

Executive Summary

This Report sets forth the Commission's analysis of the U.S.-China relationship in the designated areas of investigation in our Congressional mandate: China's proliferation practices, China's economic reforms and U.S. economic transfers to China, China's energy needs, Chinese firms' access to the U.S. capital markets, U.S. investments into China, China's economic and security impacts in Asia, U.S.-China bilateral programs and agreements, China's record of compliance with its World Trade Organization (WTO) commitments, and the Chinese government's media control efforts. Our analysis, along with recommendations to the Congress for addressing identified concerns, is chronicled in the Report's nine chapters, and summarized herein.

Overall Assessment of Economic and Security Challenges

Along with specified areas of investigation, Congress gave the Commission the overarching mission of evaluating on an annual basis "the national security implications of the bilateral trade and economic relationship between the United States and the People's Republic of China (PRC)." As reflected in our Congressional mandate, the Commission takes a broad view of "national security" in making this assessment. We have attempted to evaluate how the U.S. relationship with China affects the economic health of our nation, our industrial base, the military and weapons proliferation dangers we face, and our political standing and influence in Asia. Taken together, these elements paint a full picture of how the relationship impacts our broader national security interests.

Based on our analyses to date, as documented in detail in our Report, the Commission believes that a number of the current trends in U.S.-China relations have 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.

Nonetheless, the Commission believes 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. The United States has played – and continues to play – an enormous role in the economic and technological development of China. As the Commission has documented through our hearings and reports, U.S. trade, investment, and technology flows have been a critical factor in China's rise as an economic power. We need to use our substantial leverage to develop an architecture that will help avoid conflict, attempt to build cooperative practices and institutions, and advance both countries' long-term interests. The United States has the leverage now and perhaps for the next decade, but this may not always be the case. We also must recognize the impact of these trends directly on the domestic U.S. economy, and develop and adopt policies that ensure that our actions do not undermine our economic interests.

When the Congress approved Permanent Normal Trade Relations (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 goals, and must configure its policies toward China to help make them 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 in China that can be an important partner in addressing regional and global security challenges, including weapons proliferation, terrorism, and peaceful resolution of the cross-Strait situation.

The Commission examined in depth the extent of ongoing cooperation between China and the United States on traditional national security matters, most particularly China's assistance in resolving the North Korea nuclear weapons crisis. The Commission believes that China's performance in this area to date has been unsatisfactory, and we are concerned that U.S. pressure on trade disputes and other unrelated aspects of the relationship may have been toned down by the administration as a concession for China's hoped-for cooperation on this and other vital security matters. The Commission believes that any real progress with China on both the trade and security fronts will require the use of substantial and continuing leverage on the part of the United States.

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 WTO. But China will likely not initiate the decisive measures toward more meaningful economic and political reform without substantial, sustained, and increased pressure from the United States. And while the United States must pursue its own interests, it is vital for other nations to join our efforts if we are to succeed. Our recommendations to Congress in this Report provide our assessment of particular tools the United States can use to exercise its leverage.

Key Findings and Recommendations

The Report presents its key findings, analysis, and recommendations to Congress in nine chapters, organized in three sections capturing the major themes of our Congressional mandate. While our analysis has been divided in this manner, all of these areas interrelate in assessing the broader question of how the U.S.-China economic relationship affects U.S. economic and national security interests. We recognize that the United States' vast economic transfers to China are inseparable from the larger geopolitical and military developments at issue.

We include within this Executive Summary our priority recommendations to Congress. A full list of the Report's recommendations, by chapter, follows in a separate section.

U.S.-China Trade and Economic Transfers

Bilateral trade and investment flows between the United States and China are taking place on a massive and rapidly increasing scale. Assessing how these flows are affecting the U.S. economy – and with that U.S. economic security – is an essential area of the Commission's work.

Litmus Test for Global Trade Relations

The development of the U.S.-China economic relationship has broader implications for the path of globalization writ large. As generally understood, globalization refers to the process of creating a unified global economy through the breaking down of barriers between national economies. It encompasses the increased integration of national goods, financial, and labor markets. In goods markets, globalization takes the form of increased goods and services trade between countries and the internationalization of production through global supply chains. In labor markets, it

manifests itself through increased labor migration and movement of production to labor markets that are the most cost-effective in terms of wages and working conditions, whether or not they are the result of artificial conditions. In financial markets, it shows up in the international diversification of investor portfolios and increases in cross-border financial flows.

The Commission believes that the U.S.–China economic relationship is of such large dimensions that the future trends of globalization will be influenced to a substantial degree by how the United States manages its economic relations with China. It is reasonable to believe that U.S.-China economic relations will help 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 not, the opposite will likely be true.

Further, the Commission recognizes that many of the challenges facing the U.S. economy from globalization require changes in U.S. policy that go well beyond specific responses to China's practices. Improving U.S. economic competitiveness and the welfare of U.S. workers will require actions including enhanced national commitments to education, infrastructure modernization, changes in U.S. tax policy to encourage U.S.-based production and research and development (R&D), and to more comprehensive retraining programs for U.S. workers negatively impacted by trade. However, given our mandate, we have focused our recommendations to Congress on items tailored to meet the more specific economic challenges of China.

The Imbalanced U.S.-China Trade Relationship and the Consequences for the U.S. Economy

The dominant feature of U.S.-China economic relations is the U.S. goods trade deficit, which rose by more than twenty percent in 2003 to a record \$124 billion. This deficit now constitutes over twenty-three 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 as compared with \$152 billion in imports in 2003 – is by far the United States' most lopsided trade relationship as measured by the ratio of imports to exports. China is heavily dependent on the U.S. market, with exports to the United States constituting 35 percent of total Chinese exports in 2003.

A key factor contributing to the U.S. deficit with China is the undervaluation of the Chinese yuan against the U.S. dollar. This gives Chinese manufacturers a competitive advantage over U.S. manufacturers. Economic fundamentals suggest that the Chinese yuan is undervalued, with a growing consensus of economists estimating the level of undervaluation to be anywhere from fifteen to forty percent. The Chinese government persistently intervenes in the foreign exchange market to keep its exchange rate pegged at 8.28 yuan per dollar, and through these actions appears to be manipulating its currency valuation. A second factor contributing to imbalances in U.S.-China trade is China's mercantilist industrial and foreign direct investment policies. These policies involve a wide range of measures including technology transfer requirements, government subsidies, discriminatory tax relief, and limitations on market access for foreign companies. Finally, China's labor markets do not provide adequate recognition of workers' rights, thereby resulting in artificially low wages that disadvantage our economic interests.

The U.S. trade deficit with China is of major concern because (i) it has contributed to the erosion of manufacturing jobs and jobless recovery in the United States, (ii) manufacturing is critical for

the nation's economic and national security, and (iii) the deficit has adversely impacted other sectors of the U.S. economy as well. 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.

Recommendation: In the absence of concrete progress by the administration in moving China toward an substantial upward revaluation of the yuan against the dollar and to repegging the yuan to a trade-weighted basket of currencies, Congress should pursue legislative measures that will direct the administration to take action – through the WTO or otherwise – to combat China's exchange rate practices. The administration should concurrently encourage our trading partners with similar interests to join in this effort.

Recommendation: Congress should direct the United States Trade Representative (USTR) and the Department of Commerce to undertake immediately a comprehensive investigation of China's system of government subsidies for manufacturing, including tax incentives, preferential access to credit and capital from state-owned financial institutions, subsidized utilities, and investment conditions requiring technology transfers. The investigation should also examine discriminatory consumption credits that shift demand toward Chinese goods, Chinese state-owned banks' practice of noncommercial-based policy lending to state-owned and other enterprises, and China's dual pricing system for coal and other energy sources. USTR and Commerce should provide the results of this investigation in a report to Congress that assesses whether any of these practices may be actionable subsidies under the WTO and lays out specific steps the U.S. government can take to address these practices.

China's Mixed Record in 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 does not have a market-based economy. To protect against trade distortions and unfair trade practices resulting from China's non-market status, the agreement includes a special WTO review mechanism – the Transitional Review Mechanism (TRM) – to monitor China's compliance and special safeguard provisions giving WTO members the right to protect themselves against sudden surges of Chinese imports.

Though China has made progress in reducing tariffs and otherwise formally meeting a large number of its WTO accession commitments, significant compliance shortfalls persist in a number of key areas for U.S. trade. Among areas of concern are China's manipulation of its currency, continued provision of direct and indirect subsidies to Chinese producers, use of unjustified technical and safety standards to exclude foreign products, poor enforcement of intellectual property rights (IPR), and discriminatory tax treatment for domestic semiconductor production. Moreover, China has deliberately frustrated the effectiveness and debased the value of the WTO's TRM, which was intended to be a robust mechanism for assessing China's WTO compliance and for placing multilateral pressure on China to address compliance shortfalls.

Recommendation: Congress should press the administration to make more use of the WTO dispute settlement mechanism and/or U.S. trade laws to redress unfair Chinese trade practices. In particular, the administration should act promptly to address China's exchange rate manipulation, denial of trading and distribution rights, lack of IPR protection, objectionable labor standards, and subsidies to export industries. On IPR, the United States

must take action to force China to enact credible criminal penalties for IPR violations and to greatly enhance enforcement. Another key priority for U.S. trade officials must be ensuring China's compliance with its WTO commitments to refrain from forced technology transfers used as a condition of doing business. In pursuing these cases, Congress should encourage USTR to consult with trading partners who have mutual interests at the outset of each new trade dispute with China.

Recommendation: Congress should press the administration to make better use of the China-specific section 421 and textile safeguards negotiated as part of China's WTO accession agreement to give relief to U.S. industries especially hard hit by surges in imports from China.

Recommendation: Congress should encourage USTR and other appropriate U.S. government officials to take action to ensure that the WTO's Transitional Review Mechanism process is a meaningful multilateral review that measures China's compliance with its WTO commitments. If China continues to frustrate the TRM process, the U.S. government should work with the European Union, Japan, and other major trading partners to produce a separate, unified annual report that measures and reports on China's progress toward compliance and coordinates a plan of action to address shortcomings.

Governance and Security Concerns with China's Outreach to the Global Capital Markets

The Chinese government has selectively chosen firms – predominately state-owned enterprises (SOEs) – to list on international capital markets, primarily in Hong Kong and New York, and may bring as much as \$23 billion in initial public offerings to global capital markets in 2004, a marked increase over the past few years. Yet, Chinese corporate governance standards lag far behind those in the United States. Accounting and reporting standards are weak, and China lacks a sound, transparent system of credit ratings. As a result, even the most sophisticated investors lack adequate disclosure when it comes to Chinese debt and equity listings in international capital markets.

Moreover, inadequate transparency and disclosure prevents the U.S. government and investors from understanding the possible nexus between Chinese firms listing on U.S. and international capital markets and weapons proliferation and/or China's defense-industrial complex. Many SOEs were previously controlled by the People's Liberation Army (PLA), and there is concern that unofficial links to the PLA remain intact after privatization. At least one firm listed in China's capital markets and available for purchase by qualified U.S. investors – China North Industries Corp. – has been sanctioned for proliferation by the U.S. government, and there are concerns that other Chinese firms listed or trading in China or in the United States may be engaging in similar activities.

Without adequate information about Chinese firms trading in international capital markets, U.S. investors may be unwittingly pouring money into black box firms lacking basic corporate governance structures, as well as enterprises involved in activities harmful to U.S. security interests.

Recommendation: Congress should reinstate the reporting provision of the 2003 Intelligence Authorization Act [P.L. 107-306, Sec 827] directing the director of Central Intelligence (DCI) to prepare an annual report identifying Chinese or other foreign companies

determined to be engaged or involved in the proliferation of weapons of mass destruction or their delivery systems that have raised, or attempted to raise, funds in the U.S. capital markets. In addition, Congress should expand this provision to require the DCI to include a broader interagency review of the security-related concerns of Chinese firms accessing, or seeking to access, the U.S. capital markets that would examine linkages between proliferation and other security-related concerns and Chinese companies, including their parents and subsidiaries, with a presence in the U.S. capital markets.

Recommendation: Congress should bar U.S. institutional or private investors from making debt or equity investments, directly or indirectly, in firms identified and sanctioned by the U.S. government for weapons proliferation-related activities, whether they are listed and traded in the United States or in the Chinese or other international capital markets.

We note that these bilateral trade and investment dynamics are occurring at a time of significant economic stresses in China, with growing numbers of economists and financial analysts cautioning about the possible bursting of the bubble in China's economy. These predictions rest on concerns about the economy overheating and on concerns about the weak foundation of the Chinese banking system, which has accumulated nonperforming loans estimated to be \$500 billion after decades of making loan decisions based on policy or political grounds rather than financial considerations.

These suspect capital allocation practices raise cautionary flags about the sustainability of China's economic boom. It is crucial that U.S. policymakers understand the potential ramifications for the U.S. economy and investors, China's Asian trading partners, and China's domestic stability should China's economic bubble burst.

Regional and Geostrategic Developments

The Commission examined China's rise as a regional power and its central role in the global security challenges stemming from the proliferation of weapons of mass destruction (WMD) and access to energy supplies. In this examination, we weighed the extent to which China is contributing to or undermining a more stable global security environment.

China's Regional Diplomatic Offensive

Through trade and investment, China has become increasingly interconnected with its Asian neighbors. Investors from Hong Kong, Taiwan, Japan, South Korea and Southeast Asia are helping to fuel the export processing industries of China that deliver a wide array of manufactured goods to the United States and Europe through global supply chains. China's industrial growth has attracted foreign direct investment that might otherwise have gone elsewhere; some industries in Northeast and Southeast Asia have been displaced by competition from China; but Asian suppliers also have been increasingly feeding China's export processing industries and domestic markets. Large trade surpluses with China in 2002-03 contributed to the growth of most regional economies.

Enhanced regional economic linkages have served China's political agenda. Through increasingly active and sophisticated bilateral and multilateral diplomacy, China is presenting itself as a country that is peacefully rising, offering win-win solutions for its economic partners in Asia. It has shown a greater willingness in recent years to participate actively in multilateral

forums on both economic and security issues – such as APEC, the ASEAN Regional Forum, and the Shanghai Cooperation Organization. Evidence indicates that this diplomatic strategy is making inroads for China, despite a wariness of China's growing military power, particularly on the part of Japan.

While China has undertaken a diplomatic offensive in Asia to reassure its neighbors of its long-term peaceful intentions, buying time and space in the process to pursue its economic development and military strengthening, countries in the region appear to perceive the United States as losing focus on Asia as it prosecutes the war on terrorism. The Commission believes that the United States' influence and vital long-term interests in Asia are being challenged by China's robust regional economic engagement and diplomacy, and that greater attention must be paid to U.S. relations in the region.

Recommendation: Congress should revitalize U.S. engagement with China's Asian neighbors by encouraging U.S. diplomatic efforts to identify and pursue initiatives to demonstrate the United States' firm commitment to facilitating the economic and security needs of the region. These initiatives should have a regional focus and complement bilateral efforts. The Asia-Pacific Economic Cooperation forum (APEC) offers a ready mechanism for pursuit of such initiatives.

Growing Tensions Across the Strait and in Hong Kong

China has not offered win-win political solutions to Taiwan and Hong Kong. China has been building missile forces and positioning its military to deter Taiwan from taking political steps Beijing considers unacceptable moves towards independence and to coerce Taiwan to end the island's continued separate status. Further, China is using its political clout to keep Taiwan out of regional and bilateral economic arrangements and to otherwise economically marginalize the island. Taiwan President Chen Shui-bian's recent reelection and Chen's plan for constitutional revision have heightened China's anxiety regarding Taiwan and heightened the near-term prospects for conflict. In Hong Kong, China's National People's Congress has undercut Hong Kong's autonomy and self-governance by its recent unilateral decisions to rule out near-term direct elections for Hong Kong's chief executive and Legislative Council. Moreover, Beijing has engaged in a systemic campaign in recent weeks to intimidate the democracy movement in Hong Kong by depicting its leaders as unpatriotic toward China, directing an unprecedented visit of eight Chinese warships to Hong Kong's harbor, and prohibiting legislative debate on electoral matters in Hong Kong's legislature.

China's recent actions toward Taiwan and Hong Kong call into question its commitments to a peaceful approach toward Taiwan and to preserving Hong Kong's autonomy and self-government. These developments merit a fresh look at U.S. policies in these areas by the Congress and executive branch. In particular, recent developments across the Strait are putting increasing stress on the United States' one China policy, demonstrating the need for a new assessment of this policy that takes into consideration current realities.

Recommendation: Congress should consult with the administration to assess jointly whether the PRC's recent interventions impacting Hong Kong's autonomy constitute grounds for invoking the terms of the U.S.-Hong Kong Policy Act with regard to Hong Kong's separate treatment. This includes U.S. bilateral relations with Hong Kong in areas such as air services, customs treatment, immigration quotas, visa issuance, and export controls. In this context,

Congress should assess the implications of the National People's Congress Standing Committee's intrusive interventions with regard to matters of universal suffrage and direct elections. Congress and the administration should continue to keep Hong Kong issues on the U.S.-PRC bilateral agenda and work closely with the United Kingdom on Hong Kong issues.

Recommendation: Congress should enhance its oversight role in the implementation of the Taiwan Relations Act. 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. In this same context, Congress and the administration should conduct a fresh assessment of the one China policy, given the changing realities in China and Taiwan. This should include a review of:

- The policy's successes, failures, and continued viability;
- Whether changes may be needed in the way the United States government coordinates its defense assistance to Taiwan, including the need for an enhanced operating relationship between U.S. and Taiwan defense officials and the establishment of a U.S.-Taiwan hotline for dealing with crisis situations.
- How U.S. policy can better support Taiwan's breaking out of the international economic isolation that the PRC seeks to impose on it and whether this issue should be higher on the agenda in U.S.-China relations. Economic and trade policy measures that could help ameliorate Taiwan's marginalization in the Asian regional economy should also be reviewed. These could include enhanced U.S.-Taiwan bilateral trade arrangements that would include protections for labor rights, the environment, and other important U.S. interests.

Recommendation: Congress should consult with the administration on developing appropriate ways for the United States to facilitate actively cross-Strait dialogue that could promote the long-term, peaceful resolution of differences between the two sides and could lead to direct trade and transport links and/or other cross-Strait confidence-building measures. The administration should be directed to report to Congress on the status of cross-Strait dialogue, the current obstacles to such dialogue, and, if appropriate, efforts that the United States could undertake to promote such a dialogue.

China's Intermediary Role in the Standoff with North Korea

China has become a major diplomatic player in the ongoing standoff with North Korea over Pyongyang's development of nuclear weapons. As host of the Six Party Talks, China has helped bring North Korea to the table; but has not adequately employed its considerable political and economic leverage over North Korea to drive Pyongyang towards acceptance of the goal of achieving a complete, verifiable, and irreversible dismantlement of North Korea's nuclear weapons programs. Even as events in North Korea unfold, Chinese state companies continue to pursue deals to sell WMD-related items to countries of concern to the United States. The United States has repeatedly imposed sanctions in response to these activities; but sanctions remain limited to penalizing offending companies, despite many of these companies' direct affiliation with top levels of the PRC government or military.

The United States has placed great faith in China's ability to move North Korea toward renouncing its nuclear weapons programs. The U.S.-China working relationship to defuse this crisis has been lauded as an essential component in bilateral relations, one that appears to trump other areas of U.S. concern. The Commission believes China has not effectively utilized its substantial leverage over North Korea to produce a workable resolution and regards China's performance in this regard over the next few months as a key test of the U.S.-China relationship.

Recommendation: Should the current stalemate in the Six Party Talks continue, Congress should press the administration to work with its regional partners, intensify its diplomacy, and ascertain North Korean and Chinese intentions with a detailed and staged proposal beginning with a freeze of all North Korea's nuclear weapons programs, followed by a verifiable and irreversible dismantlement of those programs. Further work in this respect needs to be done to determine whether a true consensus on goals and process can be achieved with China. If this fails, the United States must confer with its regional partners to develop new options to resolve expeditiously the standoff with North Korea, particularly in light of public assessments that the likely Korean uranium enrichment program might reach a stage of producing weapons by 2007.

Recommendation: Congress should press the administration to renew efforts to secure China's agreement to curtail North Korea's commercial export of ballistic missiles and to encourage China to provide alternative economic incentives for the North Koreans to substitute for the foreign exchange that would be foregone as a result of that curtailment.

China's Energy Trajectory and the Implications for Global Energy Markets

China has moved past Japan to rank second behind the United States in global energy consumption, and is the world's second largest oil consumer and its third largest oil importer. These trends have made China increasingly dependent on imported energy sources. China has pursued its energy security strategy via bilateral energy deals, and does not maintain a meaningful strategic petroleum reserve or participate in multilateral energy market stabilizing arrangements. China's rising energy demand has put added pressure on global petroleum supplies and prices. Indeed, the recent escalation in gasoline prices in the United States has been attributed, in part, to the impact of China's growing pressure on world oil supplies and the absence of any mechanism in place to counter this pressure and maintain stable prices for consumers. It also has had consequences for China's economy, as energy shortages and blackouts have led to slowdowns in industrial production in certain sectors.

Energy needs have driven China closer to the Middle East and Africa, as well as neighbors in Central Asia, Russia and the Pacific. China seeks to lock in secure energy supplies, especially new sources of gas and oil not subject to potential disruption in a time of conflict. China has sought energy cooperation with countries of concern to the United States, including Iran and Sudan, which are inaccessible by U.S. and other western firms. Some analysts have voiced suspicions that China may have offered WMD-related transfers as a component of some of its energy deals.

China's growing energy needs, linked to its rapidly expanding economy, are creating economic and security concerns for the United States. China's energy security policies are driving it into

bilateral arrangements that undermine multilateral efforts to stabilize oil supplies and prices, and in some cases may involve dangerous weapons transfers.

Recommendation: Congress should direct the secretaries of State and Energy to consult with the International Energy Agency with the objective of upgrading the current loose experience-sharing arrangement, whereby China engages in some limited exchanges with the organization, to a more structured arrangement whereby the PRC would be obligated to develop a meaningful strategic reserve, and coordinate release of stocks in supply disruption crises or speculator-driven price spikes.

Technology and Military Advancements

China has undergone rapid advancements in technology development, military modernization, and media control. These advancements are altering bilateral and regional trade flows, the cross-Strait military balance, and the Chinese government's ability to control the media and shape perceptions of the United States and its policies.

China's Coordinated National Strategy for Technology Development

The Chinese government has developed and pursued a coordinated strategy for attracting and directing national and foreign investment into high-tech research, development, and production. This strategy for high-tech investment has been a sustained, multi-year effort that has paid dividends for economic growth, science and technology institutions, educational infrastructure, technical levels of workers and industries, and military modernization. The United States and other foreign partners – both commercial and governmental – have contributed significantly to these developments. U.S. advanced technology and technological expertise is transferred to China in a number of ways, both legal and illegal, including through U.S. invested firms and research centers in China, Chinese investments in the United States, bilateral science and technology (S&T) cooperative programs, and Chinese students and researchers who return home following their work and study at U.S. universities and research institutes.

China's development as a locus of high-technology manufacturing and R&D has been a key component of its economic reform strategy, and the pace of this development has exceeded many outside observers' expectations. What China does with its growing technology capabilities – whether it converts them to military uses and/or to control the free flow of information to its population – is of direct national security concern to the United States. Moreover, the extent to which these advances allow China to challenge U.S. competitiveness in technology development is a vital matter for U.S. economic security.

The U.S. government collects inadequate data on the shifts of U.S. high-tech investment, technology transfers, and R&D to China. Information on U.S. transfers of technology subject to export licensing is compiled and government reporting on official S&T cooperation efforts has improved somewhat under Congressional mandate; but the overall picture of U.S. contributions to the development of China's technology growth and R&D base is not at all clear. Assessments of the implications of these shifts for the United States' long-term technological superiority and for China's competitiveness – both commercially and militarily – are difficult to make as a result of this gap in knowledge. Moreover, the process by which the U.S. government reviews acquisitions of American companies by Chinese and other foreign investors – the Committee on Foreign Investment in the United States (CFIUS) – focuses solely on traditional national security

concerns with such investments, while failing to consider broader U.S. economic security interests.

Recommendation: Congress should direct the administration to develop and publish a coordinated, comprehensive national policy and strategy designed to meet China's challenge to the maintenance of our scientific and technological leadership and competitiveness in the same way it is presently required to develop and publish a national security strategy.

Recommendation: Congress should revise the law governing the CFIUS process to expand the definition of national security to include the potential impact on national economic security as a criterion to be reviewed, and should direct the administration to transfer chairmanship of CFIUS from the Secretary of the Treasury to the Secretary of Commerce.

Military Modernization and the Shift in the Cross-Strait Military Balance

Commission research and hearings indicate that 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. China's modern arsenal includes an increasingly sophisticated nuclear missile force that is of direct strategic concern to the United States, while in the Western Pacific theater China has deployed over five hundred conventional short-range ballistic missiles that threaten Taiwan and longer-range conventional missiles that could threaten Japan and U.S. 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 and, to a lesser extent, from Israel.

China's quantitative and qualitative military advancements have resulted in a dramatic shift in the cross-Strait military balance toward China, with serious implications for Taiwan, for the United States, and for cross-Strait relations.

Recommendation: Congress should urge the President and the secretaries of State and Defense to press strongly their European Union counterparts to maintain the EU arms embargo on China.

Recommendation: Congress should direct the administration to restrict foreign defense contractors who sell sensitive military-use technology or weapons systems to China from participating in U.S. defense-related cooperative research, development, and production programs, which restriction can be targeted to cover only those technology areas involved in the transfer to China, and to provide a comprehensive annual report to the appropriate committees of Congress on the nature and scope of foreign military sales to China, particularly from Russia and Israel.

Continued Controls Over The Media

The Chinese government continues to exercise strong controls on the dissemination of information via the public media. While there has been some loosening of controls on reporting of news relating to many areas of business and society in China, red lines remain that are dangerous for individuals or organizations to exceed.

The Chinese government's propaganda machinery has not withered away during twenty-five years of reform and opening; rather it has modernized. This was proven beyond doubt during the SARS epidemic of 2003. The Chinese government's intensive efforts to cover up the outbreak of SARS showed the breadth of the government's control, while the ability of many in the population to nonetheless access information about the epidemic via the Internet, text messaging, and other new media demonstrated the limitations of this control in a growing high-tech society.

Government censorship; jamming of some overseas broadcasts, including those of U.S. government-sponsored outlets like the Voice of America; blocking of foreign and domestic Internet Web sites; and punishments for those who disseminate information beyond the government's tolerance remain widespread. Open criticism of China's leaders, questioning of the Communist Party and its policies, organizational activities that are independent of government control, and anything perceived as conducive to political conduct remains taboo in the public media. The Chinese government has used its control over the media to shape the population's perceptions of the United States and its policies, leading to a consistent message in the Chinese media that has been particularly critical of U.S. foreign policy and intentions in Asia.

Despite the Chinese government's much heralded reversal of policy to encourage more open and accurate reporting of SARS during last year's outbreak, there has in practice been no fundamental change in the Chinese government's approach to controlling the media, including information available through the Internet. This control shapes the Chinese population's perceptions of the United States and its policies, enhancing the risk of misperception and miscalculation in the bilateral relationship and increasing the potential for, and the difficulty of, managing crisis situations.

Recommendation: Congress should enhance funding for the Broadcasting Board of Governors' programs aimed at circumventing China's Internet firewall through the development of anticensorship technologies and methods, and direct the Department of Commerce and other relevant agencies to conduct a review of export administration regulations to determine whether restrictions are needed on the export of U.S. equipment, software, and technologies that permit the Chinese government to surveil its own people or censor free speech.

Conclusion

It is now commonplace to assert that the U.S.-China relationship will be our most significant bilateral relationship during the Twenty-First Century. Our trade and investment with China already has 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 open, democratic and market-oriented society, to the benefit of both our economic and national security interests.

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 the wrong direction. With a renewed and realistic 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.