

SUBMITTED TESTIMONY OF

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**CHINESE PENETRATION OF THE GLOBAL CAPITAL MARKETS:
ARE AMERICAN INVESTORS UNWITTINGLY BUYING THE ROPE
TO BE USED FOR THEIR ‘HANGING’?**

before the
U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION
11 August 2005

Introduction

Co-Chairmen Wessel and Robinson, let me begin by expressing my gratitude for several things: First, for including me in this panel on the People’s Republic of China’s penetration of the world’s capital markets. Second, for recognizing – as this Commission has from its inception – the security implications of Chinese and other actual or potential adversaries’ access to U.S. and foreign capital markets.

Third, for the enormous contribution that you and your colleagues are making to official and public awareness of the PRC’s increasingly ominous strategy. I believe that the record compiled in your impressive series of hearings and annual reports offers convincing evidence of:

- a) the real value of the “second opinion” on China that you provide as our government’s only independent, all-source-informed, official vehicle for such advice and
- b) that China is systematically pursuing a strategy that should alarm freedom-loving people in this country and around the world. Its aim is, I believe, to displace the United States as the world’s preeminent economic power and, if necessary, to defeat us militarily.

It is in the context of such a strategy that we must address China’s access to and use of American and other foreign capital, a subject to which I will return momentarily.

Finally, I would like to express particular appreciation to Roger Robinson, with whom I have had the pleasure of working for the past eighteen years. I have benefited greatly from his expertise and mentoring on economic and financial security matters. In my estimation, he is truly the preeminent thinker in the country on the intersection of traditional national security concerns with economic, financial, energy and technology security developments. Like many others here and abroad, I can honestly say he has

taught me practically everything I know about the latter subjects and I hope today to amplify, augment and reinforce findings and recommendations adopted by this Commission under his leadership.

The CNOOC-Unocal Precedent

As members of this Commission know, I was privileged to appear last month alongside Chairman D’Amato in a hearing convened by the House Armed Services Committee. We both testified against the then-pending effort by the Chinese National Overseas Oil Company (CNOOC) to acquire Unocal. It is very gratifying that just yesterday, Unocal’s shareholders voted to sell their company to another American concern, Chevron, instead of Communist China’s state-owned CNOOC.

We should be under no illusions, though. As long as China’s Communist Party continues to exercise dictatorial control over the country and its resources – not least, the immense wealth being accumulated as a result of America’s record trade deficits – the PRC will be pursuing various means of advancing its strategy at our expense. Those will include, among other initiatives, the following:

- Further efforts to purchase or otherwise acquire (including, where possible, by theft) strategic energy resources, minerals, materials and technologies;
- Rapidly accelerating and increasingly offensively-oriented military modernization efforts, including a focus on techniques given the name “Assassin’s Mace” evidently intended to defeat decisively the U.S. military. (In this connection, I would urge this Commission to receive a briefing from one of your counterpart panels that reported last year on the possibility such a “catastrophic” attack against our country might be carried out by ballistic missile-delivered electro-magnetic pulse weapons);
- Expanded attempts to obtain access to and, ultimately, control over strategic choke points around the world; and
- Money-enabled influence operations in pivotal regions from Africa, Siberia, the Middle East, Central Asia and Latin America to here in the United States itself (the last not least in the form of the purchase of vast quantities of U.S. government debt instruments).

Again, I applaud the U.S.-China Economic and Security Review Commission’s sustained effort to document and warn about these developments. I very much hope that before this session of Congress is concluded that your findings and recommendations will be translated into much-needed legislative initiatives. We at the Center for Security Policy look forward to working with you in that connection.

China and the Capital Markets

For the moment, let me focus on a microcosm of the larger problem we confront from Communist China and its strategy: The PRC's deliberate, systematic effort to use the U.S. and other foreign capital markets to sustain its many state-owned enterprises (SOEs) and to underwrite their activities. At least some of these entities (notably, several government-owned banks) are believed to be in serious economic difficulty. In fact, but for the past support of the Chinese treasury – *support the Communist regime has established can be transferred to American and other investors via Initial Public Offerings (IPOs) on foreign capital exchanges* – these SOEs would almost certainly be unsustainable.

The question before us today is: **What are the financial and strategic implications of the Chinese bringing to market, both here and overseas, companies that are effectively agencies of the state, SOEs whose true financial conditions and activities are not fully disclosed to investors?**

I believe that it is neither in the interest of American investors nor of the country as a whole to be underwriting Communist China's state-owned enterprises engaged in such activities as: the manufacture of intercontinental-range ballistic missiles and space-based weapons designed to blind our satellites; the proliferation of weapons of mass destruction; the suppression, in conjunction with police units and regional and national level governments, of human rights; the despoiling of the environment; the crushing of Tibetan freedom; and various business dealings with terrorist-sponsoring states.

My guess is that most U.S. investors would feel the same way – *provided* they *knew* that the Chinese SOEs whose stocks are often the object of glitzy road-shows and enthusiastic sales pitches by leading investment bankers are engaged in such activities and/or that the companies' books have been "window-dressed" to conceal their actual financial condition.

Take, for example, the prospective IPOs of Chinese government-owned banks that are each said to be hoping to raising billions of dollars when listed in Hong Kong and perhaps New York later this year or early next year: China Construction Bank (expected to garner some \$5 billion) and Bank of China (also an estimated \$5 billion). Yet another of these financial SOEs, the Bank of Communications recently issued an IPO in Hong Kong worth \$1.9 billion.

Let us be clear. These are *foreign government-owned entities*, not private firms. The Chinese government appears to be actively working with leading international banking houses to shape the appearance, assets, liabilities, profit margins and public relations tactics of these state-owned enterprises.

Despite such efforts, the PRC seems simply to be dressing-up what were, until recently, insolvent banks in the hope that international capital markets will contribute to bailing them out. This process involves the off-loading of non-performing loans onto

asset management companies in a fashion very reminiscent of the U.S. savings and loan crisis. Indeed, the PRC appears, in fact, to have modeled its strategy on the American experience.

The Communist regime is also publicizing measures being taken to track down and apprehend high-profile embezzlers, gangsters and other criminals so as to convey an image of rigor, discipline, accountability and the rule of law. These steps are clearly meant to counteract the growing body of experience of American and other foreign companies doing business with China – namely, that it is corruption and “connections,” rather than an enforceable legal code, that determines how one fares.

I would suggest that a far more accurate indicator of Chinese intentions to foster a free market economy, one in which American businesses and investors can safely and constructively participate, would be if *private sector* Chinese companies were coming to the U.S capital markets. Instead, reportedly some 90% of those being listed in overseas exchanges are state-owned enterprises – despite the fact that, according to some estimates, SOEs only comprise 40-50% of today’s Chinese economy.

One must ask: Where are the *private* Chinese companies that could be coming to overseas markets? Does the PRC really want them – and the private sector of the Chinese economy – to prosper and grow? Or is their exclusion, by and large (with the exception of some high technology enterprises), from access to the foreign exchanges an indication that the government is determined to perpetuate its SOE dinosaurs at the expense of its private enterprises. In other words, is this gambit really little more than a disingenuous fund-raising device of epic proportions intended to prop up the remains of China’s socialist economy?

Concerns on this score are only further heightened by the fact that China is confining sales of its state-owned entities’ stock to U.S. public pension funds, mutual funds and other investors to only about 10-15% of the total. In exchange for giving the Communist regime what can amount to billions of dollars, will these new investors enjoy any shareholder rights? The answer is decidedly “No.” Nor will they be assured adequate disclosure, transparency, accountability or corporate governance. The playing field remains as uneven as it was in the case of the SOE CNOOC’s fraudulent portrayal of its bid for Unocal as a “purely commercial venture” and paragon of “free trade.”

The truth of the matter is that U.S. investors wouldn’t accept for a single day the “black box” nature of many of these Chinese transactions on foreign capital markets if the company in question were an American one. *Neither would the Securities and Exchange Commission.*

A Useful Precedent: Financial Penalties for Abetting Sudanese Genocide

The fact is that Chinese SOE’s use the same production facilities to make not only consumer items like refrigerators but components for ICBMs. They are also in unsavory places like Iran, Syria and Sudan. In fact the PRC’s largest oil company, China National

Petroleum Corp. (CNPC) has a 40% equity share in the Greater Nile Petroleum Operating Company and reportedly takes 50% of Sudan's oil production. There are hundreds, if not thousands, of Chinese on the ground providing arms and training to the genocidal government in Khartoum, fueling the killing fields of that country and clearing areas of interest for oil exploitation.

Yet, PetroChina – an artificially created subsidiary manifestly designed to enable CNPC to finesse strenuous opposition to the parent company's IPO when it was first announced in 1999 – is today listed on the U.S. and other foreign exchanges. Fortunately, Harvard University's endowment recently decided to divest its holdings of Petrochina stock in light of CNPC's reprehensible activities in Sudan and the fact that there is no difference between CNPC and Petrochina (despite investment bankers' efforts to help China portray the two as bifurcated). Other universities are following suit.

In addition, the State of Illinois recently passed a statute requiring divestment from their public pension fund portfolios of all companies doing business with Sudan. New Jersey is following suit. And, I am pleased to report, **other states – led by Louisiana – are creating new reporting requirements that may lead to divestment of companies doing business not only with Sudan but with other terrorist-sponsoring states (with whom China generally has close ties).**

This activity is the most important development in the financial security field since the divestment campaign that helped force the South African regime to abandon apartheid, resulting in its subsequent fall from power. Of necessity, the divestment campaign on behalf of Sudan involves taking a stand against China more than any other nation. China is, after all, the most indifferent of any country in the world to the suffering in Sudan. Indeed, it is systematically aiding and abetting it.

As this Commission knows, the groundwork for such actions against attempts by Chinese "black box" SOEs to penetrate U.S. capital markets – and, thereby, to raise money for odious activities like the rape of Sudan – was laid in 1999 and 2000 by an informal, ad hoc group known as the Petrochina Coalition. Involving an array of organizations (including the AFL-CIO, Friends of the Earth, Freedom House, the Center for Security Policy, the International Campaign for Tibet, the American Anti-Slavery Group and the International Rivers Network), the Coalition created sufficient controversy about and opposition to CNPC/Petrochina's U.S. IPO through a counter-road show and other means as to reduce the offer's expected value by some 70% (i.e., from \$10 billion to just \$2.89 billion).

I would argue that the Petrochina Coalition's success in opposing one of China's premier SOEs as it sought to underwrite unsavory Chinese behavior with help from U.S. investors is anything but old news. It is a story that is very much in play today as universities, city and state legislatures and officials and other public-spirited organizations become alive to this phenomenon -- and adopt strategies for countering it.

Sinopec and Proliferation

That more can and urgently needs to be done is clear from the recent actions of another Chinese SOE, Sinopec: Last October, Sinopec signed a \$70 billion deal with the Islamofascist regime in Tehran to develop Iran's oil and natural gas fields. Sinopec is also in Sudan, a fact its representatives tried to deny when they took \$3.4 billion from U.S. and other investors in June of 2000.

In addition, as Gary Milhollin told this Commission last March:

Among Sinopec's many subsidiaries are two that have been sanctioned a total of four times since 1997 for selling chemical weapons equipment and technology to Iran. These companies, Nanjing Chemical Industries Group and Jiangsu Yongli Chemical Engineering and Technology Import/Export Corporation, are fully-owned subsidiaries of the Sinopec Group, which holds decisionmaking authority over them.

Mr. Milhollin noted, however, that, "The Sinopec Group has never been sanctioned or even mentioned in sanctions announcements." In fact, it is a virtual certitude that none of the U.S. investors in Sinopec have any idea that the company they partly own is involved in such activities.

The US-China Commission's Role

Given this Commission's legislatively established mandate to "evaluate the extent of Chinese access to, and use of United States capital markets, and whether the existing disclosure and transparency rules are adequate to identify Chinese companies which are active in United States markets and are also engaged in proliferation activities or other activities harmful to United States security interests," I respectfully submit that you have an obligation to determine several things:

- What steps are being taken to ensure that American investors are aware of the true nature of the Chinese companies in which they are being asked to invest?
- Are such companies' proliferation-, terrorism- and military production-related activities – or, in the case of Chinese banks, those of the PRC companies to which they lend – listed in the risk section of the prospectus or elsewhere in their disclosure-related filings?
- If not, is that because such activities are not to be considered material risks to investors? **Or, is it simply that we are supposed to accept that the Chinese can do as they wish with our money -- and that, despite "transparency," "accountability," "due diligence" and "good governance" being the watchwords of the American capital markets these days – such principles do not apply when China's wants to conduct businesses in those markets? If so, this arrangement would amount less to "free trade" than a "free pass" for Beijing.**

In particular, with respect to Chinese state-owned banks coming to our capital markets, this Commission would be well-advised to insist that investors be able to review such banks' loan portfolios. After all, these are the banks' *assets*. I strongly suspect that the borrowers include: the People's Liberation Army's vast array of enterprises, SOEs and front companies involved in technology theft (the *Wall Street Journal* reminded us yesterday that PetroChina has been part of Communist China's unprecedentedly comprehensive effort to obtain U.S. secrets and proprietary information); slave-labor and other human rights abusing concerns; companies responsible for widespread environmental deprivations; and businesses helping to crush Tibetan aspirations for renewed freedom and independence. If such assets are in the banks' portfolio, American investors have a need-to-know before they are invited to underwrite – and, thereby, to enable – such conduct in the future.

Similar scrutiny is no less in order with respect to Chinese companies already in the global capital markets such as China International Trust and Investment Corp. (CITIC) and China Ocean Shipping Company (COSCO). The former is chaired by Wang Jun, who also chairs Poly Technologies – a state-owned arms manufacturing conglomerate. The latter amounts to the Chinese merchant marine.

Then, there is Northern Industries (Norinco), another huge Chinese arms-producing concern. Norinco is arguably the most famous serial proliferator in China, yet its stocks trade on the “A-share” market of China's Shenzhen exchange, to which American portfolios have access only via what Beijing dubs “qualified foreign institutional investors” (QFIIs) such as Goldman Sachs and Morgan Stanley. Even though Norinco has been subjected to import controls and other U.S. sanctions for its proliferation-related activities (among other things, Norinco was caught in a sting operation in March 1996 trying to sell purported American drug-dealers AK-47s, shoulder-fired “Red Parakeet” anti-aircraft missiles and grenade-launchers), it is still possible for U.S. investors unwittingly to help fund such activities through QFIIs.

Buying the Rope

I am concerned that the PRC's efforts to bring its dubious state-owned enterprises to the world's capital markets is not evidence of a Communist Chinese commitment to free trade. Rather, it is a reflection of Beijing's refinement of the quote attributed to Lenin: They want the capitalists to *buy* the rope with which China ultimately will hang them.

The PRC's play for American investors is more than an effort to raise fresh capital for unsavory – and, at least in some cases, highly *dangerous* – purposes. It is a particularly insidious part of the ominous, overarching strategy described above: **If millions of American investors can be induced to have a vested interest in the physical and financial viability of Chinese firms engaged in such behavior around the world, Beijing stands to create a “China Lobby” even more formidable than that represented to date by co-opted American business interests.** It can reasonably

expect to be able to prevent future sanctions and suppress opposition to transactions like CNOOC's acquisition of Unocal.

This prospect is made all the more appalling by the fact that among those whose funds will be invested in such a fashion are *millions of Americans who would never knowingly want to be put in such a position as having their pensions tied to the success of Chinese arms manufacturers, proliferators, etc.* **Think of the outrage veterans, firefighters, policemen and women, teachers and other patriotic government employees would feel – if only they were aware of what the Communist Chinese and their helpers have in mind.**

This reality makes it all the more scandalous that a highly relevant provision contained in the 2003 Intelligence Authorization Act (P.L. 107-306, Sec. 827) was repealed under circumstances that are far from clear. **As a result, there is no longer a statutory requirement for annual reports by the Director of Central Intelligence 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 U.S. capital markets.**

A Job for the Cox Securities and Exchange Commission

I would, consequently, recommend that this Commission make a priority of seeking the reenactment of such a requirement. In the meantime, I would strongly second a suggestion Vice Chairman Robinson made in the *Financial Times* today. Specifically, the new **Chairman of the Securities and Exchange Commission, Chris Cox**, should be strongly encouraged to make an “enhanced effort” to ensure that U.S. investors are afforded the same transparency with respect to Chinese offerings in the American capital markets as is required of U.S. companies. In fact, **particularly with respect to PRC-owned banks, even greater transparency is in order, since Chinese government ownership and state-owned borrowers puts them in a different class than their American counterparts.**

This Commission should encourage the SEC to conduct an urgent review of the Chinese presence in our debt and equity markets for all kinds of concerns raised by PRC SOEs that already here – notably: disclosure, transparency, governance, do they have any history of proliferation or other security-related abuses (arms smuggling, tech theft, intelligence front companies), etc.

Given the material risk such security-related activities would obviously represent to share-holders, how could this information possibly be withheld? If the information is classified, the SEC and the Treasury should be urged to identify other means to ensure that investors are able to make informed decisions about the true nature of the company in question.

It is hard to imagine a better person to accomplish this vital contribution to transparency and accountability than Chairman Cox. After all, in his previous incarnation, Rep. Cox chaired a congressional commission that concluded in 1999:

The Securities and Exchange Commission collects little information helpful in monitoring PRC commercial activities in the United States. This lack of information is due only in part to the fact that many PRC front companies are privately held and ultimately -- if indirectly -- wholly-owned by the PRC and the Chinese Communist Party itself. **Increasingly, the PRC is using U.S. capital markets both as a source of central government funding for military and commercial development and as a means of cloaking U.S. technology acquisition efforts by its front companies with a patina of regularity and respectability.** (Emphasis added.)

What the Cox Commission found to be true in 1999 is even more true today. In fact, it is even more true than it was when a second, independent commission chaired by former CIA Director John Deutch determined that:

Because there is currently no national security-based review of entities seeking to gain access to our capital markets, **investors are unlikely to know that they may be assisting in the proliferation of weapons of mass destruction by providing funds to known proliferators.** Aside from the moral implications, there are potential financial consequences of proliferation activity -- such as the possible imposition of trade and financial sanctions -- which could negatively impact investors.

The Deutch panel felt so strongly about the need to address this problem that it went on to recommend that:

[The U.S. government] assess options for denying proliferators access to U.S. capital markets. **Options considered should include ways to enhance transparency, such as requiring more detailed reporting on the individuals or companies seeking access or disclosure of proliferation-related activity, as well as mechanisms to bar entry of such entities into the U.S. capital markets.** Along with the possible costs and benefits of various options, this review should consider the potential effectiveness of unilateral actions and the impact of those options on the health and viability of the global capital market in general and U.S. capital markets in particular. (Emphasis added.)

The Congress' Role

If all else fails, I would urge that Congress take up the cudgel as it did so usefully in the CNOOC-Unocal case. In particular, until such time as state-owned entities like the Bank of China and the China Construction Bank, along with their investment banks, list these Chinese enterprises' entire loan portfolios, the legislative branch should act to block the initial public offerings of such banks in the U.S. equity markets.

This is only reasonable. After all, just as the loans of a bank are its assets, asset quality is a fundamental calculation for would-be American investors prepared to conduct serious pre-investment due diligence.

Even though one can be confident that these Chinese banks, and their U.S. and possibly foreign investment bank advisors, labored hard to “window dress” those institutions by removing a myriad of non-performing and controversial loans (particularly to other state-owned enterprises), I would bet the ranch that such loan portfolios will still include defense-related industries, known proliferators, arms smugglers and producers, human rights abusers, environmental despoilers and enterprises associated with the repression of Tibet and human liberties more generally.

We must stop confusing free trade with China with a free pass for some of its most worrisome activities -- and the state-owned enterprises who engage in them.