

Testimony of Robert A. Kapp

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**Subcommittee on East Asian and Pacific Affairs
Senate Foreign Relations Committee**

"EFFECTS AND CONSEQUENCES OF AN EMERGING CHINA"

March 19, 2003

Mr. Chairman, members of the Subcommittee:

Thank you for inviting me to appear before you today.

I. Introduction.

I am Robert Kapp, president of the US-China Business Council. The Council (www.uschina.org) was established in 1973. The Council, a tax-exempt nonprofit business association under Section 501(c)(6) of the Internal Revenue Code, is the principal organization of American companies engaged in trade and investment with China, serving approximately 225 leading corporations and firms from its Washington headquarters and field offices in Beijing and Shanghai. The Council provides a combination of business advisory services, written information and analysis (primarily online), meetings and programs of all kinds, and advocacy work on public policy issues of concern to its broad business constituency, both in the US and in China. The Council has long enjoyed productive and close engagement with many Members of the Senate and House, many Committees and Subcommittees, and many members of Congressional Staff. We welcome such contacts, and believe that the Council can provide dispassionate and accurate information and perspectives to our counterparts on Capitol Hill, as we do to many in the executive branch and to our business constituents.

The Council publishes the leading magazine on US-China trade and economic relations, The China Business Review (www.chinabusinessreview.com). As it happens, the new issue of our magazine, celebrating the Council's 30th anniversary, has appeared only this week. Most of the article content of this issue, by authoritative American and Chinese analysts, deals with the very subject of today's hearing. I have taken the liberty of making copies of this issue available to members of the Subcommittee, in the hope that they or their staff will find them useful in exploring the themes of today's hearing.

I congratulate this Subcommittee for getting an early start in the new Congress on the broad subject of US-China relations. China has a way of bursting upon the Congressional agenda in times of acute crisis, and then disappearing almost without trace from Members' priorities when things settle down. This relationship is too huge, and its

implications not only for America's interests but for the interests of world peace and prosperity too significant, for it to be treated in this manner. The Senate Foreign Relations Committee and this Subcommittee can do the Congress and the nation a major service by staying the course on our relations with China, year in and year out, hearing the good and the bad, the positive and the negative, and placing the US-China relationship into the broadest context of American interests and policies worldwide.

II. US-China Trade and Economic Relations: "The Data."

It is no secret that our country and China now participate in a vast economic engagement that places the US second on China's list of trade partners and China fourth on our own. In a year of economic sluggishness, US-China trade in 2002 grew rapidly. US figures show US exports to China up more than 15% over 2001 the largest and most rapid export growth booked with any of our trade partners. Chinese exports to the US continued to expand very rapidly as well, and the merchandise trade deficit reached unprecedented levels.

China's economy continued to move ahead strongly, driven by a combination of domestic market growth, government deficit spending to deter deflationary trends and mitigate reform-driven unemployment, stronger than predicted export performance, and strong incoming FDI levels. The bulk of China's very large FDI inflows continues to come from Asian points of origin, most notably Hong Kong, Taiwan, and Japan, with more Asian investment booked under British Virgin Islands.

Chinese figures show the top six import suppliers to the PRC as Japan, Taiwan, South Korea, the US, Germany and Hong Kong, with Taiwan's exports to the mainland rising 39% in 2002. China's top export destinations continue to be the U.S., Hong Kong, and Japan, with South Korea and Germany running far behind.

China's total foreign trade grew by nearly 22 percent in 2002; exports and imports both rose by more than 20%. China's overall positive trade balance of around \$30 billion was higher than that of 2001, about the same as that for 1999, and lower than that for 1997 and 1998. China's trade with the Asia-Pacific region grew most rapidly. Overall, China's top 6 trade partners in 2002 were (in order): Japan, the U.S., Hong Kong, Taiwan, South Korea and Germany. Taiwan replaced South Korea in the #4 slot, its trade with the PRC rising by 38.1 percent.

Exports from non-state-controlled firms rose more than 27%, a sign of the growing international activity of non-governmental enterprises as China, under WTO, further opens the door to international business by domestic firms. Economists have long noted that the non-governmental sector of the Chinese economy is far more dynamic and far more effective at generating employment than the state sector, but that the state sector continues to enjoy far greater access to capital than do non-state firms.

In the first nine months of 2002, 60% of all incoming investment came from the Asian region, with the U.S. accounting for 10.5%. Exports from FIEs -- foreign invested

enterprises -- accounted for 52% of all Chinese exports in 2002, according to Chinese numbers.

Among the key features of the Chinese economy in 2002 were the accumulating evidence of a large domestic market for consumer durables and consumer goods, exemplified by the rapid growth of auto sales, and the concurrent deepening of income and wealth disparities within Chinese society, both on the rural-urban continuum and between the heavily advantaged coastal region and the more poorly endowed interior and "rust belt" regions. One informed observer has argued that widespread privatization of housing ownership has had a very powerful stimulating effect on China's domestic markets.

The central government has continued to pour resources into infrastructure development -- dams, pipelines, modern highway networks, telecommunications systems, and so forth -- whose economic returns may not be immediate. The government (as of today, the new team that has just taken high office) faces huge challenges in dealing with persistent budget deficits, widespread industrial unemployment and rural economic distress, and the twin burdens of adhering to WTO market-opening requirements while simultaneously ameliorating the economic dislocations that such adherence is widely expected to entail. Meanwhile, the vast enterprise of shrinking the role of the public authority in the economic and social life of the populace while maintaining and even increasing the effectiveness of national authority across the length and breadth of China's huge land mass grinds ahead, bounded on the one side by the looming danger of excessive audacity and on the other by the impossibility of holding back the tide of continuing economic reform.

Faced with the broad range of economic and social challenges merely hinted at here, the regime has given strong signals in the past year that a stable international situation, including a stable relationship with the United States, is an important prerequisite for the domestic economic progress on which it must concentrate. For one expression of that viewpoint, I commend to your attention the article by Prof. Huang Renwei in the issue of The China Business Review that I am presenting to members of the Committee. We expect the heavy focus on pressing domestic demands to continue under China's new leadership.

III. China in the WTO: The "data" of a work in its early stages.

Evaluation of China's "performance" in adjusting its institutions, laws, and practices to the requirements detailed in its WTO accession papers began almost from the day China joined the WTO in December, 2001. American businesses, who had played such a significant advisory role in helping the government to define the far-reaching obligations that the United States insisted China accept if it were to be admitted to the WTO, viewed China's entrance into the WTO with optimism, in the belief that a China committed to conducting its now-massive international commerce under rules and dispute mechanisms established by the global trading community would prove a more congenial and dependable trade counterpart than a China left to its own devices outside the framework which governed the conduct of the rest of the world's trading nations. That remains their view.

Partly because China's WTO accession was unprecedented in the complexity and detail of its commitments, and partly because of the intense political controversy surrounding the PNTR debate in the United States, this country has established multiple governmental mechanisms for examining China's continuing progress toward full implementation of its commitments, not only at the outset of its membership in the WTO, but each year for the long period of its phasing in of required market openings. The WTO itself has subjected China to annual review of its performance as well.

Thus, the US-China Business Council offered to the Trade Policy Staff Committee, coordinated by the Office of the U.S. Trade Representative, its preliminary assessment of China's earliest progress as a WTO member, in testimony last September.

I attach an article I wrote at that time, "WTO: Toward Year Two," which summarized very briefly the much more detailed analysis the Council produced (the longer document is available at the Council web site, www.uschina.org, at "China and the WTO/Public.")

We concluded, in essence, that after only ten months of Chinese membership in the WTO, it was premature to form sweeping conclusions about the extent, the effectiveness, or the forthcomingness of China's WTO conformity efforts. We observed that, near the end of the first year, the WTO glass was half full, not half empty, primarily because China had reduced tariffs on time and in full keeping with its first year obligations, had made very extensive efforts to amend existing laws and regulations or put new WTO-compatible laws on the books; and that the government was clearly involved in a wide-ranging effort to introduce the notions and the methods of a WTO-consistent economy to tens of thousands of administrators and cadres who were essentially confronting an entire new conceptual and administrative universe for the first time.

We noted, as well, however, that the first year had begun to reveal a number of emergent problems which demanded resolution in the second year of China's WTO membership

These included inadequacies in the establishment of the "tariff rate quota" systems, for both agricultural and non-agricultural products; delays in instituting stable import policies on GMO commodities; the absence of timely establishment of WTO-required auto-financing systems; continuing lacunae in the critical area of legal and regulatory transparency, despite some examples of noticeable progress; the nascent practice of posting excessively high capital requirements on new service-sector businesses in a manner that militated against international companies' full realization of new WTO-mandated market opportunities; manipulation of certain tax practices, notably relating to the "VAT" or Value Added Tax, in ways that suggested inappropriate favoritism toward domestic products; opacity in the critical area of trading and distribution rights for foreign invested enterprises; and the perennial problem of intellectual property rights protection and enforcement.

We noted, further, that with "Year Two," the process of phasing in key Chinese market opening commitments would begin in earnest, and expressed the hope that such phase-ins would proceed as smoothly and definitively as possible.

Now, in March 2003, we are moving into the middle portion of "Year Two." The United States Government has engaged directly with Chinese authorities on a number of the most significant issues mentioned in our list of concerns above. China is just finishing a period of political transition that began with the Party Congress last November and concluded with the end of the National People's Congress on March 18. Some of the key Chinese agencies responsible for policies and actions central to fulfillment of China's WTO obligations are being reorganized, merged, or redirected. A period of uncertainty as to who reports to whom and who has the power to do what in the WTO implementation realm may be before us; we hope that any such hiatus will be short.

While the US-China Business Council recognizes that "Year Two" has a long time to run, we are of the view that the months since submission of our TPSC report last fall have shown few significant advances in China's WTO acclimatization and implementation. As we have noted to our Chinese interlocutors many times, time is passing.

The list of our concerns has changed little since the fall of 2002: the TRQ regime, opaque or discriminatory use of technical standards whose effect is to block access of foreign products to China's markets, continuing excessive capital requirements in most service sectors, telecommunications sector licensing requirements, inadequate progress on the establishment of trading and distribution rights for certain foreign-invested firms, inappropriate use of VAT rebates in a manner that discriminates against imported products, the drawn-out GMO controversy, the unresolved problem of rampant intellectual property abuse -- all remain of concern to the Council and its members.

At the same time, we are well aware that United States agencies are receiving rising numbers of requests for protection against Chinese imports, both from traditional heavily protected sectors of the US economy and from individual makers of products now facing Chinese competition in US markets. Further, China itself has developed and is now using its own anti-dumping rules and institutions with increasing frequency and thoroughness.

IV. Economic and Commercial Relations: A Quick Summation

Taken as a whole, the immense process of economic and social change rolls on. China continues to move in the directions that, presumably, Americans want to see it go. The economy is very heavily marketized now. The profit motive has trumped the planned economy to a degree unimaginable a few years ago. The heavy hand of the state has been removed from many aspects of Chinese citizens' lives. The Chinese government continues to move away from the remnants of the Stalinist planned economy, often against entrenched bureaucratic vested interests and often at the cost of cutting once-dependent constituencies adrift. An important trend gradually moving ahead now is the reduction of the stultifying and corruption-ridden but all-pervasive system of bureaucratic approvals and licensing in favor of a more equitable and routinized system that places

fewer obstacles in the path of productive economic activity -- for Chinese and non-Chinese alike.

China's domestic market is an established fact of real significance to many US firms. Chinese companies and entrepreneurs increasingly have assimilated the language and the methods of global commerce. Contrary to the familiar portrayal of deluded and befuddled business people throwing their money down the drain in the vain pursuit of the mythical China market, many of our Council's member companies are doing well there, and view China either as a short-term bright spot in an otherwise bleak business landscape or as a compelling mid- to long-term venue for business development. Smaller US companies are unquestionably stirring as well, beginning to see China for the first time as a place where they, too, might seriously explore profitable opportunities.

The economic development of China, including the improved economic circumstances of hundreds of millions of Chinese citizens and the expansion of the modern Chinese industrial economy -- are widely seen by American companies as highly positive developments -- especially since U.S. products are best suited for more advanced economies and for consumers with money to spend.

China has proven, as well, capable of manufacturing a vast array of products to world specifications at highly competitive prices, and has established itself as a supplier of many manufactured goods to foreign markets, including the United States. Clearly, China has become an integral component in many firms' global marketing and sourcing strategies. This trend is likely to continue.

This "emergence," as the Subcommittee has called it, of China in the world economy is important news for China's trade partners, including the United States. And it is this complex mixture of good and bad news that leads me to the final section of this testimony.

IV. The meaning of "China's Emergence."

Mr. Chairman, barring internal systemic crisis such as might arise from a collapsing banking system or a catastrophic worsening of China's already serious rural and urban social dislocations or from a decisive degradation of China's corruption-ridden administrative structures, the China whose remarkable trajectory has been the object of world wonder and admiration over the past decade is here to stay. While specialists vary in their assessments of the fragility of China's economic and social stability, most view China's track record over the past twenty years, for all its potholes, as very impressive, and conclude that China is far from the brink of systemic failure. It would be a very risky bet to assume that China is headed back into the weakness and global insignificance that the older among us -- and the parents of the younger among us -- used to take for granted.

China's high-level politics, however opaque they might be to Western eyes, still appear demonstrate continuity and "normalcy." The transition to new Party and government leadership has been navigated to conclusion only in the past few hours. The regime has now passed a longer period free of wrenching internal political conflict than at any time

since its founding. The deep-seated assumption, arising from Mao's time, that any leader of China must be a charismatic "mobilizational" figure is outmoded; China's leaders are educated, administratively experienced, technologically literate, and for the most part unspectacular. The era of "Great Man Rule" is over.

The regime's stalwarts, like our own still come to their posts from overwhelmingly domestic backgrounds. But China possesses a large pool of internationally competent talent, in government and increasingly in business. The contrast with the situation twenty years ago could not be more stark.

China's international relations are generally stable, especially on its borders. Its position in the Asia-Pacific regional economy is increasingly prominent and has not caused the economic disaster in the region that some observers had predicted; indeed, China's Asian neighbors are increasingly interested in building bilateral and regional cooperative links with China that might help to assure their place in a regional economy heavily influenced by China's trade behavior. China is an engaged, generally responsible player in most major world bodies.

The US-China dialogue of the past eighteen months, characterized by repeated meetings of the heads of government and near-routine consultations at the cabinet level -- and, I'm happy to say, by expanded Congressional engagement with China -- appears to be on a civil and respectful course, even when the two nations cannot fully agree. Human rights and labor issues continue to rankle, and should not be lightly dismissed, but the past year has seen a few hopeful moments, including the visit of representatives of the Dalai Lama to China and the release of Mr. Xu Wenli. Somewhat amazingly, after the tumult of the period from the Lee Teng-hui visit through the Taiwan Straits missile crisis, the missile technology brouhaha, and the successive controversies over campaign finance, the Cox Commission, Los Alamos, the Belgrade Embassy bombing, the Long Beach and Panama Canal questions, and the EP-3 Hainan Island incident, US-China relations are said by both sides to be "better than ever before."

China has, as the title of this hearing suggests, "emerged."

Yet the full implications of China's arrival among the ranks of the very significant nations of the world are still, somehow, unexplored. I hope the Subcommittee will excuse me for going beyond the narrow professional focus of the US-China Business Council for a moment to comment on this broader problem.

The recitation of our business and economic relations with the PRC above is a small facet of this larger picture. And there are a number of disquieting signs.

It is common to observe that with the collapse of the Soviet Union the "strategic rationale" for US-China relations evaporated, and that in its absence a plethora of individual issues has tossed US-China relations one way and then another.

Perhaps the "war on terror" has re-established that overarching commonality of interests needed to advance the bilateral relationship. Perhaps not.

An arms race is underway in the Taiwan Strait, identified by all observers as the point of greatest military volatility in US-Chinese relations. No matter where one chooses to identify first causes, the fact of that military race is undeniable.

To the alarm of American observers, some Chinese strategic analysts paint a portrait of a United States bent on "blocking" China's rise, constricting its economic opportunities, emasculating its strategic and regional military strength, compromising its sovereignty, and undermining its political system. The writings of such commentators often claim more attention in the United States than the writings of those who posit a more cordial US-China relationship as one of the core elements of Chinese foreign policy.

From time to time, American observers find in China a state determined to reassert ancient imperial pretensions to world power, a regime that takes the United States as China's "principal enemy" and bends its efforts to ensuring its ability to confound American economic and military power.

Some analysts in China view the United States with alarmed uncertainty. They find it difficult to conclude, for example, from the recently published National Security Strategy, whether China is the real intended target of the American pledge to prevent the emergence of any military challenges to U.S. power, or whether the China that the United States pledges to work with in a consortium of major powers dedicated to eradicating the threat of global terrorism is the Americans' "real" China.

Significant bodies of opinion in both countries see conflict between the American "status quo power" and the Chinese "rising power" as likely, if not unavoidable. The costs of such conflict are not addressed.

Some powerful voices within the United States see China's increasing ability to compete with the developed industrial nations, including the US, as a mortal threat to the US economy and thus to U.S. national security.

In spite of the resumption of cordial US-China engagement in the aftermath of September 11, with cooperation in the campaign against global terrorism as its centerpiece and rapidly growing economic engagement as its most visible manifestation, the two nations have yet to achieve -- or perhaps even to seek -- a durable set of understandings as to their intentions and their understandings of each others' national interests.

There is no sign of effective dialogue between the two countries as to what constitute the legitimate needs and aspirations of both, when the two bump against each other. Each side has its list of "non-negotiables," but there seems little results-oriented communication -- official or otherwise -- as to where and how to reach mutually satisfactory understandings in areas of latent conflict.

In the absence of such a consensus over basic goals and mutual interests, the "data" of this relationship -- whether trade numbers or facts and figures about weapons deployments -- are left to be interpreted by believers according to their preconceptions. The fascinating and disturbing thing about the entire strategic dialogue, to which our trade and economic engagement is from time to time a footnote, is that in the absence of US-China communication about the nature of this relationship, those who "know" out of conviction what the relationship is now and must become can all point to the facts and figures to prove their points of view. There seems to be little concern, moreover, for questions of how the United States and China might act purposefully to establish consensus, defuse frictions, and reduce the possibilities of major conflict.

Ironically, the conundrums that China poses for the United States today arise from China's growing ability to function in the world as a "normal" nation, and not as the grotesque and demonic state that Americans saw with such alarm in the 1950s and 1960s. Surely, with the emergence of a country this large, this significant to the future of the global commons, this invigorated by a sense of finally achieving the elusive breakthrough to prosperity and security, the United States and China should be trying with maximum energy to answer the riddle of their future relationship.

China's "emergence" is a fact. The world is a different place as a result. The United States Senate and all Americans should be asking: how are the interests of the United States best secured in this new and different world? Should we take China's emergence solely as an existential danger toward whose undoing we should bend every ounce of American strength? Would that be feasible? What would it cost? Would the world be with us? What would it mean to "prevail"?

Does China's emergence require that the United States examine its own definitions? Can the U.S. and China do more to harmonize their interests and their engagements? Are the current fault lines in US-China relations fixed for all time? Is it even worth exploring these questions anew, and more effectively, with China than we have managed to do thus far? What might be the dangers in doing so? Is such an effort simply beyond the abilities of leaders in two such disparate societies to manage?

I hope that the Senate Foreign Relations Committee and this Subcommittee will not avert their eyes from big-picture question like these, Mr. Chairman, for it is in the answers to these questions that the meaning of the economic and trade data, the micro-level experiences of Americans in business and other walks of life, will emerge to inform the thinking of our legislators and policy makers. The work needs to go forward in the absence of US-China crisis. I thank the Subcommittee for getting started.

V. A Concrete Concern: The Ongoing Problem of Visa Processing

Mr. Chairman, before concluding my testimony, I would like to raise one very practical and immediate issue, with which I believe the Subcommittee and perhaps the full Foreign Relations Committee ought to be concerned. The American business community engaged with China has, since the summer of 2002, encountered serious difficulties in

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regard to the travel to the United States of Chinese citizens in the employ of US firms, or at the invitation of US firms, for legitimate business purposes. Many visa applications for business travel have been delayed for four to six months, without explanation. Some visa applications have been denied, after lengthy delays, again without explanation.

The press has already reported on a series of cases in which US firms have been unable to bring to the United States Chinese citizens whose travel to the US is integral to the US companies' achievement of valuable sales, implementation of signed sales agreements with Chinese customers, training of Chinese personnel in the use of legitimately purchased US equipment, or planning of US company business development strategies in China.

The disruption of visa processing appears to be the result of two separate U.S. policy thrusts. One aims at strengthening U.S. border security by denying entry to dangerous individuals. The other is to tighten access to U.S.-origin technology by augmenting existing export controls. The U.S. business community strongly supports improvements in border security and understands the need for appropriate export controls.

At the same time, it is clear that any truly effective new visa procedures must eliminate, or minimize as fully as possible, the unnecessary "collateral damage" that the current procedures are causing to American companies attempting to function in today's global economy.

Whether the problem lies in the inadequacy of manpower and equipment resources for the prompt and predictable processing of visa applications, or in the policy definitions and administrative guidelines (not transparent to those outside of the relevant government agencies) that have occasioned these very counterproductive results, we sincerely hope that Members of this Subcommittee will turn their attention to the task of remedying these problems and restoring the maximum possible level of effectiveness in the visa evaluation process.

We have worked, as part of a larger coalition of concerned business associations and companies, for many months on this issue, with representatives of executive branch agencies and with members of Congressional staff in both Houses of Congress. The matter appears now to reside principally in the newly created Department of Homeland Security, with which we hope to establish productive working contact. We appreciate, in advance, your willingness to take an interest in this matter, and hope we can remain in close contact with you about it.

Thank you very much.