

Statement of
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Thank you to Pei Minxin and the Carnegie Endowment for the opportunity to participate in this discussion today, and to my fellow panelists Bert Keidel and Michael Swaine, whose reputations precede them and with whom I expect to have a spirited discussion.

I hope our host and moderator will forgive me for sharing a personal comment. When he invited me to speak today, Minxin noted that he had been a beneficiary of the Chinese Student Protection Act, legislation developed by my former boss, Congresswoman Nancy Pelosi, after Tiananmen Square, to protect the many Chinese students who, by virtue of having been students at that time in the United States, were presumed by the Chinese government to have been pro-democracy and therefore a threat. The values and principles for which those students and workers in China stood over 16 years ago are no less important and no less inspiring today. We, as a nation, have benefited from the contributions of the students who were not free to return home and I would like to acknowledge Minxin and the many others who have made the United States their home and embraced wholeheartedly the freedoms we so easily take for granted here.

Now, on to the contentious topics, starting with the title of today's panel: "Dark Clouds on the Horizon." From the perspective of benefits to the United States of the status quo in U.S-China relations, I am not sure that the clouds are on the horizon. The sun has really not been shining in this relationship for a number of years. That is the starting point for examining the state of U.S.-China relations, as well as for assessing what troubles lie ahead.

Fundamentally, it appears that our approach to dealing with China has not been particularly effective in the pillars that are often used by Administrations to define foreign policy objectives – the benefits of trade, halting the proliferation of weapons of mass destruction, and promoting democratic freedoms. We do not have any consensus on how we should define our relations with China or even how we perceive the Chinese government – is it a friend? an ally? a strategic competitor? a strategic partner? a potential enemy? an enemy already? There is agreement only that China is a member of the United Nations Security Council and that it is a large and growing economy situated in Asia. There is a huge gap between the perceptions of the American people and the policy elite about everything to do with this relationship.

And, while the United States approaches its dealings with China on an ad hoc basis, the Chinese government has a strategic vision for what it wants to accomplish. It is no surprise that we are consistently out-negotiated and out-maneuvered on issues of concern.

This time last year, I testified on behalf of the US-China Commission before the House Armed Services Committee to present the findings of the Commission's Annual Report, which I note was unanimous and bipartisan, no small feat given the political climate and the broad range of backgrounds, interests, and constituencies the Commissioners represent.

I mention this testimony, not because I want you to know that I testified before Congress, but because I revisited what I said then and realized that none of the trends we identified one year ago have improved, and in fact, many of them have worsened.

Among the Commission's findings, last year, which will sound familiar today:

On Economic Security:

* China is not adhering sufficiently to its WTO trade commitments; market access is still a problem for U.S. goods and services; and rampant piracy of intellectual property rights continues.

True, there was yet another new agreement with the Chinese government just announced on IPR protection – but the headlines say it all, “China Makes More Pledges on Piracy,” in the Post for example. New pledges and agreements to tackle this problem have been announced going back to the days of Carla Hills' service as USTR, well over ten years ago. The other agreements have, for the most part, been ineffective or ignored, why should we expect more from this one?

* The U.S.-China trade relationship continues to be heavily imbalanced, with a skyrocketing trade deficit of \$124 BILLION in 2003.

All right, that one has changed. The deficit for 2004 was \$162 billion. Two days ago, the Post reported that China's exports surged in June while import growth slowed, resulting in, according to Chinese government figures, a \$9 billion overall Chinese trade surplus with the world, its third largest monthly surplus on record. Also according to the Post, over the first six months of this year, China's exports worldwide rose 33% over the same period last year.

* China continues to be heavily dependent on the U.S. market, with 35% of its exports coming to the U.S. At the same time, only 4% of U.S. goods exports go to China. The deficit has grown at over 20% per year since 1990.

* All of these factors, and others, including China's poor labor practices, are contributing to the erosion of the U.S. manufacturing base and the loss of jobs.

On National Security:

* Despite claims that China is helping to halt the proliferation of weapons of mass destruction and related technology, numerous examples of such proliferation from China continue. Serious allegations have been made that North Korea is using Chinese facilities as trans-shipment points for North Korean WMD exports to third countries.

* Despite claims that the Chinese government is helping with the North Korea crisis, and indeed, some credit is due for their assistance in getting North Korea's participation in the Six-Party Talks, serious questions exist about why China is not exerting its considerable leverage on North Korea.

* China is channeling its economic strength into rising political influence and military power in Asia, at a time when Asian countries perceive that the U.S. is focused on challenges elsewhere in the world.

* China is also ratcheting up its military modernization programs aimed at Taiwan, and frictions are growing between China and both Taiwan and Hong Kong.

Last year, the Commission also focused on energy security and reported that:

On Energy Security:

* China moved past Japan to rank second behind the United States in global energy consumption. It is the world's second largest oil consumer and its third largest oil importer.

* China's rising energy demand has put added pressure on global petroleum supplies and prices. The recent escalation in gasoline prices here at home has been attributed, in part, to the impact of China's growing pressure on world oil markets.

* 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. It also seeks to control the resources at the well-head or the source, bypassing world market mechanisms.

* China has sought energy cooperation with countries of concern to the United States, including Iran and Sudan, which are inaccessible by U.S. firms. Some analysts have voiced suspicions that China may have offered weapons of mass destruction-related transfers as a component of some energy deals.

The trend line on many of these problems is not improving. Add to this mix the concern of Americans across the country about their own job security and the uncertainty of the economic future for their children; their perception that everything they buy is made in

China (July 4th comic strip); continuing frustration about China's currency valuation; and, gasoline prices that are spiking up as much as 10 cents a gallon in a week. This is the climate in which CNOOC's bid for Unocal has been made.

It would, however, be a mistake to dismiss the questions and concerns about the implications of this potential deal as "simply" an emotional response. Labeling a policy disagreement an emotional response does the debate no service. Indeed, just yesterday, Senators Grassley and Baucus, the Chair and Ranking Member of the Senate Finance Committee, two men not known for their emotional responses on trade issues, wrote to President Bush urging that CFIUS undertake a serious review of the national security implications of a CNOOC takeover of Unocal. We should all insist that serious consideration be given to the full range of real issues, which have been raised.

A number of my fellow Commissioners, although not all, agree that economic security is an integral part of national security. I offer for your consideration a comment made by Dr. William Schneider, Chairman of the Defense Science Board, at a recent Commission hearing on the Defense Industrial Base. Responding to a question, Dr. Schneider said, "Of course, it's the national economy that's ultimately the source of our military power. There are very few precedents for a country being able to do much in the way of maintaining a comprehensive military capability without a strong national economy."

While on the topic of the interconnectedness of economic and national security, let us look to the argument that we hear from some quarters that we cannot do anything to upset the Chinese government because if we do, they will stop financing our misguided fiscal policies, to the current tune of \$277.6 billion. Of course, the specter of economic blackmail in this case is specious, given that China holds only 6% of publicly held U.S. debt. And, the United States continues to hold, but not recognize or exercise, the leverage in the U.S.-China economic relationship – the reality that the Chinese government needs continued unfettered access to the US market in order to fuel its economic growth. And finally, what is the realistic likelihood that the Chinese government is going to take its money and invest it elsewhere, in Eurobonds, for example?

Technically, of course, the Committee on Foreign Investment in the US (CFIUS) is supposed to address only national security concerns, although national security is not defined and is open to interpretation. What are the national security concerns raised by CNOOC's acquisition of a private American oil company? Economic security and energy security are directly linked, as are energy security and national security.

CNOOC is 70% owned by the Chinese government. It is one of three Chinese state-owned oil enterprises. The purchase of Unocal was approved by the State Council, China's cabinet, and the governor of the State Central Bank helped to assemble the financing package. The enterprise has direct and special access to the unlimited deep pockets of the Chinese government's reserves.

Calling the transaction a free market activity is absurd and a distortion of the notion of free markets. The loan package is heavily subsidized -- \$7 billion from CNOOC's parent, China National Offshore Oil. \$2.5 billion of that is interest free and the rest is a 30 year loan at 3%. \$6 billion more is coming from a State-owned bank. Such heavy subsidization would make possible the \$18.5 billion acquisition by a company worth only \$22 billion itself. Reports indicate the offer could be increased.

China National Offshore Oil, the parent company, is 100% owned by the Chinese government. The CEO of CNOOC and its parent, Mr. Fu, is one and the same person, and was appointed to both posts by the Communist Party of China. And in response to those who would argue that the Communist Party has no role in the company, from CNOOC Ltd's Annual Report (its 20-F), here is the description of the newest Board member, Mr. Wu: "In 2001, Mr. Wu became the director of the Ideology Affairs Department of CNOOC. Mr. Wu was appointed President and Chief of Discipline and Inspection Group of CNOOC in 2003."

The sole function of the Communist Party Discipline and Inspection Group at CNOOC is to assure that the party members presently assigned to CNOOC follow party direction fully and faithfully. That is the expertise Mr. Wu brings to CNOOC's governance. Interestingly, the party disciplinarian Mr. Wu was named to the Board following the departure of a former Swiss Ambassador who, it has been reported, objected to CNOOC's pursuit of Unocal.

And let's lay to rest the notion that CNOOC is just another company that responds to world energy prices. The majority of Unocal's holdings in Asia are liquified natural gas. In the PRC, the price of LNG is subject to national price controls, an exception carved out in its WTO accession agreement. A 70% government controlled company will be receiving \$7 billion in subsidies to purchase a raw material that is traded domestically under centrally-dictated controls. Where is the free market in that equation?

It is reasonable to ask why the Chinese government is so interested in acquiring Unocal. One reason, of course, is that its strategy to achieve energy security is based on direct control of reserves, rather than in competing on the open market. This approach is in direct conflict with the efforts of the U.S. and other countries in the International Energy Agency to develop fungible, transparent, and efficient energy markets. We already know that China's approach to energy security has foreign policy consequences for the U.S., as Chinese government oil companies purchase major stakes in Iranian and Sudanese oil fields, complicating efforts to deal with Iranian nuclear weapons and missile programs and the genocide in Sudan.

Why should the Chinese government's control of CNOOC matter? Unocal holds reserves from the Gulf of Mexico to the Caspian, in Southeast Asia, Africa, Europe and South America. Its energy assets are estimated to be 1.75 billion barrels of oil and oil equivalents reserves, and another 1.5 billion barrels of undeveloped oil and gas fields.

On our own territory, Unocal's assets include offshore platforms in Cook Inlet, Alaska, and the Gulf of Mexico. Do we want the authoritarian government in China to control critical energy resources on American territory? And what do we think about giving them control over US-based pipelines and refinery facilities?

Some would say this is no problem, because Unocal provides only a small portion of US oil needs. If that is the case, where is the line where the portion is too large? Is there such a line? We are not the only country confronting these issues. The Canadian Parliament is now considering legislation to tighten its investment laws to block foreign takeover of any Canadian company for national security reasons, in response primarily to concern about Chinese acquisition of Canadian raw materials and natural resources.

Then there is the question of our national security interests in other regions of the world, particularly in Asia – both “hard power” and “soft power.” Unocal's natural gas facilities in Indonesia provide a significant amount to Taiwan, Japan, and South Korea. How would that be used as leverage in a conflict in the Taiwan Straits, or to influence events in the region, or political process, or as leverage over any of our allies there?

We are already seeing a diminution of US influence in South and Southeast Asia as the Chinese government engages in “natural resource” cash diplomacy. Are we willing to cede further our presence and influence in Thailand and Vietnam? Unocal's annual report notes that 15% of Bangladesh's natural gas requirements are supplied by Unocal and that number is expected to reach 35% by 2008. If those resources are provided by the Chinese government, does that have any implications for the United States?

And finally, but central to a national security analysis, is the question of Unocal's possession of certain materials, technologies and equipment, including cavitation, deep sea exploration and drilling, with national security implications. Some oil exploration and drilling equipment, including software, is controlled for export because of its dual use potential, in some cases for nuclear testing, in others for detecting submarines.

Unocal is also the owner of the last U.S. source of rare earth minerals. Rare earth minerals are a critical component of magnets used in JDAMS, smart bomb technology and other vitally important military applications. We first saw China's interest in acquiring rare earth materials and bonded magnet technology when a Chinese state-owned company purchased Magnequench in 1995. Just six weeks ago, Magnequench, now a Chinese company, announced its intention to acquire AMR Technologies in Canada. With this acquisition and the acquisition of Unocal, the Chinese government will have cornered the supply of rare earth materials, used not only in military technologies, but also essential to virtually all electronic devices, including computers, mobile phones, and plasma LCD/displays.

CNOOC has made some pledges as part of its bid – pledges, for example, to maintain American jobs. But when Magnequench was purchased by a Chinese company, promises were made to the employees that the parent would not take the plant to China and that it would guarantee employment for a number of years. Well short of that guarantee,

however, the plant was closed, the facility was dismantled and shipped to China, and the workers lost their jobs. How do we know that CNOOC's promises will be upheld? And what recourse do we have if they are not?

We know from recent articles that a number of people, some quite eminent, are representing the Chinese government's interests in this bidding process. But, as is often the case in so many aspects of US-China relations, we must ask who is looking out for U.S. interests?

The only answer in this case would be the members of CFIUS. But is the CFIUS process broken? It certainly looks like it could use some substantial reform. Since 1988, CFIUS has reviewed some 1530 transactions, and required only one divestment through Presidential determination. The process needs a better and more expansive definition of national security; it needs transparency, and it certainly could use some Congressional oversight.

The House of Representatives has weighed in overwhelmingly twice recently, with close to 400 people voting each time to raise serious questions about this deal. Dismissing the import of these votes is foolish. While reflecting the cumulative frustrations of policy failures regarding China for the past years, they are also shaping the storm clouds in the years to come.

Thank you.

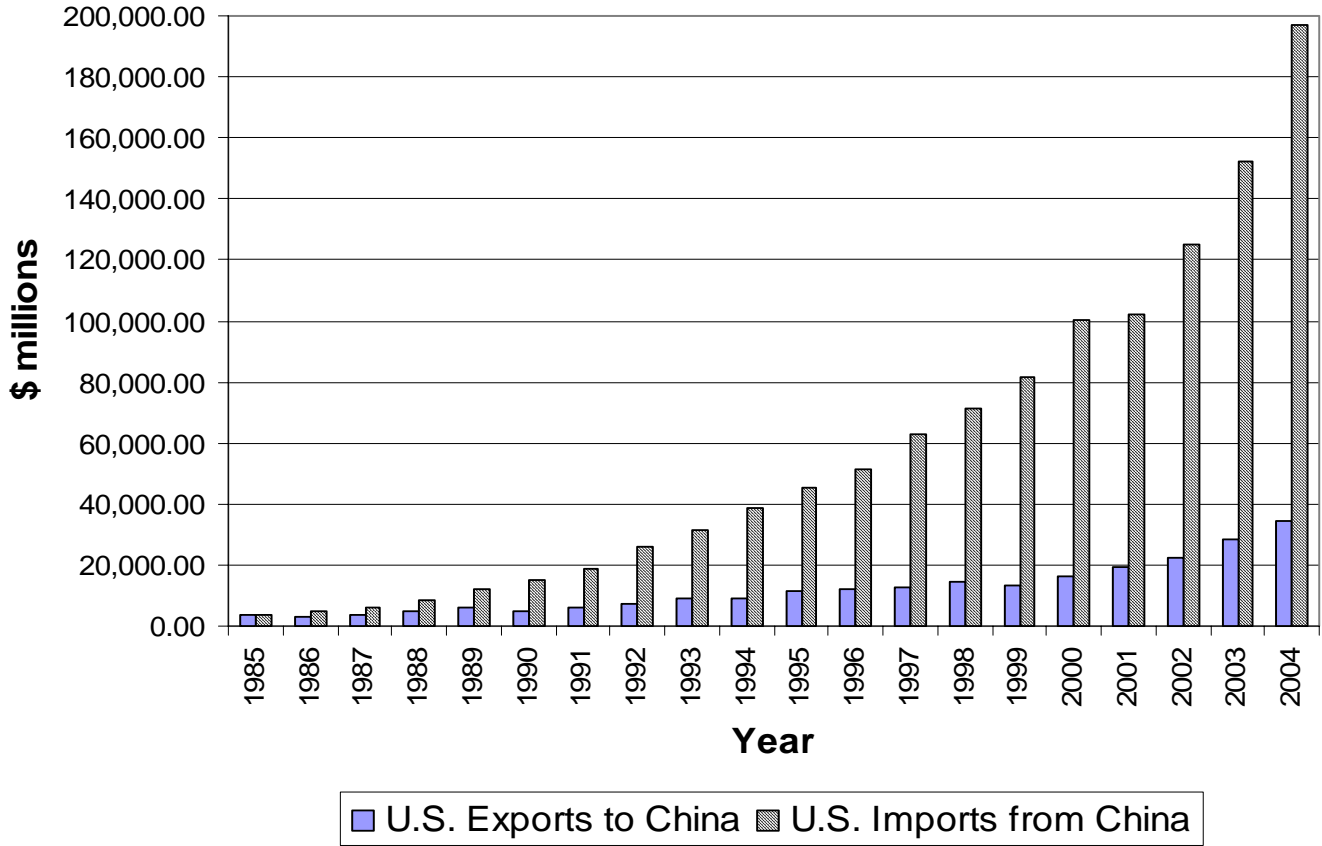
The China Deficit:

Data Source: Bureau of Economic Analysis, U.S. Department of Commerce



U.S. China Trade

Data Source: Bureau of Economic Analysis, U.S. Department of Commerce





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