

The Effects and Consequences of an Emerging China

Testimony of

Larry M. Wortzel, Ph.D.

Vice President and Director, The Kathryn and Shelby Cullom Davis Institute
for International Studies
The Heritage Foundation

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Mr. Chairman and distinguished members of the Committee, thank you for inviting me to address the regional factors related to China's rise as an economic and strategic power in East Asia. With respect to the security problems on the Korean Peninsula, China is a prime actor. More broadly, China's economic growth, its military capacity, its industrial strength, and its entry into world economic markets challenge its regional neighbors and the United States.

Today's hearing comes at a critical time for the American people as well as America's friends and allies. Some Americans have opined that the United States cannot keep its focus while it conducts a war on terrorist organizations, stands ready to disarm Iraq, continues to support the democracy on Taiwan, and addresses the problem of the North Korean nuclear program. The very fact that the Senate Foreign Relations Committee is holding this hearing demonstrates the powerful capacity of this democracy to manage multiple complex strategic challenges in a mature and deliberative, yet timely and decisive way.

China is involved in all of these issues in one way or another. As a permanent member of the United Nations Security Council, Beijing gave half-hearted support to the war against al-Qaeda and the Taliban in Afghanistan. Beijing also professes support for the long-term war on terrorism, believing that it faces its own internal Islamic separatist terrorist threat. With respect to Iraq, while Beijing supported United Nations Resolution 1441, the Chinese leadership made it clear that it did not support the use of force in Iraq, but French intransigence permitted Beijing to avoid taking a position in any subsequent

vote. Over Taiwan, the United States and China disagree about the question of that island republic's sovereignty and about American arms sales under the Taiwan Relations Act; but it is fair to say that neither Beijing nor Washington wants to see the question of Taiwan's relationship to the communist government of China resolved by force. Neither the United States nor China wants to see a war on the Korean Peninsula. I believe that China would prefer to see the Peninsula divided and loathes the idea of a unified and democratic Korea.

Let me address Korea first and then turn to economic and other regional security factors.

The Korean Peninsula

Developments on the Korean Peninsula have worked to increase Beijing's political influence in the region. During the years I worked as a military attaché in China, the senior generals of the People's Liberation Army made it clear that China would not let North Korea collapse. I was consistently told that in the event of a major crisis, war, or collapse in North Korea, China must be consulted on any military action to be taken. Three senior generals who fought against the United States in the Korean War stated that if U.S. forces had to stabilize a collapsed North Korea or move into North Korea to fight there again, and those forces approached the Chinese border without consulting with Beijing, it could force the Chinese military to enter into Korea as the PLA did in 1950.

China provides somewhere between 70 percent and 88 percent of North Korea's fuel needs and between 30 percent and 40 percent of North Korea's food needs. Secretary of State Powell has given a range of figures for China's support for North Korea, as have other U.S. officials. The figures I cite are from the former defense minister of South Korea. It is clear that the statements of Chinese generals that Beijing will not permit North Korea to collapse are correct. Moreover, the magnitude of this aid means that the People's Republic of China is probably the country with the most influence over North Korea. Unfortunately, Beijing seems unwilling to pressure North Korea to end its nuclear program.

I believe that the leadership of China finds itself in a position that it enjoys. Diplomats and legislators from Tokyo, Seoul, and Washington are rushing to Beijing to seek assistance in ending the North Korean nuclear program. This parade of visitors puts Beijing into a central position on regional issues that the Chinese Communist Political Bureau must relish. Moreover, the fact that China's nuclear proliferation to Pakistan has been more or less accepted by the United States means that Beijing has managed to undermine a major pillar of American foreign policy—the non-proliferation regime. The situation with North Korea is more delicate than that in Pakistan, however, because Beijing fears that a nuclear-armed North Korea could drive Japan to abandon its peace constitution and even to consider expanding its military capabilities to include nuclear weapons and delivery systems. Centuries of animosity and war between Japan and China have left deep clefts between the two countries. The last thing Beijing wants to see is a re-militarized Japan. United States diplomacy must emphasize to Beijing the potential

consequences of failing to stop North Korea's nuclear program, and of China's proliferation behavior.

The senior leaders of the Chinese Communist Party continue to support the negotiating position of North Korea in dealings with the United States. Both Pyongyang and Beijing insist that the only way to resolve the diplomatic and security dilemma is direct negotiations between the United States and North Korea. Seoul also prefers to see direct U.S.–North Korean talks. I believe such an approach would be a mistake. Any solution to the nuclear program in North Korea must be multilateral. The same is true for North Korea's economic problems.

The 37,000 U.S. troops in Korea are part of a United Nations Command. The U.S. fought in the Korean War and negotiated the armistice ending the fighting on the Peninsula on behalf of the United Nations. The International Atomic Energy Agency, the body charged with monitoring the North Korean nuclear program, is a United Nations agency. Russia, Japan, South Korea, China, and the United States all have a stake in any outcome in Northeast Asia. The Korean Energy Development Organization, or KEDO, which provided heavy crude oil to North Korea under the 1994 Agreed Framework, is a multilateral organization. Finally, bilateral United States talks with North Korea only serve to isolate South Korea and freeze Seoul out of the settlement of the security threat it faces.

An interesting facet of the 1953 Armistice ending the fighting on the Korean Peninsula is that South Korea refused to sign and has not signed to this day. Instead of arguing for the United States to negotiate bilaterally with the North, Seoul should begin its own talks to finalize that armistice. Ending the state of war on the Peninsula would open the way for a wider round of regional talks about trade and economic development for North Korea if it verifiably ends its nuclear program.

All of the nations involved on the Korean Peninsula recognize that North Korea must resolve its food and energy needs, as well as its economic problems. Pyongyang must do this by reforming its Stalinist, command economy; changing its military-first policies; and ending the use of blackmail to gain concessions from its neighbors and the world. There should be no help for North Korea, however, until Kim Jong-il meets the obligations he has to South Korea and end the nuclear program.

Free Trade and National Security

Free trade builds wealth and prosperity for the United States and all involved in the fair exchange of goods. China has benefited from turning from a Stalinist, centrally planned system toward a market economy, as have the Chinese people. The increase in economic freedom in China has created a body of entrepreneurs and ordinary citizens who have a variety of choices of where they live, how they invest, and what they buy. This means that the state and the Communist Party have less control over major aspects of the lives of China's citizens.

China's turn to a market economy has produced consistent economic growth for the country. Its economic standing in Asia has given Beijing political influence in the region, and China's trade with its neighbors has grown rapidly. According to recent estimates, China's gross domestic product today is \$1.1 trillion. The future growth rate for China's gross domestic product is expected to be between 7 percent and 9 percent, according to the *Economist Intelligence Unit*. Regionally, only Vietnam is expected to have that potential with a future growth rate of 7 percent. Japan is projected to have a future GDP growth rate of only 0.7 percent. The Taiwan Institute of Economic Research (TIER), a major private think tank on the island, on November 7, 2002, revised its 2002 economic growth forecast for Taiwan slightly downward to 3.05 percent from 3.09 percent. Singapore's economic growth is expected to reach 3.1 percent in 2003 and accelerate to 5.1 percent in 2004, according to the February 10, 2003, issue of *The Economist*.

China's merchandise exports grew 301 percent between 1990 and 2000, greater than the rest of Asia except the Philippines, where exports grew at a rate of 391 percent for the same period. China is attracting needed capital and export markets away from its neighbors. World foreign direct investment (FDI) flows into China between 1995 and 2000 were about \$245.1 billion. For Hong Kong and China combined, investment flows reached \$377 billion. By comparison, for the same period South Korea only attracted \$33.1 billion in FDI, Singapore \$52.1 billion, and Malaysia \$31.3 billion, according to the July 2002 *Report to Congress by the U.S.–China Security Review Commission*.

However, China did not attract the most U.S. FDI for the same period. China received \$6.8 billion while Japan attracted \$21.4 billion, Hong Kong \$13.7 billion, and Singapore \$13.4 billion.

The lesson for Beijing here should be clear: American capital—Western capital in general—flows to nations with stable legal systems, the rule of law, strong property rights, and transparent banking and financial systems. That is the lesson of *The Index of Economic Freedom*, published annually by The Heritage Foundation and the *Wall Street Journal*. It is an outcome that supports United States policy goals in trading with China: the creation of a market economy, increased rule of law, and a China that functions in the world abiding by rules-based behavior.

I believe that American trade with China benefits the United States. Such trade creates and supports American jobs. At the time that trucking unions demonstrated against permanent normal trade relations with China, in 2000, about 40 percent of the shipping containers that passed through the port of Seattle, Washington, contained goods bound for or being imported from China. Those containers translate into American jobs.

Competition in the marketplace creates an environment in which industries must innovate and transform themselves or face obsolescence. Corporations and whole sectors of industry revitalize themselves in the face of fair competition. That said, there are prudent reasons for national security controls on certain exports where some goods are withheld from the marketplace. If a nation poses a direct threat to the United States or its

allies, or if its security policies pose a latent threat, it is prudent to restrict the sale of military goods to that country. This is the case with China, especially because of China's explicit threats against Taiwan. Also, given the history of the use of the Chinese People's Liberation Army to suppress the democratic movement in the 1989 Tiananmen Massacre, there is no reason to make the Chinese military a more effective force.

With respect to dual-use items—those with both military and civilian application—I would encourage a careful examination of licenses with increased end-user verification as well as pre- and post-license checks. Where the United States is the world's unique possessor of technological and manufacturing capabilities with clear military application, there are prudent reasons to control the licensing of such technologies or capabilities.

Regional Security

The United States and the People's Republic of China share a number of common national interests. Both nations seek a peaceful and non-nuclear Korean Peninsula; both seek to stop international terrorist organizations from disrupting commerce and their respective ways of life; both work to end international trade in drugs and persons; and both want to see a stable environment where trade flourishes, creating economic growth. However, there are still a number of areas of serious disagreement between China and the U.S. The resolution of how the democratic Republic of China on Taiwan and the Communist government of the People's Republic work out their differences on Taiwan's

sovereignty is a major area where Washington and Beijing disagree. China refuses to renounce the use of force to bring Taiwan under its control.

I do not believe that is the most volatile policy difference between the U.S. and China, however. In my view, it is Beijing's expansive interpretation of its own territory that can lead to conflict, as demonstrated by the confrontation over how China handled the peaceful passage through international airspace by a United States EP-3 reconnaissance aircraft in April 2001. China's insistence in its own territorial laws that it controls airspace and the sea out to 200 miles, the Exclusive Economic Zone, is an interpretation of the Law of the Sea that the United States cannot allow to stand, or the right of free passage of vessels and aircraft for free trade will be impeded. Moreover, China's expansive claims in the East and South China Sea compete with those of Japan, Indonesia, Malaysia, the Philippines, Brunei, and Vietnam. China is building the type of military to back up those claims with credible force and to deny the United States the flexibility to operate its own forces in these areas.

China's military buildup is not a challenge to American military superiority, but it is worrisome because of Beijing's history of using the military to reinforce its expansive territorial claims. Japan's air and naval capabilities are purely defensive, but the Japanese Self-Defense Force's technological and equipment capabilities far outstrip those of China. The single exception to this is in the area of ballistic and cruise missiles. China has developed a strong ballistic missile force and is modernizing its long-range missiles to be mobile and armed with multiple warheads. Today, both the United States and its

allies, especially Japan, are without ballistic missile defenses. Because of China's modernization, and the threat from North Korea, the early development and deployment of ballistic missile defenses is critical to security in the Asia-Pacific region. Beijing is also building (and buying from Russia) a dangerous force of land attack and anti-ship cruise missiles. Cruise missile defense requires improved radar, but the basic defensive systems are already in the American and Japanese military inventories.

China's Presence in U.S. Capital Markets

Chinese state-owned companies and the Chinese government have raised an estimated \$20 billion over the past decade from international bond offerings, according to the 2003 *Report of the U.S.-China Security Review Commission*. They have raised more than \$40 billion in international equity markets over the past decade, with over \$14 billion coming from initial public offerings in U.S. capital markets in the three years preceding the publication of the commission report. Some argue that such actions by China raise capital that supports Beijing's military expansion. Indeed, it is very difficult to tell which Chinese entities are related to or wholly owned by the People's Liberation Army. It is prudent to deny known Chinese entities that engage in proliferation access to the U.S. markets. The Securities and Exchange Commission should require foreign companies to file registration statements electronically, should review such filings to see whether the companies are subject to U.S. sanctions, should seek information from filing companies about their business with U.S.-sanctioned countries, and should share such information with the Treasury Department.

In general, I would argue that China's investment in the United States, like the trade between China and the U.S., represents a tool of influence in the economic relationship between the two countries. However, the United States should not close its capital markets and must exercise caution in denying Chinese firms access to the markets. One discussion in which I participated with those who proposed to keep Chinese companies from trading with the United States suggested that any Chinese entity that produces goods for military use should be kept from doing business in the United States. Such an approach is foolish in my view and would lead to a response against American companies, hurting U.S. economic interests. Chinese industries are increasingly producing goods for both civilian and military markets. They function like major American conglomerates. Should a U.S. company be penalized because it produces both toasters and military radar? I think not. In the case of China, if it is a clandestinely owned PLA company, that may not be the case. But Chinese firms, even state-owned firms, ought to get equitable treatment if they operate in the marketplace according to SEC rules.

China's Future Economic Growth

China could turn into the second largest trading nation in the world by the year 2020 with a per capita income equal to that of the Republic of Korea or Portugal today, according to the World Bank's *China 2020* report published in 1997. Should China focus on being a trading nation rather than a major military power, and reform its legal and

financial institutions, this outcome is feasible. However, China faces huge problems that will only be exacerbated when it finally complies with its obligations as a member of the World Trade Organization. Today, about half of its state-owned companies are not making a profit. No one knows how many of the loans out from Chinese banks are non-performing, but the rate may be around 46 percent. There are some 140 million agricultural workers who are unemployed or underemployed and floating around the country looking for work. The World Bank expects that to grow to 200 million people. The Chinese state is failing to deliver health care and education to its people, demonstrating the bankruptcy of the Communist Party and undermining its legitimacy.

Anyone who gives a straight-line prediction about where China will be in 20 years is making it up. United States policy is about right—to encourage reform and to anticipate a China that has an educated populace, a productive work force, and a nation that operates in a world of rules-based behavior. However, we must “handicap” the potential outcomes. This particular one may get a two or three in five. It is also possible that we will see a China in chaos, with the legitimacy of the ruling party collapsed and the floating labor population tearing the country apart. And it is possible that the emerged Chinese state will have a powerful, coercive military that threatens not only its neighbors, but the United States as well. Thus, while the United States embraces policies that encourage the first outcome, it must maintain its military edge and the ability to defend American interests in the event of the last outcome.