

EXECUTIVE SUMMARY

This report sets forth the Commission's analysis of the U.S.-China relationship in the topical areas designated by the Commission's Congressional mandate: the areas for the Commission to consider and about which it is to make recommendations to the Congress. These include China's proliferation practices; the qualitative and quantitative nature of economic transfers of United States production activities; the effect of China's development on world energy supplies; the access to and use of U.S. capital markets by China; China's regional economic and security impacts; U.S.-China bilateral programs and agreements; China's compliance with its access agreement to the World Trade Organization; and the implications of China's restrictions on freedom of expression. Our analysis, along with recommendations to the Congress for addressing identified concerns, is chronicled in the Report, and summarized herein.

COMMISSION ASSESSMENT OF U.S.-CHINA ECONOMIC AND SECURITY RELATIONS

Congress gave the Commission the overarching mission of evaluating "the national security implications of the bilateral trade and economic relationship between the United States and the People's Republic of China," and reporting its evaluation to Congress annually together with its observations specifically concerning the topical areas listed above. The Commission takes a broad view of "national security" in making its assessment and has attempted to evaluate how the U.S. relationship with China affects the economic health of the United States and its industrial base, the military and weapons proliferation dangers China poses to the United States, and the United States' political standing and influence in Asia.

In its previous three annual reports, the Commission outlined a number of worrisome trends in the economic and security relationship between the United States and China. The Commission's assessment for 2006 is consistent with those past analyses, but this year has employed the notion of a "responsible stakeholder" in the international community—that is, a state that not only observes international norms but works to strengthen those norms—as a measure of Chinese activities. This term has been employed by senior members of the Bush Administration, but the Commission believes that the underlying concept has informed U.S. policy for many years. Unfortunately, no consistent strategy or policy has been formed to achieve these goals. It is the Commission's judgment that, while China's influence is growing as its wealth and power increase, and there remain many reasons to hope that China might in some future day stand as a pillar of the international community, its behavior is as yet far from meeting that standard. Indeed, many of the trends of the past year raise serious doubts whether China is yet willing or prepared to play such a role.

The Commission further observes that uncertainties about China's role in the world raise serious questions for the United States. No nation has a greater interest in assuring that China's rise to power serves to strengthen the international system than does the United States.

Moreover, the Commission concludes that the matter of China's role as responsible stakeholder is a matter of some urgency: the threats to international security arising from the spread of ethnic conflict, terrorism and weapons of mass destruction; the challenges of a globalized economy; the weaknesses of failed and failing states; concerns over environmental degradation or pandemic diseases that do not recognize boundaries or state sovereignty; and, perhaps most of all, challenges to the legitimacy of democratic forms of governance all place increasing stresses upon the international community. The preservation of peace, prosperity, health, and liberty all require that China contribute to the global public interest rather than continue to pursue its own narrow national interests.

COMMISSION FINDINGS

The Report presents its findings, analyses, and recommendations to Congress in 12 segments organized in six chapters, touching on the requirements of the Commission's Congressional mandate. However, the Commission has attempted to take an integrated approach to its assessments, believing that economic, security, and other issues are essentially interrelated. The intersection of U.S. geopolitical, economic, security, diplomatic, and cultural interests forms a complex web of concerns that comprise the overall relationship between the United States of America and the People's Republic of China.

The Commission's findings are included in this Executive Summary. At the Summary's conclusion, the ten key recommendations the Commission makes to Congress in the Report are listed. The Commission makes a total of 44 recommendations to the Congress in this Report. Those pertaining to each of the six Report chapters appear at the conclusion of the chapter, and a comprehensive list is provided beginning on page 175.

The U.S.-China Trade and Economic Relationship

Although China is increasingly integrated in the global economy, the Commission believes that profound differences remain between the open-market approach of the United States and the managed-trade principles and predatory practices observed by the Chinese government. In particular, China's record of adhering to the obligations it incurred upon its entry into the World Trade Organization has been inconsistent, and it remains an open question whether China will change its domestic practices to observe international trade norms or will continue to bend current norms to suit its domestic practices.

The Commission further recognizes that the Chinese commitment to economic reform, modernization, and liberalization faces formidable handicaps and barriers at home, not the least being the chaos and confusion that stem from China's sheer size and are exacerbated by the long legacy of state control. Nonetheless, China's reluctance to proceed with reforms and delay in meeting treaty obligations betray contradictions in Chinese policy. China's excessive reliance on export-led growth has created and is deepening fundamental distortions in the Chinese economy, including continued subsidies to state-owned or -controlled enterprises, a seriously undervalued currency, and a financial system hobbled by corruption and bad loans. China has long argued that it is not a "non-market economy," but often acts as though it intends to remain one.

Findings

The Status of China's Compliance with its World Trade Organization Obligations, and the Impact of China's Industrial Subsidies on U.S. and Other Markets

- China's adherence to its many World Trade Organization (WTO) obligations remains spotty and halting in important areas five years after China attained membership. As a result, U.S. exporters and investors face a variety of non-tariff barriers and major impediments to conducting business in China. In some areas, such as banking reform, China has made progress. But in too many cases, the government has delayed and even backtracked on its obligations.
- China "has not yet fully embraced the key WTO principles of market access, non-discrimination, and national treatment, nor has China fully institutionalized market mechanisms and made its trade regime predictable and transparent ... [and China]

continues to use an array of industrial policy tools ... to promote or protect favored sectors and industries," according to the U.S. Trade Representative.¹

- China's failure to enforce intellectual property rights provides a particularly egregious example of its noncompliance with WTO rules. China's refusal to protect copyrights, inventions, brands, and trade secrets has placed it first among nations on the U.S. Trade Representative's (USTR's) "priority watch list" of countries that tolerate intellectual piracy.²
- China has a centralized industrial policy that employs a wide variety of tools to promote favored industries. In particular, China has used a range of subsidies to encourage the manufacture of goods meant for export over the manufacture of goods meant for domestic consumption, and to secure foreign investment in the manufacturing sector.
- China artificially lowers the value of its currency to maintain an export-led trade policy. The State Administration for Foreign Exchange accomplishes this by buying dollars and other foreign currency in China at a fixed rate of around 8 renminbi to the dollar. Only small fluctuations in the value of the renminbi are allowed.
- At times, China's central government and governing bodies in the provinces and localities appear to be operating at cross purposes. Decisions by the central government meant to comply with WTO rules sometimes are ignored in the provinces. Regulations established by Beijing aren't necessarily enforced elsewhere.

China's Approach to Intellectual Property Rights and its Production of Counterfeit Goods

- Despite its many promises to comply with its international obligations to protect intellectual property, China has failed to deter widespread violations of trademarks, copyrights, and patents. The failure stems from lenient rules and regulations, mild penalties for transgressors, and an overall lack of enforcement. Although the central government has made some effort to pass stricter laws, enforcement at the local and provincial levels lags far behind. Ultimately, the central government is required by its World Trade Organization membership to accept responsibility.
- China's failure to protect intellectual property is a serious problem for U.S. competitiveness. U.S. intellectual property industries contribute to more than half of all U.S. exports and represent 40 percent of U.S. economic growth. While the full extent of loss to U.S. industry due to Chinese intellectual property rights violations is unknown, U.S. industry reports losses in the billions. The U.S. Chamber of Commerce estimates that the global intellectual property industry loses \$650 billion annually in sales due to counterfeit goods.³ And some analysts estimate that China is responsible for as much as 70 percent of this counterfeit goods market.⁴ Annual losses to the U.S. copyright industries are estimated to be between \$2.5 billion and \$3.8 billion.⁵ And U.S. pharmaceutical industries lose 10 percent to 15 percent of annual revenues in China due to intellectual property infringement.⁶

¹ U.S. Trade Representative, *2006 National Trade Estimate; Foreign Trade Barriers*, (Washington, DC:: March 2006) p. 92.

² U.S. Trade Representative, *2006 Special 301 Report*, (Washington, DC: April, 2006), p 1.

³ First Global Conference on Combating Counterfeiting, May 25-26, 2004, cited in U.S. Chamber of Commerce, *Countering Global Counterfeiting and Piracy*, Summer 2006, p. 6.

⁴ Ted Fishman, "How to Stop Intellectual Property Theft in China." *Inc. Magazine*, June 2006.

⁵ U.S. Trade Representative, *2005 Special 301 Report*.
www.ustr.gov/assets/Document_Library/Reports_Publications/2005/2005_Special_301/asset_upload_file195_7636.pdf.

⁶ U.S. Trade Representative, *2005 Special 301 Report*.

www.ustr.gov/assets/Document_Library/Reports_Publications/2005/2005_Special_301/asset_upload_file195_7636.pdf.

- The Customs Bureau of the U.S. Department of Homeland Security made 3,709 seizures of counterfeit goods originating from China in fiscal year 2005, totaling \$64 million.⁷ Total exports of counterfeit goods from China to the United States generally are estimated to be much higher and can be expected to increase even further. Not only is China's enforcement of intellectual property laws weak, but China also has liberalized its strict export licensing regime to allow any business to export. As more businesses begin to export, counterfeit goods will be easier to ship.
- Counterfeit exports from China pose a health and safety threat to U.S. citizens. The World Health Organization reports that counterfeit pharmaceuticals of Chinese origin cost pharmaceutical companies \$32 billion a year.⁸ Chinese counterfeiters have produced batteries that explode because of faulty manufacturing and engine timing belts that break after only one-fifth the time of the authentic product.⁹
- Official Chinese government data estimate that counterfeit products account for 15 percent to 20 percent of products made in China and equal eight percent¹⁰ of China's \$2.2 trillion¹¹ gross domestic product (GDP). In some cities, the manufacturers and distributors of counterfeit goods are the major employers and the dominant contributors to the tax base.
- Many local governments in China are so financially dependent on the counterfeit trade that they are reluctant to interfere with the violations, and officials at those levels often profit personally from counterfeiting.
- Several U.S. industries, particularly those dependent on copyright protections, report high piracy rates of their products in China. For example, the piracy rate for business software has reached 86 percent.¹² In this situation, the WTO dispute settlement mechanism provides the strongest enforcement tool available to the United States government to address China's failure to enforce intellectual property rights.
- Market barriers to American exports to China contribute to the climate of piracy in China. When U.S. companies experience Chinese government censorship, delays, distribution restrictions, or other barriers in getting their products to market, counterfeiters move in first.

China's Financial System and Monetary Policies and their Effects on the United States

- China's financial system is an increasingly important element in Beijing's development strategy and program to preserve internal stability. China's banks serve the nation's development strategy in several key ways. The banks, which are predominantly state-owned or state-controlled themselves, often are called on to make loans to other state-

⁷ Department of Homeland Security, U.S. Customs and Border Protection, and U.S. Immigration and Customs Enforcement, *FY2005 IPR Seizure Statistics*, p. 5.
http://www.cbp.gov/xp/cgov/import/commercial_enforcement/ipr/seizure/fy05_midyear_stats.ctt/fy05_ipr_midyear.pdf.

⁸ "counterfeit drugs cost the global pharmaceutical industry US\$32bn a year . . . a significant proportion of these counterfeits originate in China." PriceWaterhouseCoopers, *Investing in China's Pharmaceutical Industry*, March 2006, p. 5.

⁹ Senate Committee on Commerce, Science and Transportation, *Piracy and Counterfeiting in China*, Testimony of Franklin J. Vargo, March 8, 2006.

¹⁰ Wayne M. Morrison, *China-US Trade Issues*, (Congressional Research Service, Washington DC: May 16, 2006), p. 10. www.usembassy.at/en/download/pdf/china_trade.pdf.

¹¹ Central Intelligence Agency, *World Factbook*. www.cia.gov/publications/factbook/geos/ch.html. The Ministry of Commerce of the People's Republic of China reported a \$2.3 trillion GDP for 2005. English.mofcom.cn/aarticle/topic/bizchina/macroecconomy/200608/20060802933465.html.

¹² Business Software Alliance, *Third Annual BSA and IDC Global Software Piracy Study*, May 2005. p. 4. www.bsa.org/globalstudy/upload/2005-2006%20Global%20Piracy%20Study.pdf.

owned enterprises without attention to creditworthiness, collateral, or other typical lending requirements of banks operating in real market-driven economies. Instead, Chinese banks often are expected to grant low interest loans, carry large amounts of defaulted loans on their books, or forgive such debts held by government-owned companies. In a centrally planned economy such as China's, these loans are a device for subsidizing various activities and specific industries that China's power structure favors. The ultimate goal is to preserve internal stability and strengthen the control of the Chinese Communist Party.

- Serious and potentially crippling problems threaten the financial system in China and render it vulnerable to excessive volatility and collapse. These problems include a large number of defaulted bank loans, an underdeveloped stock and bond market, an immature insurance system, poor accounting practices, and excessive government ownership and control over the economy, including a refusal to let the currency be governed by market forces. China cannot fully develop a free-market system until these problems are substantially resolved.
- A financial crisis in China would harm its economy, decrease China's purchase of U.S. exports, and reduce China's ability to fund U.S. borrowing, particularly the U.S. budget deficit. An economic crisis in China has the potential to raise U.S. interest rates, thereby placing major additional costs on U.S. businesses and individual consumers and producing dislocation in the U.S. economy. It also could exacerbate Chinese domestic political tensions in an unpredictable fashion. This is why the condition of China's financial system is of concern to the United States.
- The Chinese government's deliberate undervaluation of the renminbi makes U.S. products more expensive to Chinese consumers who therefore purchase fewer of them. Conversely, China's undervalued currency also makes Chinese products cheaper in the United States, and therefore U.S. consumers purchase more of them. The combination is a major contributor to the record-high and still-growing U.S. trade deficit. The undervalued Chinese currency harms American competitiveness and is also a factor encouraging the relocation of U.S. manufacturing overseas while discouraging investments in U.S. exporting industries.
- There has been so little independent regulation of accounting procedures in China that the health of the entire securities and insurance sectors remains questionable. Chinese officials remain highly reluctant to allow independent and objective assessments of the financial system by foreign auditors and credit rating agencies.
- The ownership of U.S. Treasury securities, government agency bonds, and corporate bonds cannot be easily tracked. Foreign holders of U.S. Treasury securities, including foreign central banks, need not disclose their ownership and are not required to do so by either the United States or by international agencies. The lack of accurate data makes it difficult to predict the effect of a sell-off by any one country of dollar-denominated assets.

China's Global and Regional Activities and other Geostrategic Developments

In recent years, China has begun to exercise diplomatic influence approaching its economic importance. If China's willingness to honor its trade obligations is at issue, its commitment to accept its geopolitical responsibilities is even more in question.

China's impact is felt far beyond East Asia. In the Middle East, in Africa, in South Asia, and in Latin America, China is coming to be regarded almost as a second superpower. Of particular concern to the Commission is China's seeming posture as a potential counterweight to the United States, and its disposition to support volatile and repressive regimes as its client states. China's

continuing record of proliferation, including its indulgence of North Korea's nuclear and missile programs and its involvement in Iran's programs, is deeply destabilizing. And China's apparent willingness to value its own energy needs above the needs of international security is indicative of a nation as yet unprepared or unwilling to shoulder the burdens of a stakeholder state.

Findings

China's Regional Activities

- China's stated diplomacy promotes friendly relations with other countries, regional peace and stability, and development of complementary economic cooperation.¹³ However, some of China's international relationships, namely those with totalitarian, repressive governments, conflict with U.S. values.
- China's regional activities in Latin America, Africa, and the Middle East and around East Asia are beginning to assume the character of a counterbalancing strategy vis-à-vis the United States. That is, China's support for rogue regimes and anti-American governments and groups in vital regions serves an international purpose to balance American power, create an alternative model of governance, and frustrate the ability of the international community to uphold its norms.
- China's economic development policies can exacerbate instability in volatile regions. Beijing's export-led growth has magnified trade imbalances, and complicated and inhibited local economic development strategies, in some instances undermining those governments' ability to prevent or respond to the rise of terrorist groups.
- China's strategy to isolate Taiwan is manifest in its foreign policy actions around the world, including encouraging other nations to switch their recognition to the People's Republic of China, and preventing Taiwan from participating in international organizations.

China's Proliferation and Involvement in North Korea's and Iran's Nuclearization Activities

- Chinese companies and government organizations continue to proliferate weapons, weapons components, and weapons technology. Some of these transfers violate China's international nonproliferation agreements, harm regional security in East Asia and the Middle East, and are a measure of China's failure to meet the threshold test of international responsibility in the area of nonproliferation. Given strong U.S. interests in both regions, Chinese proliferation threatens U.S. security and potentially could place at risk U.S. troops operating in those regions.
- China possesses the unique ability to influence North Korea's actions, partly because of the great extent to which North Korea depends on it for consistent supplies of food and fuel. Notwithstanding its commendable efforts to persuade North Korea to remain involved in the Six-Party Talks seeking to obtain North Korean agreement to end its nuclear program, China has refused to use its leverage effectively to pressure North Korea to cease its nuclear and missile development activities and, in particular, not to conduct the nuclear test it conducted in October.
- Chinese companies and government organizations continue to assist Iran's missile development program, and have aided Iran's nuclear program. China also has refused to cooperate in the efforts by a number of nations to persuade or force Iran to halt its military nuclear program and instead has offered political and moral support for Iran and obstructionism in the U.N.

¹³ "Main characteristics of China's Foreign Policy," Embassy of the People's Republic of China in the United States of America. www.china-embassy.org/eng/zmgx/zgwjzc/t35077.htm.

- China's continued frustration of nonproliferation efforts may precipitate additional nuclear proliferation, including nuclear weapons development and transfer of nuclear weapons to non-nuclear nations and terrorists, proliferation of other weapons of mass destruction, and conventional arms races.

China's Energy Needs and Strategies

- China's strategy of securing ownership and control of oil and natural gas assets abroad could substantially affect U.S. energy security—reducing the ability of the global petroleum market to ameliorate temporary and limited petroleum supply disruptions in the United States and elsewhere.
- In 2005, China became the second largest international oil consumer after the United States with a daily demand of 5.5 million barrels per day.¹⁴ In 2006, China will account for 38 percent of the total growth in world oil demand.¹⁵ The continuation of China's dramatic year-over-year increases of nearly half a million barrels per day (an increase of approximately 16 percent in 2005 and 14 percent in 2006)¹⁶ in petroleum consumption will place growing stress on the world's energy resources and distribution systems, which will affect the supply available to the United States and the cost of that supply.
- China's energy policies, taken as a whole, are not consistent with the economic or geopolitical behavior of a responsible stakeholder; they distort markets and destabilize volatile regions. As China's energy needs and consumption grow, its failure to observe these international norms becomes increasingly problematic.
- The air pollution resulting from China's energy use policies and practices not only is exacting a toll on the health of China's population and ecology but also is detrimentally affecting the air quality of the western United States.
- In recent years, China has made progress in instituting, codifying, and enforcing environmental standards and controls relating to fuel consumption and has pursued cleaner coal-burning technologies, but still faces a daunting air and water pollution crisis. If China does not address these problems aggressively, it will exacerbate what is already an environmental catastrophe.
- Some U.S. cooperative efforts with China on energy efficiency and environmental friendliness have realized success, offering limited encouragement that the rate of growth of China's energy consumption can be slowed and the environmental consequences of its energy use mitigated. Such results are profoundly in the interest of the United States as well as China.

China's Military Power and Its Effects on American Interests and Regional Security

A consistent theme of previous Reports by the Commission has been the increasing scope and pace of Chinese military modernization. The Commission is concerned that the People's

¹⁴ Jin Liangxiang, "Energy First—China and the Middle East," *Middle East Quarterly*, vol. 12, iss. 2 (Spring 2005). www.meforum.org/article/694.

¹⁵ U.S. Department of Energy, Energy Information Administration, *Country Analysis Briefs: China*, (Washington, DC: Updated August 2006). www.eia.doe.gov/emeu/cabs/China/Full.html.

¹⁶ U.S. Department of Energy, Energy Information Administration, *Country Analysis Briefs: China*, (Washington, DC: Updated August 2006). www.eia.doe.gov/emeu/cabs/China/Full.html. See also U.S. Congress, *Energy Policy Act 2005, Section 1837: National Security Review of International Energy Requirements*, report prepared by U.S. Department of Energy, (February 2006), p. 4.

Liberation Army (PLA) may be pursuing a path to project power beyond the immediate needs of defending the mainland. It is becoming a force capable of challenging the U.S. military in the western Pacific and beyond.

The pace of PLA modernization continues to exceed U.S. estimates. The Commission believes that the military balance in East Asia is increasingly favorable to China and increasingly challenging to U.S. interests and allies. The Chinese military's ability to deny access and freedom of operation to U.S. forces, and its further ambitions to project its own military power are accelerating. In particular, the Commission concludes that Taiwan's ability to defend itself from attack and intimidation is in doubt and that China could impede the United States' ability to intervene successfully in a crisis or conflict.

Findings

China's Military Modernization

- China continues its extensive military modernization program. For the tenth year in a row, China's new annual military budget will reflect double-digit growth over the previous year's. According to Chinese government figures, the 2006 budget will increase 14.7 percent from the previous year to approximately \$35 billion. The Department of Defense believes China's actual defense expenditures could be two to three times higher at \$70-105 billion.
- In the near term, among China's principal military modernization aims are to deter Taiwan from moving toward independence; to defeat and occupy Taiwan if it declares independence and to accomplish this before U.S. or other military assistance can arrive; and to deny U.S. forces the ability to intercede effectively in such a conflict and prevent China from prevailing.
- Despite calls for increased transparency, Beijing continues to shroud much of its military structure, activities, and intentions in secrecy, leading to increased chances for misunderstanding and potential conflict.
- China has recognized the profound effectiveness and strategic importance of force multipliers such as advanced command, control, communications, computers, intelligence, surveillance, and reconnaissance capabilities (C4ISR) employed by U.S. forces, and it is exerting great efforts to enhance its C4ISR abilities and integrate them in its military procedures. Once the People's Liberation Army (PLA) achieves these objectives, it will be a much more effective and formidable fighting force.
- China's military intentions beyond Taiwan remain unclear. The PLA understands itself to be in an extended military competition with the United States.
- The PLA's doctrine recognizes that to succeed against a sophisticated potential adversary such as the United States, it must among other things be able to disrupt the adversary's C4ISR advantages through such means as attacking its computer and communications systems. Accordingly, the PLA is establishing information warfare units and capacities and developing anti-satellite capabilities.
- China is pursuing measures to try to control the seas in the Western Pacific and development of space warfare weapons that would impede U.S. command and control.

The Effect of U.S. and Multilateral Export Controls on China's Military Modernization

- China makes a concerted effort to modernize its military by obtaining military-related systems and technologies from other countries, particularly Russia. China uses legal and illegal means, including espionage, to obtain such technologies from the United States.
- There is only one full time U.S. export control officer stationed in China to verify that licensed U.S. dual-use items are used in the location and for the purpose for which they are licensed. There also is only one full-time U.S. export control officer stationed in Hong Kong to verify that dual-use items licensed for use there remain in Hong Kong and are used as intended rather than being diverted, possibly to China. As a result, it is impossible to adequately oversee compliance with U.S. export licensing requirements by licensees in China or Hong Kong. This makes it easier for militarily-sensitive U.S. materials and technology to be misused or diverted without detection and without penalty to the licensees and thereby undermines the credibility of the export control process.
- China, in violation of a U.S.-China agreement, often fails to schedule timely end-use inspection visits of dual-use items licensed for export to China. This frustrates U.S. oversight of compliance with U.S. export licensing requirements by licensees in China, and makes it easier for militarily-sensitive U.S. materials and technology to be misused or diverted without detection and without penalty to the licensees and thereby undermines the credibility of the export control process.
- Export controls are likely to be substantially effective only if they are multilateral, if there are no notable sources of the controlled goods and technologies who choose to disregard the controls, and if all source nations administer and enforce the restrictions effectively. While unilateral controls may delay acquisition of controlled goods and technologies by targeted nations, those delays are unlikely to be significant if a targeted nation is intent on acquisition and if other nations possess and are willing to make available the goods and technologies.
- The memberships of most of the existing multilateral export control regimes have not agreed that China should be a target of their efforts and so do not seek to impede Chinese acquisition of the items and technologies of which they try to facilitate and coordinate control by their member nations. Not surprisingly, therefore, these regimes and their controls play no role in preventing China from acquiring items and technologies the United States believes are militarily-critical. This highlights the fact that effectively controlling the acquisition of items and technologies by a particular nation requires multilateral agreement *both* that possession of the items and technologies should be controlled and that the nation in question should be a target of the controls.

The Military Balance Across the Taiwan Strait

- The cross-Strait military balance of power currently substantially favors the mainland. China possesses advanced aircraft, submarines, surface vessels, and ballistic missiles, in greater quantities and, in many cases, equal or greater sophistication, than Taiwan's. In an all-out conflict between the two, Taiwan, if relying only on its own capabilities, would be unable to prevent China from ultimately realizing its objectives.
- Taiwan is growing increasingly dependent on the threat of intervention from the United States to deter China from initiating hostile action against Taiwan, and on U.S. intervention to survive any attack or invasion China launches.
- The People's Liberation Army (PLA) Navy's surface vessel and submarine force is capable of considerably delaying the arrival of any naval force that might attempt to intervene in a Taiwan crisis and degrading its combat power. However, the lack of an integrated command, control, computers, intelligence, surveillance, and reconnaissance

(C4ISR) architecture currently precludes effective joint targeting of a carrier battle group.¹⁷

- There is substantial agreement among experts that a “window of vulnerability” will exist between 2008 and 2015 for U.S. forces that likely would be involved if the United States made a decision to intervene militarily in a pre-conflict China-Taiwan crisis or in a China-Taiwan conflict. Many of the Chinese modernization programs focused on Taiwan, including weapons systems such as submarines, destroyers, cruise missiles, and maneuverable ballistic missiles, and advances in C4ISR and targeting, will be deployed around or soon after 2008, while some U.S. capabilities to defeat these advances, such as ballistic missile defenses, littoral strike assets, and an integrated anti-submarine warfare network, probably will not become operational until approximately 2015. This will decrease the deterrent effect of the possibility of U.S. intervention in a China-Taiwan conflict, and will increase the cost to the U.S. of intervening.
- The speed and force with which a U.S. force could respond to a Taiwan crisis will be affected by the degree to which it can secure access to bases and ports in the region. Access to such facilities in Japan, Singapore, and Philippines would be especially important.
- Despite disagreement within the Legislative Yuan, the Taiwan government is committed to its own defense and is taking measures to improve its deterrent posture. It has begun development of an indigenous surface-to-surface missile and is seeking to purchase greater numbers of F-16 fighter aircraft from the U.S.

A Case Study of the Automotive Industry that Illustrates Challenges to U.S. Manufacturing and the U.S. Defense Industrial Base

The Commission conducted a hearing in Dearborn, Michigan to examine China’s effect on the U.S. automotive industry and its implications for the U.S. economy and security. The next five to ten years will witness a new phase of Chinese economic development: an automotive industry capable of producing a large volume of vehicles of sufficient quality to compete in international markets. Indeed, the Commission believes China’s goal, once its production capacity matures, will be to seize significant shares of markets abroad rather than simply to provide vehicles for domestic consumption; that is, China will continue to follow its model of export-driven growth, with the U.S. market serving as the primary target.

China’s rising automotive sector—Chinese firms already are an important factor in auto parts and other subsidiary industries—will shake the international car market. In particular, it will place additional stress on U.S. industry, both the “Big Three” domestic manufacturers, already struggling to restructure their businesses to remain competitive in the current environment, and those foreign-based firms with plants in the United States. The many subsidies provided by the Chinese government to the auto industry will quickly distort the nature of the market. This will be true especially in the United States, where markets are most open.

The Chinese challenge to the U.S. auto industry is a significant assault, increasing in magnitude and in pace, on American manufacturing. The automotive sector has been and remains a core element in the U.S. economy, generating great wealth for its firms, its employees, and its

¹⁷ For more information on Chinese use of network-centric warfare to attack carrier battle groups, see Zhang Kaide and Zhao Shubin, “Shimin Daji Zhihui Kongzhi Jishu Chutan” (“The Command and Control Technology of Time Critical Strikes”), *Zhihui Kongzhi yu Fangzhen (Command and Control Simulation)* 28, No. 2 (April 2006), pp. 1-5. Also see, Nie Yubao, “Daji Haishang Di Da Jian Jianting Biandui de Dianzi Zhan Zhanfa” (“Current Methods for Electronic Warfare Attacks on Heavily Fortified Naval Formations”), *Wo Jun Xinxi Zhan Wenti Yanjiu (Research on Questions about Information Warfare)*, (National Defense University Press, Beijing: 1999).

suppliers, spurring generations of economic growth across the country, and transforming the quality of American life. While China has yet to demonstrate the ability to produce automobiles of quality in great volume, there is no reason to presume that it will not do so.

The Commission further believes that China's achievements in automotive manufacturing serve as an example of how its progress up the "value-added" chain of manufacturing has begun to affect the U.S. defense industrial base. The downsizing of the U.S. auto industry is having enormous repercussions as important skills and capabilities are lost. Military supply chains are inherently vulnerable to unpredictable shocks—as the shortages of parts resulting from unanticipated use and loss rates in Iraq and Afghanistan clearly demonstrate. To the degree that U.S. military systems increasingly rely on commercially available components, including some automotive components, production and supply uncertainties may have national security consequences.

Findings

- China's automobile production capacity already exceeds domestic demand by 10 percent to 20 percent.¹⁸ This overcapacity is projected to grow to 8 million vehicles by 2010 and it is very likely that China will begin exporting vehicles to the United States within the next five to ten years. Chinese industrial subsidies, undervaluation of the currency, discriminatory tariff rates, tax breaks, and a host of other unfair trade practices will make the price of Chinese vehicle imports artificially low in foreign markets. The U.S. auto industry will find it difficult to compete with unfairly-priced imports and will likely lose an additional share of the domestic market.
- Serious intellectual property violations by Chinese companies are harming U.S. consumers and American manufacturers. Auto parts are being counterfeited, intentionally misrepresented, and sold as genuine—all in direct violation of both China's trademark laws, which clearly are not being enforced, and China's World Trade Organization (WTO) obligations. American citizens are being put at risk as inferior Chinese counterfeit auto parts find their way under the hoods of vehicles driven on our streets, while U.S. companies lose significant market share and brand reputation to such counterfeit goods.
- Chinese regulations currently require automakers to exceed a 40 percent domestic content requirement or face higher tariffs on the imported auto parts. These discriminatory tariffs pressure China-based auto assembly companies to use parts manufactured in China rather than U.S.-manufactured parts. This violates the promises China made, and the legal obligations it assumed, as part of its accession to the WTO. These regulations are intended to force U.S. and other manufacturers to shift parts production to China, resulting in U.S. manufacturers losing business and U.S. workers losing jobs.
- China's WTO-illegal trade practices are serving to hollow out the U.S. manufacturing base. The loss of America's sophisticated manufacturing capabilities has serious national security implications. As the U.S. manufacturing base diminishes, the U.S. military risks losing its ability to easily, quickly, and reliably procure much-needed weapons systems, components, and spare parts. With a smaller industrial base to draw from, military leaders are increasingly concerned about maintaining warfare capabilities, especially in the event of actions not supported by the People's Republic of China.
- As the U.S. defense establishment becomes increasingly reliant on the private sector for commercial off-the-shelf parts and components, the military risks losing control of its supply chain.

¹⁸ D. Leiker, K. Schicker, D. Tsui, *Crusin' - An In-depth Look at the Chinese Auto Industry* (Robert W. Baird & Co. Incorporated: June 2006), p.6.

- The problems with which American car makers and parts manufacturers are struggling exemplify the challenges that the U.S. industrial base faces as China expands its industrial prowess and continues to utilize unfair trade advantages.

China's Internal Problems, Beijing's Response, and Implications for the United States

Economic progress has lifted hundreds of millions of Chinese out of abject poverty; this is a significant achievement for China and for the world. However, hundreds of millions more continue to live at subsistence levels and Chinese growth has itself created or exacerbated divisions within Chinese society. This internal instability often elicits a repressive response from Beijing. The Commission remains concerned about the international consequences that may result from Chinese internal instability and is at the same time concerned about the external effects of the Chinese Communist Party's measures to retain political control.

China suffers from worsening environmental conditions, endemic corruption, fear of energy shortages, an inadequate public health system, population shifts, and other problems that provoke chronic social discontent. The Beijing government's confusion about, and its reluctance and delay to address, these tremendous issues is itself a further problem: China remains prone to treat all protest or political disagreement as a challenge to the state and the party and to respond with repressive and often violent measures. Also troubling to the Commission is China's frequent tendency to try to refocus internal dissent toward the outside world, with a particular emphasis on Japan, Taiwan, and the United States. Whether this is the government's intent matters little; the result is that Chinese popular opinion is inflamed and international tensions are increased.

Findings

- While China's rapid economic development continues, serious internal problems exist, such as environmental degradation, increased energy demand that threatens to outstrip energy supplies, corruption, censorship, and increasing social discontent.
- China has acknowledged some of its internal problems and even enacted rules or regulations intended to address them. The United States government is conducting some bilateral programs with China aimed at remedying internal problems. However, China is not allocating enough of its own time, energy, or resources to effectively solve many of them.
- A number of the internal challenges facing Beijing have international implications, including implications for the region and the United States. Some of these problems are not limited by boundaries, such as pollution and epidemic diseases originating in China. The number of Americans that go to China, the increasing number of Chinese going abroad, and Beijing's failure to address these problems, could spread epidemic diseases to the United States.
- The constraints of China's one-party system limit its ability to deal with its internal problems.

China's Media and Information Controls

In an ongoing effort to maintain its hold on power, promote nationalism, limit access to a free press, and stifle dissent, China has been increasing its control over media and information flows, including the Internet. Through this control and manipulation, the Chinese government shapes

public opinion, including public opinion regarding Taiwan and the United States. This creates misunderstanding and can induce public protests against foreign countries. The Commission remains concerned about the long-term effects of these practices on the way that Chinese citizens who are subjected to manipulated and highly controlled information view the United States and other democratic nations.

Findings

- The Chinese government has put in place extensive controls to direct the flow of information to its citizens, stifling dissent and allowing the government to shape public opinion and views of foreign countries, such as the United States.
- The use of legislation and the imprisonment of journalists, especially Chinese employees of foreign media, have led the Chinese media to “self-censor” to avoid prosecution. The U.S. government, media, and businesses are unable to obtain basic economic, market, demographic, agricultural, and political information.
- The Chinese government filters the Internet, using regulation, software and hardware to prevent citizens from accessing information it deems unacceptable, as well as information from foreign media sources. Internet-related U.S. companies that wish to do business in China are forced to choose between complying with Chinese regulations that limit free speech, or not entering the Chinese market at all.

THE COMMISSION’S KEY RECOMMENDATIONS

The Commission believes that 10 of its 44 recommendations to Congress are of particular significance. These are presented below in the order in which they appear in the Report. The complete list of 44 recommendations appears at the Report’s conclusion, on page 175.

- ***Pressing a WTO case against China’s IPR violations***—The Commission recommends that Congress urge the U.S. Trade Representative to press ahead aggressively with a WTO case against China for its manifest failures to enforce intellectual property rights, selecting the best of many potential cases in order to establish a strong precedent, and that Congress urge the U.S. Trade Representative to enlist other nations to join in the case. (*Chapter 1*)
- ***Securing China’s cooperation to end genocide in Darfur***—The Commission recommends that Congress urge the Administration to seek direct dialogue and cooperation with China with regard to securing a resolution to the conflict in the Darfur region of Sudan that will halt the genocide occurring there and provide security and basic human rights for the affected population. Congress should instruct the Administration to report semiannually on China’s actions in Sudan and any progress that has been made through dialogue with China. (*Chapter 2*)
- ***Facilitating Taiwan’s participation in international organizations***—The Commission recommends that in response to China’s efforts to isolate Taiwan, Congress encourage the Administration to implement a long-term policy to facilitate Taiwan’s participation in international organizations and activities for which statehood is not a prerequisite, such as the World Health Organization, the Community of Democracy, the Proliferation Security Initiative, and other multilateral public health, counterproliferation, counterterrorism, and economic organizations as appropriate. Congress should instruct the Administration to report annually on its actions to ensure that Taiwan is not isolated in the world community. (*Chapter 2*)

- ***Inspecting North Korean ships at sea and containers in Chinese ports***—The Commission recommends that Congress urge the Administration to seek agreement with China to carry out inspections at sea of ships bound to or from North Korean ports and establish a U.S.-China joint operation to inspect for contraband shipping containers being moved to or from North Korea when they pass through Chinese ports, in fulfillment of the obligations under U.N. Security Council Resolution 1718 to prevent the sale or transfer of missiles, and nuclear and other weapons-related materials and technologies, to and from North Korea. (*Chapter 2*)
- ***Permitting sanctions against Chinese parent companies of proliferating subsidiaries***—The Commission recommends that current sanctions against Chinese companies that proliferate equipment and technology related to weapons of mass destruction and their delivery systems be broadened and harmonized for increased effectiveness. The Commission recommends that Congress expand current sanctions regimes to extend penalties to the Chinese parent company of a subsidiary that engages in proliferation activities, regardless of the parent company’s knowledge of or involvement in the problematic transaction. Access to U.S. markets (including capital markets), technology transfers, and U.S. government grants and loans should be restricted from proliferating countries and their Chinese parent companies and related subsidiaries irrespective of the related firms’ knowledge of the transfers in question. (*Chapter 2*)
- ***Insisting China fulfill its obligations under U.N. Resolutions sanctioning North Korea for proliferation***—The Commission recommends that Congress instruct the Administration to insist that China fulfill its obligations under U.N. Security Council Resolutions 1695 and 1718 and take more significant measures to denuclearize the Korean peninsula and counter North Korean proliferation activities. The Congress should further instruct the Administration to report semiannually about specific actions the Chinese government has taken in this regard. (*Chapter 2*)
- ***Conducting a strategic dialogue about the use of space***—The Commission recommends that Congress direct the Administration to engage in a strategic dialogue with China on the importance of space surveillance, the military use of space, and space weapons. Such a dialogue should include strategic warning and verification measures. (*Chapter 3*)
- ***More effectively assessing China’s military modernization***—The Commission recommends that Congress instruct the Director of National Intelligence, working with the Department of Defense, to formulate and establish a more effective program for assessing the nature, extent, and strategic and tactical implications of China’s military modernization and development. (*Chapter 3*)
- ***Tracing supply chains of critical weapons systems***—The Commission recommends that Congress require the U.S. Defense Department to trace the supply chains of all components of critical weapons systems. (*Chapter 4*)
- ***Prohibiting U.S. companies from disclosing information about Chinese users or authors of online content***—The Commission recommends that Congress prohibit disclosure by U.S. companies to the Chinese government, in the absence of formal legal action by the Chinese government, of information about Chinese users or authors of online content. Congress should require that where a U.S. company is compelled to act, it shall inform the U.S. government. A compilation of this information should be made publicly available semi-annually. (*Chapter 6*)