken soup diplomacy. They make us feel better but they don't really do any good, and in this particular case they do have a very clear adverse effect. They hurt the poor people of Burma.

They hurt the people that are powerless, the people that can't do anything about it. They don't hurt the people that are causing the problems. They don't hurt the government. They don't hurt the military. We think we've accomplished something, and in fact we

have made the situation worse there and we put ourselves in a more difficult situation for precisely the reason that you said, we can't get rid of them now without going through a very complicated process.

You're also quite right that we ought to be focused on the process and not the end product, and I thought that was a very thoughtful answer to the previous question. Let me ask just a couple questions, first to Dr. Blaxall. Could you comment briefly on how you see the timing and feasibility of oil or gas pipelines from Central Asia to China?

Dr. BLAXALL. The most important pipeline under construction is one from Western Kazakhstan to the Chinese border at Xinjiang Province. This idea originated back in 1997 when the Chinese National Petroleum Company (CNPC) obtained a 60.2 percent ownership share in the Kazakh firm, AktobeMunaiGaz, which operates two oilfields in Aktyubinsk (Kenkiyak and Zhanazhol). CNPC proposed to build a 2,800 kilometer pipeline from west Kazakhstan to Xinjiang, and then to China's Pacific Coast. This pipeline was to carry 400,000 barrels per day (bpd), or 20 million tons per year to start with, and to eventually double this capacity. This pipeline was to start at Atyrau situated at the northeast corner of the Caspian Sea, and link up with the existing pipeline from Pavlodar to Chimkent. However, since then it has become clear that Chinese production is not yet adequate to make this pipeline economically feasible, and it has been put on hold until production increases to the point where Kazakhstan can guarantee 400,000 bpd.

Two other pipelines involving CNPC have been or could be constructed. There is a pipeline from Kenkiyak to Atyrau that was constructed between June 2002 and March 2003, a distance of almost 450 kilometers. This pipeline, with a capacity of six million tons per year (240,000–300,000 bpd), connects China's Aktyubinsk field with the Atyrau terminal, thereby offering three export routes: the Atyrau-Samara pipeline through Russia; the Tengiz-Novorossisk pipeline through Russia; and the port of Aktau for shipments down to Iran. The second section of the Kazakhstan-China pipeline would construct a 1,200-kilometer section between Atasu and Alashankou on the Chinese border. This pipeline is currently being studied following visits between senior Chinese officials and President Nazarbayev of Kazakhstan in mid 2003. If it goes forward, construction could begin in mid-2004 and take two years to complete. The final decision on the construction of this link, and of the major link starting at Atyrau will depend upon whether Kazakhstan is able to provide enough oil to make these pipelines economically feasible for China. Given Kazakhstan's other commitments to Russia and its newer Western partners, this remains to be seen.

Commissioner REINSCH. Just to be sort of qualitative rather than quantitative for a minute, what do the people in these countries think of the Chinese?

Dr. BLAXALL. There is, of course, a great deal of interest in China as a market. And there is considerable respect for the economic growth that China has experienced in recent years. At the same time, of course, there is concern about the relative size of the Chinese population and the Chinese economy compared to those in the

Central Asian Republics. In some circles there is wariness as to whether or not China may have designs on Central Asia's natural resources and geography.

Commissioner REINSCH. Thank you. Dr. Lal, it seems to me that the Indian government's attitude over ten or 15 years on what we could just collectively characterize as pro-growth, pro-investment policies has been not entirely constant or consistent. Near term I think they've developed a better record, but there always seems to be lingering in the background the possibility of a reversal of course. This has happened before. What's your prognosis? Have they figured it out or not?

Dr. LAL. I'd say that there's a positive and a negative side to India's economic reforms and both of them are the same thing as their democracy, and I'd say that there is a good democratic trend and a push for economic reforms. Frankly, the BJP, the ruling party basically, was originally a party of protectionism.

Commissioner REINSCH. Right.

Dr. LAL. But when it came in, it was forced by popular pressure basically and business pressure to move forward and join the same economic reform agenda that the Congress Party had taken up eight years before. So the point is that there is definitely a popular surge for economic reforms and especially like I was mentioning before, the China example effect is huge.

They see that China has done it, and this is what can happen. We need to do this too. And there's the Bangalore effect, you know, there's a success story inside of India that they're trying to emulate. However, on the flip side, there is the lost jobs problem, and there is the constant persistent threat that's felt inside of India of foreign domination, of colonialist oppression, and this type of an idea that political parties use to try to slam one another.

And this is what slows down the process. You have a lot of protests, you have a lot of labor protests, you have basically there are serious political domestic political issues inside of India that slow down the process. However, I don't think in any way that they are able to stop it. They are simply slowing it down.

Commissioner REINSCH. Thank you.

Co-Chair BARTHOLOMEW. Commissioner Ellsworth.

Commissioner ELLSWORTH. Thank you, Madam Chairman. Dr. Wang, I know the hour is late and you've made a great contribution along with the other panelists and we the Commissioners have been sitting here all day. But could you reach into your kit of wisdom and judgment and insight and experience in and around China. For a number of years, Dr. Wang was the head of the University of Hong Kong, for example—give us just a few minutes in a nutshell, and you can do it, about the possibilities of the development of more democracy in China.

I know a number of years ago, there were some moves in some of the provinces toward representative government of some kind, a little bit more autonomy—I think that may have come to an end—but, it's an extremely important question from the standpoint of the future stability of China, and of course, it's extremely important to the United States as it's an important strand and vital strand in our relationship with China.

Dr. WANG. That is a very difficult question indeed. I think all I can say is that an overall impression would be that the powerful idea of democracy has been with the Chinese people for a long, long time, and most Chinese, if you asked them whether they want it or not, they would say yes, but if you pursue it further, and say when do you want it, how do you want it, and why don't we have it now and so on, then you'll find all kinds of reasons given why this is not quite the right time, what kind of democracy can they possibly have in China, how would democracy help China right now, all kinds of excuses come out.

But, in general, I would say democracy is a powerful idea with the Chinese. I think they like it. They'd like to see it happen, the ordinary people. But they accept the fact that the experiences of the last 100 years or so has made them rather skeptical as to whether a country as big and complicated as China can cope with this concept just overnight. In other words, they all accept that this is something that would take time.

Unfortunately, that's what they've been saying for decades. And it hasn't been happening. So if you start from the other point of view, we have a system there in China, which has done now reasonably well without democracy. In fact, you find quite a number of the leadership in China pointing to the great successes of very undemocratic economies like Korea, Taiwan, Hong Kong, when there was no democracy and how well they did economically and that China has to go through that stage before we talk about democracy. That's from the leadership.

And that's also argued quite persuasively at many levels that this is something that, yes, would be nice to have, but we can't afford to have it now because if we did try it now, it would affect development growth, economic growth, it would threaten the stability of the country because the people are not ready for it. A whole series of excuses would come from them as well. So from top to bottom a willingness to accept that this concept is a good one, is something that people must have eventually, but always excuses and a reluctance, the lack of will perhaps to try it.

And certainly from the point of view of the leadership of the Communist Party, there is no desire to risk anything that would destroy the party. I think if it were possible for them to be sure of winning any democratic elections, then democracy would be all right.

But since they're not sure of that and nobody could guarantee that for them, then it would probably be safer to leave it alone for awhile until they're a bit more sure.

Commissioner ELLSWORTH. So would you say that there is no viable movement or pressure in an organized way for democracy now in China?

Dr. WANG. There may well be tremendous wish to have one, but as you know the system doesn't allow it. The leadership of the Chinese Communist Party would any attempt to organize a democratic movement.

What they have done is from a top to bottom way allowed for democratic experiments down at the village level, and there has been a lot of that happening all over the country, experiments with democracy at the lowest level in the little villages and hamlets

around the country, and people have been elected. Exactly how democratically it's not possible to generalize. In some cases, we understand it has been genuine. In other cases, not so. The party has intervened.

But altogether experiments are being conducted, but only at the level where it makes no difference to the political power at the top. And I think that will continue for as long as the leadership in Beijing feels that that would help ease some of the tensions down at the village level where of course the rural poverty is something that does trouble the leadership. They do recognize that the growth rate of the country bears no resemblance to the poverty down below, and they are concerned that these people be allowed to at least express themselves in some way or the other, and therefore democracy does provide some way of easing that particular tension.

Commissioner REINSCH. Thank you. It's nice having you here. Thank you so much.

Dr. WANG. Thank you.

Commissioner BECKER. Could I just tack on to that? That's my question.

Co-Chair BARTHOLOMEW. Commissioner Becker.

Commissioner BECKER. I've never known of a situation anywhere in any totalitarian country or communist country in which democracy occurred from the top. Democracy always comes from the bottom. It comes from the people. It usually comes from the workers and freedom of association, demand for that, and it's like a wellspring. When it comes, it will come from the bottom. I just wanted to make that point.

Co-Chair BARTHOLOMEW. Thank you, Commissioner Becker. Commissioner Mulloy.

Commissioner MULLOY. Like Ambassador Ellsworth, I want to fully utilize the expertise of Dr. Wang, or Dr. Steinberg. I need your help to just think through something that troubles me that's in the front pages of the newspapers.

As you know, the United States has no defense treaty with Taiwan. We abrogated that in 1980. The Taiwan Relations Act says that the United States favors a peaceful settlement of the relationship between Taiwan and China. And it further says that we will provide Taiwan what it needs to defend itself. We have no obligation to defend Taiwan under that Act.

Now, it is further the policy of the United States, as expressed by President Bush and others, that we do not support Taiwanese independence. The President of Taiwan is making statements in terms of a political campaign that he's waging for reelection that is causing anxiety in the PRC and I think among some people in this country as well.

Here's what I need to know. There are people in this country who say that even if we don't support the statement being made by the Taiwanese President that if they cause the Chinese to react in a hostile manner to Taiwan, that we have to be there for Taiwan because it's the democracy. They further state that if we are not there for Taiwan, the rest of the Asian countries in Southeast Asia, Singapore, or others that we love and respect, will say we better align with the PRC, because if the U.S. doesn't support Taiwan, it means their role in Asia is gone.

Others would say no, the reaction will be there's the U.S. acting in a very unilateral fashion once again because we won't have anybody else with us. I don't think the Europeans are going to be there. So I'm trying to get a judgment. What do you think the reaction among our Asian friends would be to the type of situation that is now developing with regard to Taiwan?

Dr. WANG. I wouldn't be able to generalize for all the countries that I know of, but I would say amongst many of the countries in Southeast Asia, they accept China's argument, rightly or wrongly, that Taiwan belongs to China. That it is one country. They don't quite buy the idea that it's a purely internal matter, but they vaguely acknowledge that the Chinese have a right to say that, that is it's something within China.

And that seems to be the crux of the problem. If you look at China, if you look at Taiwan as a separate country and therefore China is invading a foreign country, then right is on your side to support the democracy in Taiwan.

But if you acknowledge, if you even just admit that Taiwan actually belongs to China, and there are just two regimes within China, as a kind of extension of the civil war that the Chinese maintain it is, then of course the rights become less clear, and I would say that many countries in Southeast Asia would say, well, if it's that, then why is America intervening in something that is an internal matter of China? So that question whether it is an internal matter of China or not, that Taiwan is part of China or not, becomes the crux of it.

Now, the Taiwanese up to recently had said that Taiwan was China, there was only one China. But until recently, in the last ten years or so, they're now trying to move away from that position, and the Chinese are really annoyed and afraid that that position might become, you know, firmed up one day and they can't allow it. As leaders of China, I think they are really afraid that they will be answerable to their people if they allowed Taiwan to become a separate country away from China.

So these are issues, which are actually beyond the control of the neighborhood. Southeast Asian countries don't really want to have a part of that. They don't want to get into any argument about that one. They're prepared to accept that if it was one country, then Taiwan's declaration of independence would be a kind of secession from within the country, which the mother country, so to speak, would have some right to stop, and other countries shouldn't interfere. That I would say would be the general acceptance.

Commissioner MULLOY. Dr. Steinberg.

Dr. STEINBERG. I think President Bush sort of modified our policy. Didn't he say we will do anything necessary to—

Commissioner MULLOY. In April 2001, after our reconnaissance plane went down, he was asked on the ABC America Morning Show, what would we do, if Taiwan was attacked by China? He said we would do whatever it takes to defend Taiwan.

Dr. STEINBERG. That's right.

Commissioner MULLOY. But that was a Presidential declaration. Of course, the Taiwan Relations Act says that that's up to the President and the Congress to deal with that issue should it arise,

through constitutional processes, meaning that the Congress has a say in such a decision, not the President alone.

Dr. STEINBERG. Well, what we've seen, I think, as mentioned in the earlier panel, is the rise of China's nationalism which is very, very important, and of all the issues connected with nationalism, Taiwan is the most important, the most politically obvious inside China, at least it seems to me.

So the prestige of China is—the PRC—is dependent on that. However, the point is we should never let it get to that stage.

Commissioner MULLOY. Right.

Dr. STEINBERG. And we should exert every pressure that we can put on Taiwan not to put the United States in the position of trying to defend Taiwan for acts that they do that are against the U.S. national interest in terms of our overall security. I think we have a very similar position in the Middle East that doesn't—but that's a separate story.

I think that the reaction of other countries, maybe not Southeast Asia, but certainly Japan and Korea would be very, very concerned about any action. We have—

Commissioner MULLOY. Any action?

Dr. STEINBERG. That China would take over Taiwan. Because we have this theater missile defense research agreement with the Japanese which involves the Japanese Navy, and the Chinese are always suspicious that that will mean something to do with the Taiwan Straits. And that Japan will get involved in the Taiwan Straits issue.

So it becomes very, very complex, and also it relates to the Korea issue that you had in the earlier panel because the movement of U.S. troops and the idea that we will take the Second Infantry Division and move them away from the DMZ, they will be more mobile, and the Chinese say mobile for what? For Taiwan. That's the only regional thing they could be mobile for, and that creates concerns.

Co-Chair BARTHOLOMEW. Okay.

Commissioner MULLOY. Thank you very much.

Co-Chair BARTHOLOMEW. Commissioner D'Amato.

Vice Chairman D'AMATO. I have two questions. One for Dr. Blaxall, and another one for Dr. Wang. In terms of energy, both Russia and Kazakhstan could provide supplies for the Chinese, who are going to be needing large amounts of it on an accelerated basis over the next 20 years. To what extent can do you think realistically the Chinese rely on it because those both involve overland travel. They don't allow the U.S. military interdiction capacity. So I think it's attractive to the Chinese. They don't have to worry about sea borne supplies being interdicted by American forces.

To what extent do the Russians and the Kazakhs actually have the capacity, given the tremendous financial depth of the Chinese being able to buy pipelines, and supplies, and buy this energy security, to what extent do you think that this problem can be alleviated via the Russian and Kazakhs, particularly petroleum, but also natural gas?

Dr. BLAXALL. Well, I think that the Chinese do feel vulnerable because almost all of the oil that they currently import comes in by sea from other continents. Whether or not the Russian oil depos-

its in Eastern Siberia and the Far East, along with Kazakh deposits, can satisfy Chinese demand remains to be seen. There is no doubt that the Russians are very interested in encouraging Chinese investments in that eastern Siberian field and that the size of the field looks sufficiently promising to conclude that substantial quantities of that production can be sold to the Chinese in the medium term. With respect to Kazakhstan, as I said earlier, there is no doubt that Kazakhstan will increase its production of oil several fold over the next five to 10 years. Much of that production is already earmarked for markets in Russia and the West, although there remain technical transport problems to overcome, particularly with respect to the major oil fields in the northern Caspian. How do the Kazakhs get that oil out? Do they continue to rely on their existing pipelines through Russia? Do they resolve the environmental concerns about building a pipeline through the Caspian Sea to connect with the Baku-Ceyhan pipeline that is already under construction? Do they find enough production to meet the minimum flow requirements to complete the Kazakhstan-China pipeline? Perhaps one solution that will emerge over time will find the Russians shipping much of their Siberian and Far Eastern oil to China in a swap deal with Kazakhstan, thereby allowing the Caspian Sea oil from Kazakhstan to flow into Russia and Europe. How this plays out will be determined over the next several years.

One factor that has not escaped the notice of the Kazakhs, however, is the importance of multiple markets to ensure maximum economic benefit from their oil supplies. They are not unaware of the problems encountered by Turkmenistan, which is totally dependent upon its pipeline with Russia to sell its vast supplies of gas. Recognizing their monopolist position, the Russians are paying below world market prices for Turkmen gas, and the Kazakhs intend to avoid this kind of situation. That is another reason why they want to have export arrangements with all of the principal importing nations, and the pipeline/transport capacity to make sure that their production can reach those markets without being held hostage to one route.

But whether or not all of that is going to be adequate to take account of the Chinese need for energy is unclear. I would say that it won't be. I would say that what we're going to see coming in from Kazakhstan and Russia will contribute to the energy needs in the country and that we'll still have considerable imports coming in from the east, at least until China can evaluate whether or not cross-country pipelines make sense as an alternative.

Vice Chairman D'AMATO. Yes. Dr. Wang, in the earlier panel—I think you were here—we discussed the question of the level of intensity of American diplomacy in the region, and the fact that that was flagging, and that there was a kind of a vacuum or a partial vacuum that the Chinese were operating in, partly our fault.

Do you agree? Singapore is a central location. You would hear a lot about the views of others in Southeast Asia and East Asia. Is there a general view from your perspective that the United States is like an old lady running around hitting people with her umbrella, and there is this new boy on the block, the Chinese? They're young, they're going for it, they're on the make and they're the new new, you know, and we're the old old.

Is that a valid assessment of the perspective there?

Dr. WANG. Singapore may not be the best example, because Singapore is counting on the United States much more than others and, in fact, reasonably satisfied with U.S. attention to Singapore. But I think it would be true to say that there are many people in Southeast Asia who feel that the United States hasn't been paying enough attention to Southeast Asia, and I think that's relative to the kind of attention that Southeast Asia was getting until the end of the Vietnam War. This is very, very low level, low intensity attention altogether.

And some of the attention also has been rather, as we see it, misplaced. For example, a lot of support for the Indonesian military, which hasn't turned out too well. I mean the reputation of the Indonesian military is not of the highest in any part of the world, and yet we all know how much the Americans put into training their military. Now one of the examples where you do have—when you paid attention, you paid attention to things that didn't work out, and that doesn't help.

So altogether I would say—and, for example, your failure to restore good relation with Vietnam. I don't know all the reasons behind it, but there has been a lot of delay about what we thought was reconciliation process that was going on, but, you know, it's been very, very slow, and I think Dr. Steinberg gave a wonderful picture of the failures in Burma. It seems to me that many mistakes were made there for maybe the best of reasons, very idealistic and so on, but in terms of what effect it had on the ground, absolutely negative and that is actually an embarrassment to Southeast Asia. Many Southeast Asian states wish Burma wasn't there or wish Burma would behave better.

But they can't change it, and the sanctions that adopted by the United States and by Europe for that matter—Europeans are just as strong—hasn't helped at all, and all these Southeast Asian efforts have all looked terribly feeble and unsuccessful, and that's been very embarrassing to the neighborhood.

So all these things add up to say, well, the U.S. is not interested enough, not going to do enough, but if China can and if China is now actively and proactively seeking out friends and generally trying to improve the situation, well, somebody is paying attention, and that's for the good, because Southeast Asians since 1997 has lost some of their confidence about how they were doing, and do want to get some help.

Vice Chairman D'AMATO. Thank you.

Co-Chair BARTHOLOMEW. Thank you. Dr. Lal, I have one final question, and I think it should be fairly easy to answer. You said that the Indians look with envy at the Chinese economic growth, Chinese economic growth of course was built by American consumers. I mean it's dependent on unfettered access to the U.S. market and American consumption of these goods that the Chinese are producing.

Do you think that the Indians are looking similarly to the American market as fueling their economic growth or do you think they're looking to the Chinese market to do it?

Dr. LAL. That's a good question. I'd say frankly I think they're looking at both. I think they're looking at everything. The Indians

have been ratcheting up their "look East" policy that includes Southeast Asia. They are following on China's footsteps in terms of trying to set up a free trade agreement, a free trade area with Southeast Asia. I know that they're definitely looking at the Chinese market.

They're also looking at the Japanese market, and they're definitely looking at the American market. So I wouldn't really rule out just about anybody.

Dr. BLAXALL. Let me add that they're also looking seriously at the Central Asian market, and have expanded their business in these countries both in the shuttle trade and in construction, as well as in other industries. India certainly sees Central Asia, which is quite a close neighbor as a promising future market.

Co-Chair BARTHOLOMEW. Interesting. Interesting. Thank you all so much for your time and for sharing your expertise and your wisdom. We're really fortunate that you all came to talk to us today. Thank you.

[Whereupon, at 5:35 p.m., the hearing was adjourned.]

**STATUTORY MANDATE OF THE U.S.-CHINA ECONOMIC AND SECURITY
REVIEW COMMISSION**

Pursuant to Public Law 108-7, Division P, enacted February 20, 2003

RESPONSIBILITIES OF THE COMMISSION.—The United States-China Commission shall focus, in lieu of any other areas of work or study, on the following:

PROLIFERATION PRACTICES.—The Commission shall analyze and assess the Chinese role in the proliferation of weapons of mass destruction and other weapons (including dual use technologies) to terrorist-sponsoring states, and suggest possible steps which the United States might take, including economic sanctions, to encourage the Chinese to stop such practices.

ECONOMIC REFORMS AND UNITED STATES ECONOMIC TRANSFERS.—The Commission shall analyze and assess the qualitative and quantitative nature of the shift of United States production activities to China, including the relocation of high-technology, manufacturing, and R&D facilities; the impact of these transfers on United States national security, including political influence by the Chinese Government over American firms, dependence of the United States national security industrial base on Chinese imports, the adequacy of United States export control laws, and the effect of these transfers on United States economic security, employment, and the standard of living of the American people; analyze China's national budget and assess China's fiscal strength to address internal instability problems and assess the likelihood of externalization of such problems.

ENERGY.—The Commission shall evaluate and assess how China's large and growing economy will impact upon world energy supplies and the role the United States can play, including joint R&D efforts and technological assistance, in influencing China's energy policy.

UNITED STATES CAPITAL MARKETS.—The Commission shall evaluate the extent of Chinese access to, and use of United States capital markets, and whether the existing disclosure and transparency rules are adequate to identify Chinese companies which are active in United States markets and are also engaged in proliferation activities or other activities harmful to United States security interests.

CORPORATE REPORTING.—The Commission shall assess United States trade and investment relationship with China, including the need for corporate reporting on United States investments in China and incentives that China may be offering to United States corporations to relocate production and R&D to China.

REGIONAL ECONOMIC AND SECURITY IMPACTS.—The Commission shall assess the extent of China’s “hollowing-out” of Asian manufacturing economies, and the impact on United States economic and security interests in the region; review the triangular economic and security relationship among the United States, Taipei and Beijing, including Beijing’s military modernization and force deployments aimed at Taipei, and the adequacy of United States executive branch coordination and consultation with Congress on United States arms sales and defense relationship with Taipei.

UNITED STATES-CHINA BILATERAL PROGRAMS.—The Commission shall assess science and technology programs to evaluate if the United States is developing an adequate coordinating mechanism with appropriate review by the intelligence community with Congress; assess the degree of non-compliance by China and [with] United States-China agreements on prison labor imports and intellectual property rights; evaluate United States enforcement policies; and recommend what new measures the United States Government might take to strengthen our laws and enforcement activities and to encourage compliance by the Chinese.

WORLD TRADE ORGANIZATION COMPLIANCE.—The Commission shall review China’s record of compliance to date with its accession agreement to the WTO, and explore what incentives and policy initiatives should be pursued to promote further compliance by China.

MEDIA CONTROL.—The Commission shall evaluate Chinese government efforts to influence and control perceptions of the United States and its policies through the internet, the Chinese print and electronic media, and Chinese internal propaganda.

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