

**Joint Statement of
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U.S.-China Economic & Security Review Commission**

**Before the
Senate Foreign Relations Committee
Hearing on
U.S.-China Relations: Status of Reforms in China
April 22, 2004**

Mr. Chairman and Members of the Committee --

Thank you for this opportunity to testify on the work of the Commission and our assessment for the Congress of the priority areas in U.S.-China relations. We are submitting this as a joint statement by the Chairman and Vice Chairman of the Commission, as an expression of the bipartisan nature of our views and the work of the Commission.¹

The Commission was established in the Fall of 2000 to “monitor, investigate, and report to Congress on the national security implications of the bilateral trade and economic relationship between the United States and the People’s Republic of China (PRC).” We were, to a large extent, a result of the decision by Congress earlier that year to grant Permanent Normal Trade Relations (PNTR) to China. The annual NTR debate in Congress had been the forum by which Congress took stock of year-to-year developments in U.S.-China relations, and ventilated concerns regarding areas where the relationship might be off track. With the approval of PNTR, the House and Senate properly recognized the importance of continuing Congress’ annual assessment of key areas of U.S.-China relations, given the growing stature of this bilateral relationship.

Following the Commission’s first Report to Congress in July 2002, Congress revised the Commission’s charter to focus our work on the following areas: China’s proliferation practices, China’s economic reforms and U.S. economic transfers to China, China’s escalating energy needs, Chinese firms’ listing or trading in the U.S. capital markets, U.S. investments into China, the regional economic and security impacts of China’s growing economic, military, and political clout, U.S.-China bilateral programs on science and technology cooperation and agreements on intellectual property rights and prison labor imports, China’s record of compliance with its World Trade Organization (WTO) commitments, and the Chinese Government’s efforts to control the media and, through that, perceptions of the United States within China. This extensive mandate reflects the complexity of U.S.-China relations, and highlights the continuing need for the United States to carefully manage this relationship.

¹ The views expressed in this testimony are those of the Commission’s Chairman and Vice Chairman and, except where specifically stated, do not necessarily reflect the views of other Commissioners.

The Commission will deliver its 2004 Report to Congress next month, which will present its findings and recommendations in the issue areas specified by Congress. We will also be answering the central theme of our mandate to provide Congress with an overall assessment of “the national security implications of the bilateral trade and economic relationship.” We hope this analysis will prove useful for the Committee’s and Congress’ important deliberations on U.S.-China policy. We would be pleased to come back to the Committee to present the full findings and recommendations of our Report once it is complete.

Today, we want to highlight for the Committee our preliminary assessment of the priority areas of concern in U.S.-China relations – those requiring the most immediate attention of the Congress – and reinforce some of the recommendations we have made to Congress on these topics over the past year.

In sum, we see the priority areas as the following:

- Effective management of U.S.-China trade and investment
- The changing dynamics of the cross-Strait relationship
- Holding China to its commitments on Hong Kong
- China’s pivotal role in the North Korean nuclear crisis

Before we address our specific concerns and recommendations in these areas, we would like to offer our assessment of the current direction of U.S.-China relations, at least with regard to the broad areas covered by our mandate. *In sum, we believe that a number of the current trends in U.S.-China relations have potential negative implications for our long-term economic and national security interests, and therefore that U.S. policies in these areas are in need of urgent attention and course corrections.*

This assessment is somewhat counter to much of the conventional wisdom in the United States today that characterizes U.S.-China relations as having reached a positive new echelon in light of the apparent cooperation between the two countries on anti-terrorism initiatives and, in particular, confronting the North Korea nuclear crisis. We recognize the importance of these developments and do not dismiss their significance. Rather, we believe that there are long-term trends in the relationship that give us cause for concern, but which can be corrected given timely and sustained U.S. attention and effort.

In light of this assessment, we believe that the time is ripe for putting the U.S.-China relationship on a more solid, sustainable footing from the perspective of long-term U.S. interests. The U.S.-China relationship is still in the relatively early stages of its development and is marked by a fluid rather than static environment. To use an analogy – the relationship is like a building where not only has the paint not dried in any room, but the architectural plans are still being revised. The United States has played – and continues to play – an enormous role in the economic and technological development of China. As we have documented through our hearings and reports, U.S. trade, investment, and technology flows have been the critical factor in China’s rise as an economic power. We need to use the substantial leverage this provides us to develop an architecture that

advances both countries' long-term interests. We have the leverage now and perhaps for the next decade, but this may not always be the case.

When the Congress approved PNTR for China, the guiding premise was that it would expand market access for U.S. goods and services and, more fundamentally, would lead to economic reform in China and, eventually, political reform. In this context, it was characterized as in our "national security interest" to support China's accession to the WTO. Having taken this significant step, the United States cannot lose sight of these important assumptions, and we must configure our policies toward China to help make these assumptions materialize – from expanded trade opportunities for U.S. exporters and a mutually beneficial trade relationship that sets global standards for fair trade, to an open, more democratic society that can be an important partner in addressing global security challenges, including weapons proliferation, terrorism, and, of course, a peaceful resolution of the cross-Strait situation.

If we falter in the use of our economic and political influence now to effect positive change in China, we will have squandered an historic opportunity. We believe China demonstrated a willingness to move in a positive direction, and to take substantial risks to do so, when it entered the global economy. And there has been substantial market liberalization in China as well as new laws improving property rights for citizens. But China will likely not initiate the decisive measures toward more meaningful economic and political reform without substantial and sustained pressure from a United States willing to utilize its tools of leverage and persuasion.

The Congress gave our Commission an important and unique task – to identify the scope of problems and shortcomings in key areas of the U.S.-China relationship, and to make recommendations to Congress concerning how to address these concerns. In this pursuit, the Commission can serve as an effective early warning mechanism to surface economic and national security concerns before they become unmanageable, and to recommend policy changes that can affect mid-course corrections in U.S. policy where necessary.

Within this framework, we will now turn to a more detailed discussion of the key areas of concern we see at the present time in U.S.-China relations, and our thinking on possible U.S. policy responses:

Effective Management of U.S.-China Trade and Investment

Trade and investment flows constitute the core of U.S. – China economic relations. Bringing these flows into proper balance will significantly determine the benefits to the United States of this important relationship. The challenge facing U.S. policymakers operates at two levels. On one level there are the immediate problems associated with the enormous trade deficit that the United States has with China and the resulting consequences for the U.S. economy, particularly the manufacturing sector. This requires attention to the issues of exchange rates and currency manipulation, and addressing China's mercantilist trade and industrial policies through vigorous enforcement of WTO and U.S. trade laws.

But beyond these immediate challenges are the implications associated with “globalization.” The Commission believes that the U.S. – China economic relationship is of such large dimensions that the future trends of globalization will depend to a substantial degree on how we manage our economic relations with China. It is reasonable to believe that U.S.-China economic relations will shape “the rules of the road” for broader global trade relations. If current failings are remedied and the relationship is developed so as to provide broad-based benefits for both sides, globalization will likely be affected in a positive manner on a worldwide scale. If trade commitments and the rule of law are honored, and trade is conducted with respect for labor rights and environmental protection, the direction of globalization will probably take a turn for the better worldwide. If not, the opposite will likely eventuate.

The dominant feature of U.S.-China economic relations is the U.S. goods trade deficit, which rose by more than 20 percent in 2003 to a record \$124 billion. The deficit with China now constitutes 23 percent of the total U.S. goods trade deficit, and China is by far the largest country component of the deficit. Moreover, U.S. trade with China – with \$28 billion in exports to China in 2003 as compared with \$152 billion in imports – is by far the United States’ most lopsided trade relationship as measured by the ratio of imports to exports. This trade deficit is of major concern because (i) it has contributed to the erosion of manufacturing jobs and the current jobless recovery in the United States, and (ii) manufacturing is critical for the nation’s economic and national security.

Therefore, our trade and investment relationship with China – with current trends continuing and the deficit expanding– is not just a trade issue for the United States, but a matter of our long-term economic health, and national security.

A key factor contributing to the deficit is the undervaluation of the Chinese yuan against the U.S. dollar. This gives Chinese producers a competitive advantage by making Chinese imports relatively less expensive, and U.S. exports relatively more expensive. It also undermines the profitability of U.S. manufacturers, thereby reducing their investment spending while also giving them an incentive to shift production to China. Economic fundamentals suggest that the Chinese yuan is undervalued, with a growing consensus of economists estimating the level of undervaluation to be anywhere from 15 to 40 percent. However, China persistently intervenes in the foreign exchange market to maintain the de facto peg of 8.28 yuan per dollar.

The 1988 Omnibus Trade and Competitiveness Act requires the Secretary of the Treasury to report to the Senate Banking Committee twice each year with an assessment of currency manipulation by trading partners. The Commission is greatly concerned that the Treasury Department has repeatedly sidestepped a finding that China is manipulating its currency, despite the mounting evidence to the contrary.

To address this, the Commission has recommended to Congress that if the Treasury Department’s efforts to effect an upward revaluation of China’s currency prove ineffective, Congress should use its legislative powers to force action by the U.S. and

Chinese Governments to address this unfair and mercantilist trade practice. For the near future, continued vigorous development of such legislative initiatives as were outlined by Members of Congress during our hearing, linking China's performance on its exchange rate policies to its continued full access to the U.S. market, appears essential to ensure the appropriate level of effort by both Governments to this matter.

A second factor contributing to imbalances in U.S.-China trade are China's mercantilist industrial and foreign direct investment policies, the purpose of which appears to be to enhance the power of the Chinese state. China has pursued industrial policies that involve a wide range of measures including technology transfer requirements, government subsidies, discriminatory tax relief, and limitations on market access for foreign companies. The Chinese Government is currently targeting the high tech, auto, and auto parts industries. The textile sector is another industry of great concern as the ending of the multi-fiber agreement (MFA) on January 1, 2005 promises to spur a massive shift of textile production to China, which will likely decimate what remains of the U.S. textile industry (which still employs 630,000 people), as well as textile industries from Mexico to Bangladesh.

To counter these practices, the Commission has recommended to Congress that:

- *The United States Trade Representative and Department of Commerce immediately undertake a comprehensive investigation of China's system of government subsidies for manufacturing, including tax incentives, preferential access to credit and capital, subsidized utilities, and investment conditions requiring technology transfers. USTR and Commerce should provide the results of this investigation in a report that lays out specific steps the U.S. Government can take to address these practices through U.S. trade laws, WTO rights, and by utilizing special safeguards China agreed to as part of its WTO accession commitments.*
- *The U.S. tax code be restructured to eliminate incentives for U.S. business, particularly manufacturing, but also services and high technology companies, to shift production, services, research and technology off-shore.*
- *Congress amend U.S. countervailing duty laws to make them applicable to non-market economies, such as China.*
- *The U.S. Government work with other interested WTO members to convene an emergency session of the WTO to extend the Multifiber Arrangement at least through 2008.*

An essential part of our mandate – as well as U.S.-China trade relations – is to assess China's progress in meeting its commitments as a member of the WTO. China joined the WTO in December 2001. Its accession agreement is extremely complex, reflecting the need for special arrangements to address the fact that China joined the WTO without having met the requirements of a market economy. To protect against trade distortions and unfair trade practices resulting from China's non-market status, China's WTO agreement includes a special review mechanism to monitor China's compliance and special safeguard provisions giving WTO members the right to protect themselves

against sudden surges of Chinese imports. It is critical that these agreements be properly and vigorously implemented and enforced.

China has made progress in reducing tariffs and otherwise formally meeting a large number of its WTO accession commitments, but significant compliance shortfalls persist in a number of areas of key importance to U.S. trade. In particular, China continues to provide direct and indirect subsidies to Chinese producers, there is rampant abuse and lax enforcement of intellectual property rights, foreign firms face discriminatory tax treatment, there is poor transparency in the adoption and application of regulations, and China uses unjustified technical and safety standards to exclude foreign products.

We are also particularly dismayed with China's level of cooperation with the WTO's Transitional Review Mechanism (TRM) for reviewing China's WTO progress. As part of its accession agreement, China agreed to be subject to this multilateral annual review of its compliance record for the first eight years of its WTO membership, with a final review after the tenth year. The TRM was an important provision of China's accession agreement – one that U.S. negotiators strenuously pressed for – because it was seen as a robust mechanism for both monitoring China's compliance progress and for applying multilateral pressure on China to correct deficiencies. Instead, however, China has undermined the TRM during its first two years by refusing to fully cooperate with and address WTO member questions and other efforts to engage China in a dialogue on compliance shortfalls. It has simply not served as the intended robust mechanism for combating China's compliance shortfalls.

Therefore, the Commission has recommended to Congress that USTR and other appropriate U.S. Government officials undertake strenuous efforts to reform the TRM process into a meaningful multilateral review and measurement of China's compliance with its WTO commitments. If this is unsuccessful, the U.S. Government should initiate a parallel process with the EU, Japan, and other major trading partners to produce a unified annual report by which to measure and record China's progress toward compliance, which report should be provided to Congress as part of USTR's annual report to Congress on this matter.

Though aware of these failings and problems, the U.S. Government has not been sufficiently vigorous in enforcing U.S. trading rights under either U.S. law or through the WTO. This is exemplified by the Administration's failure to use the China-specific safeguards available to WTO members that protect against market disruptions by Chinese imports. The International Trade Commission has conducted five Section 421 safeguard investigations against Chinese products, and in three cases it found for the plaintiffs. Yet, in all three cases the President refused to take action. These developments risk undermining the Section 421 process, as companies may cease filing legitimate petitions if, given the significant legal costs, they come to believe the Administration will not act. Moreover, the Administration was slow in implementing procedures for U.S. use of the WTO China-specific textile safeguard, and first imposed the safeguard in December 2003 on a select few categories of textiles, despite the enormous detrimental impact of imports from China on the U.S. textile industry.

Overall, we are troubled by what we see as a general hesitancy among WTO members with substantial trade relations with China to raise legitimate trade disputes with China for fear of economic retaliation. The United States finally broke the ice by bringing the first WTO trade dispute against China on its preferential value-added tax (VAT) treatment for domestically designed and produced semiconductors. We hope this will open the door to other WTO members exercising their rights under the WTO to address unfair Chinese trade practices. In fact, the United States should be actively coordinating with its major trading partners on areas of mutual concern regarding China's trade practices.

In light of the above, the Commission has recommended to Congress that:

- *The Congress should press the Administration to use the WTO dispute settlement mechanism and/or U.S. trade laws, including Section 301 provisions, to seek redress for China's practices in the areas of exchange rate manipulation, denial of trading and distribution rights, massive violations of intellectual property rights (IPR) that have cost U.S. firms billions of dollars, and government subsidies to export industries that harm the competitiveness of U.S.-based manufacturing firms.*
- *The U.S. Government should make optimum use of the special Section 421 and textile safeguards negotiated as part of China's WTO accession agreement. These important safeguards were designed to prevent our domestic industries from being injured by surges of Chinese exports.*

We note that the Commission has reported on the scope of intellectual property rights abuses in China and the lack of improvement in Chinese enforcement of IPR protections for the past two years, and recommended WTO action. We strongly reiterate the need for the U.S. Government to take more aggressive action in addressing this vital trade issue.

In addition to addressing the problems of China's exchange rate manipulation and its mercantilist trade and investment policies, U.S. policymakers must turn their attention to China's impact on globalization. In our eagerness to expand trade and investment, too little attention has been given to this critical matter.

Trade and investment are not the ends of policy, but rather the means by which we enhance our national well-being. It is not the size *per se* of these flows that matters, but rather their impact. Just as intellectual property rights are not self-organizing, it is time to recognize that trade and investment rules must be placed in a framework designed to deliver maximum well-being. Trade must be standards based, and trade agreements with China and other countries must incorporate labor rights and environmental standards. We note that the U.S. Trade Representative, Ambassador Zoellick, vigorously embraced these concepts in a recent editorial in the Washington Post (April 19, 2004).

Economic action must conform to the fundamental values that guide us as a nation. To date, our policy toward globalization has tilted toward letting the market determine our values, rather than having the market conform to our standards and values.

We take note of the high-level trade dialogue taking place in Washington this week between U.S. and Chinese officials, and are hopeful it may result in a breakthrough. We are concerned, however, that certain key issues – including China’s currency and subsidies policies – appear not to be on the table.

The Changing Dynamics of the Cross-Strait Relationship

The Committee is well aware of the significant events in the Taiwan Strait over the past few months, and the growing tensions between the two sides. Beginning with Taiwan President Chen Shui-bian’s announcement late last year that Taiwan would hold a national referendum as part of its March 2004 presidential balloting, and culminating in the dramatic reelection of President Chen last month, the state of cross-Strait relations appears to be entering a new era, one that will require new thinking by the Administration and the Congress.

This past December and February we held public hearings that explored both the economic and security aspects of cross-Strait relations and China’s military modernization efforts. Members of our Commission traveled to the region last month and had a chance to talk with high-level observers of the cross-Strait situation in Tokyo, Hong Kong and Taipei. We also commissioned a study of China’s acquisition and integration of foreign weapons systems, which is published on our website. The annual Department of Defense report on the cross-Strait military balance, the 2003 Council on Foreign Relations study of China’s military capabilities, and published reports of the U.S. Naval War College on China’s growing submarine warfare capability offer additional useful perspectives.

China’s modern arsenal includes a small but increasingly sophisticated missile force that is of direct strategic concern. In the Western Pacific theater, it is estimated that China has deployed some five hundred short-range ballistic missiles that directly threaten Taiwan and longer-range conventional missiles that could threaten Japan and our forces deployed in the region. China’s advanced naval and air weapons systems – including surface ships, submarines, anti-ship missiles, and advanced fighter aircraft – have been significantly enhanced by infusions of foreign military technology, co-production assistance and direct purchases, mainly from Russia. China’s military capabilities increasingly appear to be shaped to fit a Taiwan conflict scenario and to target U.S. air and naval forces that could become involved.

We conclude that China is steadily building its capacity to deter Taiwan from taking steps that the PRC deems unacceptable movements toward independence or consolidation of Taiwan’s separate existence, to coerce Taiwan into an accommodation, and, ultimately, to have a viable option to settle the Taiwan issue by force of arms if

necessary. A significant component of its military modernization strategy is to develop sufficient capabilities to deter U.S. military involvement in any cross-Strait conflict.

The United States cannot wish away this capacity. We cannot assume China will stay its hand because it has too much at stake economically to risk military conflict over Taiwan. In our view, we should not think of the 2008 Beijing Olympics as an insurance policy against Chinese coercion of Taiwan.

We can certainly hope that the economic benefits China gains from Taiwan investment and trade; the growing production and supply linkages among China, Japan, other Asian economies and the United States; the significant value to China of strong economic relations with the United States; and China's own desire to be seen by the world as a power that is "peacefully rising" will constrain China from using military force. Hopes, or even reasonable expectations, do not, however, provide a defense of vital U.S. interests. This is why it is more important now than ever before for the United States to uphold its key obligations under the Taiwan Relations Act (TRA) [22 USC 48], notably "to maintain the capacity to resist any resort to force or other forms of coercion that would jeopardize the security, or the social or economic system, of the people on Taiwan."

Under the TRA, the additional U.S. responsibility to assist Taiwan's military preparedness is set out clearly. The law requires the United States to "make available to Taiwan such defense articles and defense services in such quantity as may be necessary to enable Taiwan to maintain a sufficient self-defense capability." Notably, it further requires that both "[t]he President and the Congress shall determine the nature and quantity of such defense articles and services based solely upon their judgment of the needs of Taiwan." Thus, the TRA sets out a unique joint role in the formulation of Taiwan policy for the Congress and Administration, including on arms transfers decisions, demonstrating Congress' deep and abiding concerns regarding U.S. policy in this area.

Despite the TRA's provisions, we believe that the Congress and Administration are not adequately coordinating in this area and that there are other operational impediments to the United States' ability to fulfill its important obligations to Taiwan.

In addition to providing vital defense support for Taiwan against PRC military threats, the TRA further requires U.S. policy to support the "social" and "economic" system of Taiwan. This is an area of commitment the United States needs to be more alert to given current developments.

There are a number of key trends developing across the Strait that call for a reevaluation of how we implement our Taiwan policy. First, there are two paradoxical trends: on the one hand, indirect cross-Strait economic ties continue to grow with large flows of investment in the mainland by Taiwan businesses and a stream of exports from Taiwan to feed production platforms. On the other hand we see a deterioration in the cross-Strait political situation, with both Beijing and Taipei hardening in their positions.

There is also the PRC's coordinated campaign to continue to "marginalize" Taiwan in the region, both politically and economically. Taiwan is being shut out of regional groupings such as the ASEAN Plus One or ASEAN Plus Three (China-Japan-South Korea) forums and unable to participate in regional trade arrangements like the Bangkok Agreement or the China-ASEAN framework agreement on a free trade area. Further, Taiwan has been unable to find regional economies willing to engage in bilateral free trade arrangements, due largely to PRC political pressure.

Moreover, there has been a gradual de-coupling of Taiwan's large and growing investments in China from Taiwan, due to the lack of direct transportation links across the Strait. Investors' interests are more concentrated in the mainland and less in Taiwan – to the point where some observers are asking whether Taiwan is becoming a "portfolio economy" instead of a "production economy." This has proven true for foreign corporations in Taiwan as well as native Taiwan firms. We have learned that in recent years the number of U.S. regional operational headquarters in Taiwan has declined and offices downgraded to local units.

The key political trend in Taiwan over the past 15 years has been the development of a vibrant democracy with new institutional bases. This is a valuable product of steady U.S. support for Taiwan, giving it the space it needed to develop its social and economic system without coercion from the PRC. The proof of the fundamental strength of that democratic development was last month's Presidential election in Taiwan, which we were privileged to monitor as part of our trip to the region. The system was sorely tested but appears to have emerged intact and resilient. Should Chen Shui-bian's narrow victory – one in which he nevertheless received an absolute majority of the votes cast in an election with heavy voter turnout – withstand its legal challenge, it will appear to be vindication for Chen's campaign that stressed Taiwan's separate identity and a mandate for his plans for constitutional reform.

While the United States should be proud of its role in helping to develop strong democratic institutions in Taiwan, Beijing appears threatened by these developments. The State Council Taiwan Affairs Office (TAO) has issued stern warnings that the path Chen Shui-bian is laying out for constitutional reform – a referendum in 2006 and a new or amended constitution in 2008 – is tantamount to a "timetable for Taiwan independence." The TAO reiterated that no progress on cross-Strait issues could be achieved unless and until Taiwan accepted Beijing's "One China Principle."² The prospects for China letting up on its strategy of isolating Taiwan – by, for example, allowing Taiwan observer status in the World Health Organization, where Taiwan's active participation is clearly in the greater interest of China and the East Asian region – are dim.

The lack of trust across the Strait is palpable, and it goes both ways. Aside from its campaign of isolating Taiwan, China's heavy-handed interference in the political process

² FBIS Translation of "Text of Taiwan Affairs Office News Conference on Taiwan Election, More," CPP20040414000027 Beijing CCTV-4 in Mandarin 14 April 2004.

in Hong Kong – discussed later in this testimony – has only reinforced Chen Shui-bian’s argument that the “one country, two systems” formula Beijing employed in Hong Kong and has proposed for cross-Strait unification is totally unacceptable for Taiwan. Chen said in his first inaugural speech in 2000 that he is willing to talk with Beijing about a “future one China.” Beijing has steadfastly rejected the implied premise of Chen’s approach, taking the position that it will only accept cross-Strait talks if Chen agrees as a precondition that there is only “one China” now and that Taiwan is part of it.

Mr. Chairman, in the face of these current difficulties in the Taiwan Strait, we believe the U.S. “One China Policy” – based on the three Sino-U.S. communiqués and the Taiwan Relations Act – is the historic framework for conducting our official relations with Beijing and our unofficial relations with Taiwan. We must remember that this policy is U.S. policy, not Taiwan’s, not China’s. Our policy is emphatically not the same thing as the PRC’s “One China Principle.” The United States has not taken a position on the legal status of Taiwan. The United States acknowledges Beijing’s formulation but does not necessarily embrace – or reject – the PRC’s concept that “there is but one China in the world and Taiwan is part of China.” It is also true that the United States has stated it does not support Taiwan independence, or two Chinas, or one China-one Taiwan – as President Clinton reiterated in Shanghai during his visit there in 1998.

The Taiwan Relations Act has served U.S. interests well over its 25-year history, and we as a government and nation need to remain faithful to it, especially now, when the cross-Strait situation is as complex as it has ever been. The fundamentals must be remembered: our decision to establish diplomatic relations with the PRC “rests upon the expectation that the future of Taiwan will be determined by peaceful means.” This expectation must be declared at every turn.

Given the current economic and political trends in the Strait that we have outlined above – developments that call into question the state of the “status quo” in cross-Strait relations – we believe there is an immediate need for Congress and the Administration to review our policies toward Taiwan and cross-Strait relations and to determine an appropriate role for the United States in reinvigorating cross-Strait dialogue.

Accordingly, we have recommended that Congress enhance its oversight role in the implementation of the TRA. Executive Branch officials should be invited to consult on intentions and report on actions taken to implement the TRA through the regular committee hearing process of the Congress, thereby allowing for appropriate public debate on these important matters. This should include, at a minimum, an annual report on Taiwan’s request for any military aid and a review of U.S.-Taiwan policy in light of the growing importance of this issue in U.S.-China relations.

We believe Congress should consider conducting a fresh assessment of existing U.S. policy toward Taiwan, with particular attention to whether all elements of the TRA are being effectively pursued. This should include the coordination of our defense assistance to Taiwan, how U.S. policy can better support Taiwan breaking out of the international isolation the PRC seeks to impose on it, and examine what steps can be taken to help ameliorate Taiwan’s marginalization in the Asian regional economy.

Further, we suggest that Congress consult with the Administration on whether the United States should become more directly engaged in facilitating talks across the Taiwan Strait that could lead to direct trade and transport links and/or other cross-Strait confidence building measures. We will be providing more detailed recommendations on this to Congress in our upcoming Report.

Holding China to its Commitments on Hong Kong

Mr. Chairman, more than 50,000 American citizens live and work in Hong Kong. Over 1,100 American firms operate there, and the United States has more than \$38.5 billion in investments in the city. These direct interests alone demand that the U.S. Government keep a close eye on developments in Hong Kong; but there is much more at stake.

How Beijing lives up to the promise of the Sino-British Joint Declaration of 1984 and the Hong Kong Basic Law of 1990 tells us much about China's direction. We need to look at Hong Kong to gauge whether China is evolving into the more open and tolerant power that China's leadership would like us to believe is unfolding. Alternatively, are China's leaders bent on "nipping in the bud" any domestic call for democratic change – even in highly autonomous Hong Kong where such change is anticipated under China's own laws – that is not of their own making.

In response to popular calls for direct elections in 2007 for the Chief Executive and 2008 for all of the Legislative Council, as allowed under the Basic Law, the PRC's National People's Congress Standing Committee has made some telling and worrisome moves in recent weeks. First, on March 26, the Standing Committee decided on its own to intervene in the question of whether and how changes to the methods of selecting the Hong Kong Chief Executive and forming the Legislative Council could be made. The decision of the Standing Committee to self-initiate an interpretation of the Basic Law was itself a blow to Hong Kong's separate legal and political systems.

The interpretation issued on April 6 was an additional setback for Hong Kong democratic aspirations. It reinforced the message that no changes would be made without the central authorities' approval, at the beginning and the end of the process. A report by the Chief Executive to the Standing Committee would have to start any process of change, and the Standing Committee would then give direction as to whether and how changes should be made. No initiative would be allowed to rest in the hands of Hong Kong's legislature, which was ruled ineligible to present any draft bill, even on implementing changes decided by Beijing.

The Chief Executive's immediate action to submit a report to the Standing Committee, on April 15, stating there is indeed a need for change, has not been taken as a sign of progress among advocates of greater democracy in Hong Kong. Rather, the principles laid down in the report – reiterating the absolute authority of the Standing Committee in all decisions relating to Hong Kong's Basic Law and elections; emphasizing the need for a strong "executive-led" government – suggest that the fix is in.

We hope we are wrong. We hope Beijing will recognize that its own reputation as a modernizing power is at stake in Hong Kong; that not just a handful of local democratic activists and “troublemakers” care about what happens, but that the United States cares, and is paying attention.

Under the Hong Kong Policy Act of 1992 [22 USC 66], the U.S. Government has an obligation to assess whether Hong Kong’s “high degree of autonomy” and the solemn promise by Beijing to respect Hong Kong’s governing under the “one country, two systems” formula is genuine or a charade. Hong Kong’s future autonomy was set out in an international agreement, the Sino-British Joint Declaration; granted by China’s National People’s Congress; and legislated in the Basic Law. It may be true that what the PRC Government giveth, they may taketh away. But when Hong Kong’s autonomy is diminished by the direct action of the central authorities, the United States is obliged to take notice and consider its policy options.

Directly invoking provisions of the Hong Kong Policy Act to suspend certain aspects of U.S.-Hong Kong bilateral relations is an option which may be considered. If the United States were to end its special treatment of Hong Kong in some important areas – such as air services, customs treatment, immigration quotas, visa issuance, export controls – the principal pain would be felt in Hong Kong, however, not in Beijing.

The Congress and Administration should continue to let the Chinese leadership know that Beijing’s moves to limit Hong Kong’s autonomy and democratic aspirations are not in any party’s long-term interest. And that U.S. –China relations will be adversely affected.

China’s Pivotal Role in the North Korean Nuclear Crisis

The Commission’s charter calls on us to “analyze and assess the Chinese role in the proliferation of weapons of mass destruction (WMD) 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.” In the post-9/11 world, there can be no doubt that stemming the tide of WMD proliferation is of the highest national priority for the United States. The Commission’s charge to examine China’s role in WMD proliferation is part of this effort.

China has a checkered record at best on controlling its own transfers of WMD-related technologies to states of proliferation concern, including Iran, North Korea, and Pakistan, something we will document in detail in our 2004 Report to Congress. But this past year has been marked by a proliferation crisis in which China is now playing the role of an intermediary – the North Korea nuclear crisis. Given the gravity of the events unfolding in North Korea, the Commission felt it imperative to examine closely China’s participation in efforts to resolve this crisis. The key focus of our examination has been: What are the U.S. goals for resolving this impasse? What leverage can China wield to help bring about that outcome? Can we reasonably expect China to be an effective partner? For the Commission, the role China plays in this crisis is a key, if not the key,

test of the U.S.-China relationship and pivotal to the future of global non-proliferation policies.

The United States has clearly articulated that it seeks the complete, verifiable, and irreversible dismantlement of North Korea's nuclear programs. To achieve this proper outcome will require that the parties to the Six Party Talks underway with North Korea – the United States, Russia, Japan, South Korea, and China – present a strong and unified position that this is the only acceptable outcome to ensure the region's stability. But it is also necessary that China, North Korea's principal ally and financial supporter, demonstrate a willingness to exert its considerable leverage over North Korea to bring about this outcome. At the present time, we have not witnessed the appropriate level of effort from China that the situation warrants.

North Korea is heavily dependent on Chinese assistance in the form of food and fuel. Our research indicates that China provides upwards of 90 percent of North Korea's oil and 40 percent of its food. Since 1996, China has allocated somewhere between 25 to 33 percent of its foreign assistance outlays to North Korea. Moreover, the North Korean and Chinese militaries have long maintained close ties. These facts clearly indicate the considerable leverage Beijing could exert over Pyongyang, were it to choose to do so.

To date, however, China has been playing more of a host and intermediary role in the Six Party Talks, and does not appear to be pressing for its expeditious resolution. We certainly recognize the key role China has played in getting the talks started, and U.S. officials have on many occasions lauded China for this accomplishment. At the same time, it has become increasingly evident that the current impasse may not be broken without a considerably more forceful posture by the Chinese.

To date, China has been opposed to sanctions in this case, and to bringing the North Korea nuclear issue to the United Nations. Moreover, China issued a cautionary statement regarding any decisive moves by the United States and its allies in the context of the U.S.-led Proliferation Security Initiative (PSI) that might provoke Pyongyang's ire. In a telling statement, the Chinese Foreign Ministry has indicated that China “does not approve of sanctions, blockages and other measures which are aimed at putting pressure on [North Korea] . . . Doing so will not only be useless to solve the problem, but will escalate antagonism and tension.”³

Time is not on our side in confronting this crisis. As the Six Party Talks drag on, North Korea's nuclear weapons and ballistic missile programs keep moving apace. While we cannot be sure just how far North Korea has progressed, there seems to be a growing consensus that it already possesses significant capabilities in this regard and will advance considerably further within a matter of months. As these capabilities are attained, the prospects for achieving a complete, verifiable, and irreversible dismantlement by North Korea are dimming substantially. The Six Party Talks must move forward with renewed urgency, and with China playing a far more significant role – including demonstrating a

³ Catherine Armitage, “China condemns intercept plan,” *The Weekend Australian*, 12 July 2003, sec. LOCAL, 6.

willingness to exert its considerable leverage with North Korea – in obtaining an acceptable outcome.

The key question is not only whether China will be willing to exert leverage in a meaningful way on North Korea, but whether China is prepared to press the North Koreans to accept a robust and intrusive dismantlement verification regime, an essential component of a complete, verifiable, and irreversible dismantlement scenario. North Korea's failure to comply with the 1994 Agreed Framework underscores the absolute requirement for on-site inspections and verification. Given China's posture to date on the PSI, not to mention its own continuing proliferation problems, it is certainly a questionable proposition. In fact, recent news reports indicate that Chinese officials, following a meeting between the Chinese foreign minister and North Korean leader Kim Jong Il, informed a U.S. envoy that the onus was on the United States to show more flexibility in resolving the crisis.

In our view, the U.S. Government must make clear to China that its efforts in this crisis are a key, if not the key, test of the U.S.-China relationship. China's efforts in getting the Six Party Talks underway must be followed up by the active use of its substantial leverage to persuade North Korea to freeze its reprocessing efforts and verifiably dismantle its nuclear weapons and ballistic missile programs, and to accommodate an intrusive international verification regime, to ensure effective implementation of any agreement that is ultimately reached. In the event of continued stalemate and lack of Chinese success in persuading North Korea to accept these requirements, we believe the United States must develop other policy options with our partners in the region to resolve this highly critical situation.

Conclusion

Mr. Chairman and Members of the Committee, thank you again for this opportunity to testify. It is now commonplace to assert that the U.S.-China relationship will be our most significant bilateral relationship during the 21st Century. Our trade relations with China already have an enormous impact on the U.S. economy, and the security challenges before us are of the highest order. Through an appropriate mix of U.S. policies, this complex relationship can be managed in such a way as to minimize the downside risks, and enhance the prospects of moving China toward a more democratic and market-oriented society, to the benefit of both our economic and national security interests. If mismanaged, bilateral tensions and the potential for conflict will surely grow.

As we stated at the outset, we have concluded that a number of the current trends in U.S.-China relations are presently moving in a troublesome direction. With a renewed and candid focus on the relationship by the Congress, we are optimistic that U.S. policy toward China can be put on a more solid, productive footing to tackle the long-term challenges that lie ahead.