

EXECUTIVE SUMMARY

This Report sets forth the Commission's analysis of the U.S.-China relationship in the topical areas designated in 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, its economic reforms, U.S. economic transfers to China, China's energy needs, its firms' access to the U.S. capital markets, U.S. investments in China, China's economic and security impacts in Asia, U.S.-China bilateral programs and agreements, China's record of compliance with its World Trade Organization (WTO) commitments, and its government's media control efforts. Our analysis, along with recommendations to the Congress for addressing identified concerns, is chronicled in the Report, and summarized herein.

OVERALL ASSESSMENT OF ECONOMIC AND SECURITY CHALLENGES

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 (PRC)," 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.

Based on its analyses of developments during the period since its 2004 Annual Report, the Commission concludes that, on balance, the trends in the U.S.-China relationship have negative implications for the long-term economic and security interests of the United States. To prevent or reduce the negative impacts of these trends, the United States needs to establish and implement policies that provide course corrections.

The U.S.-China relationship is not inescapably destined to be adversarial, and certainly not violently so. However, while some encouraging changes are occurring in China, it is vital for the United States to recognize that in many respects China has different interests, goals, and values than the United States, and to reflect those differences in the way it deals with China. In areas where China poses challenges to the United States, the United States must meet the challenges with a variety of tools and approaches, and as aggressively as necessary to protect important U.S. interests.

Perhaps the greatest challenge that faces the United States is to develop a coherent strategic framework for approaching China in a way that does protect vital U.S. interests while recognizing legiti-

mate Chinese aspirations, minimizing the likelihood of conflict, building cooperative practices and institutions, and advancing both countries' long-term interests wherever that is possible. It then is critical for the United States to use the substantial leverage it has—because of its role as a major purchaser of Chinese exports and a major supplier of technology China wants for its economy, and because of the current U.S. status as the sole superpower—to persuade China to engage productively in the U.S.-China relationship and to work with the United States to resolve differences. This surely will test U.S. creativity and diplomatic skill.

COMMISSION FINDINGS

The Report presents its findings, analysis, and recommendations to Congress in thirteen sections, organized in five chapters, capturing the major themes of the Commission's Congressional mandate. While the Report has been divided in this manner, all these areas interrelate in any assessment of the overarching question of how the U.S.-China economic relationship affects U.S. economic and national security interests. The Commission recognizes that the United States' vast economic transfers to China are inseparable from the larger geopolitical and military developments at issue.

The Commission's findings are included in this Executive Summary. The ten key recommendations the Commission makes to Congress in the Report are listed at the conclusion of the Executive Summary. The Commission makes 57 recommendations to the Congress in this Report; the complete list of the recommendations pertaining to each of the five Report chapters is provided at the conclusion of the chapter, and a comprehensive list appears on p. 201.

The U.S.-China Trade and Economic Relationship

The U.S.-China economic relationship has continued over the past year to expand at a rapid pace. New U.S. foreign direct investment in China totaled nearly \$4 billion. The trade relationship grew markedly, with U.S. imports from China outpacing U.S. exports to China by more than five to one. The result was a bilateral goods trade deficit that reached \$162 billion in 2004—a 31 percent increase over the previous year—and is on pace to considerably exceed \$200 billion in 2005.

U.S. manufacturers in a broad array of industries are under increasing competitive pressures from domestic and foreign-invested, China-based manufacturers. Although each U.S. industry has a unique set of competitive concerns with China, the principal cross-cutting concerns are China's undervalued currency, extensive system of government subsidies (particularly those favoring export-oriented production), weak intellectual property rights protections, and repressive labor practices. Many of these appear to act as a strong inducement for U.S. and other foreign firms to invest in and relocate to China to serve the Chinese domestic market and to use China as an export platform.

China remains in violation of many critical commitments it made in order to obtain agreement that it could enter the World Trade Organization—on a transitional basis due to the extensive economic reforms necessary for its economy to conform to the market practices of WTO members. China's continued recalcitrance is caus-

ing material injury to U.S. companies, workers, and communities. It also is contributing to a highly skewed bilateral economic relationship marked by a soaring U.S. trade deficit and a weakening competitive position for many U.S. firms.

Foreign investment, mostly in the form of foreign direct investment, has underwritten much of China's economic development. However, a growing proportion of foreign funds has been accumulated via the debt and equity offerings of Chinese firms in international capital markets and, to a lesser extent, in China's weak domestic capital markets. No Chinese firms have listed in 2005 on the New York Stock Exchange, with the most frequently cited reason being their reluctance to meet the requirements of the Sarbanes-Oxley Act of 2002, particularly the requirement that the CEO and the CFO certify the company's annual and quarterly reports. However, Chinese high technology and telecommunications firms are continuing to list on the NASDAQ Exchange. These firms tend to be incorporated in offshore locations and have been able to meet U.S. standards for disclosure and corporate governance. A variety of Chinese firms, including banks and state-owned enterprises, are increasingly listing on the Hong Kong Exchange.

The Commission retains the concerns voiced in its 2004 Annual Report that transparency and disclosure by Chinese firms remain inadequate—a deficiency that is most pronounced in the case of state-run firms. This poses a substantial risk for investors, including those from the United States participating in the markets where Chinese firms are listing. It also makes it very difficult to determine the possible links of the listing firms to weapons proliferation activity and to People's Liberation Army or other Chinese defense-related activities. Although it consequently is impossible to know the full range of such involvement by Chinese firms, it is certain that some listed firms have been involved.

As trade and investment between the United States and China have expanded in importance and scope, the impact of this relationship on the global economy has grown to enormous proportions. It also remains reasonable to believe, as the Commission indicated in its 2004 Report, that "U.S.-China economic relations will help shape the rules of the road for broader global trade relations."

As China, India, and the states of the former Soviet Union have commenced active participation in the global economy in the past ten to twenty years, the global market's work force has doubled, placing major downward pressure on wages around the world. This is a function of what has been termed the "law of one price:" when capital is relatively unencumbered and the factors of production are mobile, capital will gravitate to regions with the highest rate of return. This has been occurring and continues to occur in China and elsewhere, and it is resulting in the movement of jobs, especially manufacturing jobs but increasingly service jobs as well, from the United States to China and the other countries offering higher rates of return on capital.

Findings:

- China's exchange rate reform announced in July—that included a modest revaluation of the renminbi (RMB) against the U.S. dollar and the linking of the RMB's value going forward to a basket

of international currencies—was an extremely limited step, amounting to a 2.1 percent change in value. Most economists believe that the RMB is undervalued by 15 to 40 percent. China's currency manipulation acts as a subsidy for Chinese exports to the United States and a tax on imports from the United States, and serves as an incentive for U.S. and foreign firms to move production to China.

- U.S. producers of advanced technology products are also subject to the growing pressures posed by China. In 2004, the U.S. trade deficit in advanced technology products with China grew to \$36.3 billion.
- While China has made progress toward meeting some of its commitments, it remains in violation of its WTO commitments in a number of important areas, many very significant for U.S. industries. As a result, U.S. firms continue to face market access barriers in China and unfair trade practices in U.S. and third-country markets.
- U.S. laws and the WTO provide remedies and safeguards for firms facing unfair trade practices and import surges from China. These trade tools remain underutilized and ineffective. Antidumping duties have gone uncollected; countervailing duties are presently inapplicable to China due to a Department of Commerce practice. The U.S. government has been slow to implement the China-specific textile safeguard and then the safeguard has been immobilized by litigation at a crucial time. Relief under the China product-specific (Section 421) safeguard has never been granted by the President despite three International Trade Commission decisions authorizing relief for the parties.
- China has effectively marginalized the WTO's annual review of its progress in meeting its WTO accession commitments—the Transitional Review Mechanism (TRM). It may be more productive to rely on the Trade Policy Review Mechanism (TPRM), applicable to all WTO members, to review China's WTO compliance. The first TPRM review of China will be conducted in April 2006.
- Inadequate corporate governance, disclosure, and accountability, poor regulatory supervision, rampant insider trading, frequent government intervention, and corruption continue to hinder the development of China's domestic capital markets. A related lack of confidence in China's domestic stock markets in Shanghai and Shenzhen has led to falling share values, which in June 2005 hit eight-year lows.
- Chinese firms continue to look to international capital markets to raise needed capital and enhance their global profile, though the location of such fundraising has been shifting significantly toward listing on the Hong Kong Stock Exchange. In 2004, Chinese companies listing in Hong Kong raised \$12 billion, up from \$7.5 billion in 2003.
- In 2005, Chinese companies have largely forgone listings on the New York Stock Exchange (NYSE), primarily due to the enhanced corporate reporting provisions of the Sarbanes-Oxley Act

of 2002. Privately owned Chinese companies have concentrated their U.S. listings on the NASDAQ exchange.

- China is taking a dual approach to raising capital to shore up its principal state-owned banks, which have non-performing loan levels estimated at \$350 billion to \$550 billion. While China is preparing its largest state-owned banks for overseas stock market listings, it is also selling stakes in the banks to Western banks eager to gain a foothold in the Chinese banking sector.
- China's fundraising in global capital markets has national security implications for the United States. The U.S. Treasury Department has identified a Chinese bank alleged to be involved in money laundering related to activities that could be financing North Korea's nuclear weapons programs and, according to press reports, is also investigating the Bank of China and another Chinese bank because of similar alleged activities. This raises concerns about the nexus between Chinese banks listing on international capital markets and security-related abuses.
- Because the links between military and civilian control and production by Chinese state-owned enterprises remain opaque, investors can rarely be sure whether their investments are tied to the People's Liberation Army or other Chinese defense-related activities to which some publicly traded firms appear to have been tied.
- While many U.S. firms have responded to global competitiveness challenges by outsourcing and offshoring, these individual corporate decisions do not address, and in some cases may conflict with, efforts to maintain productive capacities in industries important to U.S. economic leadership and vitality. This distinction between private and national interests is particularly pertinent with regard to the U.S. economic relationship with China, where the market may produce outcomes that are contrary to the U.S. national interest.
- The opening of the Chinese, Indian, and former Soviet bloc economies has led to more than a doubling of the global market's work force and likely will put downward pressure on U.S. wages for workers at all levels, including higher levels of the wage scale. Mobile capital and technology flows accelerate this trend.
- China has adopted an economic growth strategy that emphasizes strategic accumulation of productive capacity and access to resources. An important part of this strategy is attracting foreign investment and know-how to assist China's export-led growth.
- China obtains a competitive advantage from political and economic systems where workers are often denied fundamental workers' rights. China's paucity of environmental protections similarly functions to benefit some Chinese industries.
- The U.S. international tax regime favors investment abroad in comparison to domestic investment, providing a disincentive to companies for maintaining production facilities in the United States.

China's Technology Development and Implications for the U.S. Defense Industrial Base

China's comprehensive and coordinated strategy for technology development guides the rapid pace by which it is establishing itself as a center of technology production and, increasingly, technology innovation. Through a mix of preferential trade and investment policies, government subsidies, and other policies favoring domestic industries and production, China has made the development of its technology sectors a national priority. Attracting U.S. and other investment into China has been an important component of this strategy, particularly where transfers of technology and know-how have accompanied this investment.

U.S. technology industry leaders increasingly have warned of the challenges that China and other developing economies pose to U.S. technology leadership and called for a national strategy to maintain U.S. technology competitiveness—which is vital to the long-term health of the U.S. economy and to U.S. military superiority. The increasing reliance of the U.S. military on the private sector for certain technology developments, coupled with the movement offshore of much of the private sector's industrial and technology production, and some of its design work and research and development (R&D) activities in which China increasingly is engaging, raises the prospect of future U.S. dependence on China for certain items critical to the U.S. defense industry as well as to continued U.S. economic leadership. The Department of Defense may not be adequately considering the long-term effects on the defense industrial base of the offshoring of industries that, while not classified as critical technologies, nonetheless may have a substantial impact on defense and homeland security operations, such as the software and integrated circuits industries.

Between 1998 and 2004, the United States moved from equilibrium in trade with China of items with the highest R&D and engineering content to a deficit in advanced technology products (ATP) of \$36 billion. Foreign investment in China continues to grow markedly—with Taiwan still the largest external investor, followed by South Korea, Japan, and the United States—and much of that foreign investment is drawn to technology sectors. With this being a prominent enabling factor, China is making remarkable strides in technology production and is moving into high technology product design and R&D.

Findings:

- Science and technology (S&T) development is the centerpiece of China's comprehensive strategy to build national power. As a result, the Chinese government has a comprehensive, coordinated strategy for S&T development, which it began to implement in the mid 1980s. Government policies encourage growth and investment in key industries, among which are the software and integrated circuit industries. Such policies include foreign investment incentives, tax incentives, government subsidies, technology standards, industrial regulations, and incentives for talented Chinese students and researchers studying and working overseas to return to China. Many of these policies make it difficult, if not impossible, to achieve a level playing field in this area of U.S.-

China trade and jeopardize long-term U.S. leadership in this vital sphere.

- China has become central to the global supply chain for technology goods of increasing sophistication, and its technology research and development activities are steadily and substantially expanding. This central role grants China increased leverage in global systems of technology production.
- The technology that China is developing and producing is increasing in sophistication at an unexpectedly fast pace. China has been able to leap frog in its technology development using technology and know-how obtained from foreign enterprises in ways other developing nations have not been able to replicate. This rapid advancement is evident in the level of technologies that make up China's fast-growing trade surplus with the United States in advanced technology products (ATP), which increased by 72 percent from 2003 to reach \$36 billion in 2004.
- External investment is an important source of capital, management, and technology for China's technology sector. While total U.S. investment in China has been significant, Taiwan remains China's largest external investor, accounting for about half of total FDI in China; Japan and South Korea also are major external investors in China. Taiwan's investment in China remains concentrated in the technology sectors.
- China has made virtually no discernable improvement in the enforcement of its intellectual property rights (IPR) laws, despite the fact that the Chinese government has enacted laws to strengthen protection of IPR. Pirated IP provides cheap inputs to fuel further technological growth, but some analysts state that as China develops its own technologies, domestic parties may insist on better IP protection. However, as China's domestically designed technologies grow, there are also concerns that the government may selectively protect domestic IP while providing inadequate resources to protect foreign IP.
- Advances in China's technology infrastructure and industries, along with similar advances in other developing countries, pose a significant competitive challenge that is eroding U.S. technology leadership.
- China's approach to high technology development also includes aggressive use of industrial espionage.
- The U.S. defense establishment is increasingly reliant on the private sector for its technologies. As industries such as software and integrated circuits developed faster in the private sector than in the defense sector, the Department of Defense (DoD) turned toward the private sector to acquire state-of-the-art technologies.
- China and other foreign governments provide incentives to attract investment from the United States and other countries in advanced technology industries, which results in transfers of technology and production capacity offshore. Partly as a result of such incentives, the U.S. technology sector has moved offshore much of its production and is beginning to move offshore some

of the design for civilian technologies with applications in the defense sector.

- China's incentives for technology industries are part of a coordinated, strategic effort to obtain dual-use technologies. This strategy is focused on the software and integrated circuits industry—the two industries the U.S. defense establishment identifies as vital to today's information-based, network-centric warfare.
- While the U.S. defense industrial base is not dependent on Chinese imports at the present time, the Chinese government's coordinated strategy of utilizing incentives and subsidies to spur development of domestic capacity in dual-use technology industries is weakening the health of key U.S. commercial sectors on which the U.S. defense establishment relies.
- DoD's "trusted" and "assured" supply of high-performance microchips is in jeopardy due to the restructuring of the U.S. commercial integrated circuit industry that has moved operations offshore to Taiwan, Singapore, and China.

China's Military Power and America's Interests

China's methodical and accelerating military modernization presents a growing threat to U.S. security interests in the Pacific. While Taiwan remains a key potential flashpoint, China's aggressive pursuit of territorial claims in the East and South China Seas points to ambitions that go beyond a Taiwan scenario and poses a growing threat to nations, including U.S. alliance partners, on China's periphery. Recent and planned military acquisitions by Beijing—mobile ballistic missiles, and improved air and naval forces capable of extended range operations—provide China with the capability to conduct offensive strikes and military operations throughout the region. China's arms purchases have prompted the U.S. Secretary of Defense to publicly question the ultimate purpose of China's military buildup.

For a variety of reasons, unification with Taiwan remains one of the most important priorities for the Chinese Communist Party (CCP). This objective is of such significance that the Chinese government threatens to achieve it—and prevent any substantial contrary movement—by force if that is necessary. China's very public and frequently stated commitment to this goal has left little room for negotiation or trade-offs in the event of an emerging crisis over Taiwan. In March of 2005, China promulgated the Anti-Secession Law (ASL), a legal document that codified China's claimed authority to use force to counter further moves by Taiwan toward separation, and, as a consequence, placed additional pressure on Chinese leaders to take forceful actions in a time of crisis with Taiwan.

The failure of the two sides to agree on a formula for negotiating a solution to their differences has led Beijing to heighten its discussion of and preparations for possible military options to achieve unification. Rather than persuading Taiwan to move toward unification, the growing threat posed by China's military deployments directed at Taiwan has added to fears on the island. In a wider context, the growing volume and credibility of Beijing's threats against Taiwan constitute a serious challenge to long-established U.S. security and political interests.

In the early 1990s, China began a military transformation that abandoned its reliance on massive forces and outdated weapons in favor of a modern military armed to compete and win in a high-tech battlefield environment. In turn, Taiwan requested and received equipment that helped redress the imbalance resulting from the capabilities of new Chinese weapons. In subsequent years, however, a booming economy and generous government funding have permitted China to take long strides toward modernizing its air, naval, and missile forces. Today, China has accumulated a formidable force of ballistic and cruise missiles, advanced strike aircraft, and modern naval combatants with long range and truly lethal combat power. Since Taiwan has not adequately responded, the military balance across the Strait is shifting strongly in China's favor and poses a growing challenge to U.S. military forces and political interests in the Pacific.

In contrast to the military picture on both sides of the Strait, the economic and social ties at many levels continue to increase between China and Taiwan. Taiwan is the largest external investor in China's economy, and the number of Taiwan firms manufacturing and conducting other business in China is steadily growing. Nonetheless, the starkly different political systems and issues of self-identification pull them in opposite directions and perpetuate the tensions that have characterized the region for 50 years.

The complex and evolving set of relations among the United States, China, and Taiwan requires careful diplomacy, a strong U.S. military presence in the region, and continued U.S. monitoring of the military balance across the Taiwan Strait. The United States seeks a stable, peaceful, and prosperous Asia-Pacific region, and U.S. officials repeatedly have expressed their opposition to actions by either China or Taiwan that would jeopardize the peace by unilaterally altering the status quo.

Findings:

- China is in the midst of an extensive military modernization program aimed at building its force projection capabilities to confront U.S. and allied forces in the region. A major goal is to be able to deter, delay, or complicate a timely U.S. and allied intervention in an armed conflict over Taiwan so China can overwhelm Taiwan and force a quick capitulation by Taiwan's government.
- The combination of a U.S. policy of strategic ambiguity and Taiwan's hesitation in responding to China's aggressive military buildup sends signals of weakness and ambivalence to China, undermines U.S. deterrence efforts, leaves Taiwan vulnerable if attacked, and increases the risk that U.S. forces may be called upon to act.
- The U.S. government has not laid adequate groundwork to allow a rapid response to a provocation in the Taiwan Strait. Almost any possible scenario involving U.S. military support to Taiwan would require extensive political and military coordination with the Taiwan government and regional allies, but the foundations for such coordination have not been laid. For example, self-imposed restrictions against visits to Taiwan by senior U.S. mili-

tary officers and other government officials undermine efforts to conduct advance planning for contingencies. Additionally, failure to gain advance approvals for access by U.S. forces to foreign airfields and ports in the Western Pacific might jeopardize execution of U.S. contingency plans.

- The lack of adequate and effective confidence building measures between the United States and China increases the risk of misjudgment and miscalculation, especially in crisis situations, and therefore increases the risk that a misunderstanding or minor disagreement will lead to a serious armed conflict.
- The increasing frequency of Chinese military incursions into Japanese territory sets a dangerous course and unnecessarily increases the potential for a military clash in Northeast Asia that could engulf the United States.

China's Global and Regional Activities and Geostrategic Developments

China's foreign policy has changed dramatically over the past ten years. China's regional and multilateral goals are influenced by the need to obtain resources, particularly energy resources, and to gain access to export markets; the desire to isolate Taiwan; and the intention of diluting an international system it sees as dominated by the United States. In order to achieve its goals, China employed a more proactive and creative diplomacy and increasingly used aid, development and investment packages, and diplomatic support to win favor in regions such as Africa and Latin America. During the past year, China's global presence and influence continued to grow. It sought out new export markets for its products, and trade increased between China and many regions of the world; trade with Europe, for example, grew rapidly. China also reached out to regions such as Africa, the Americas, and the Middle East to secure the energy and raw materials its economy requires. Since the Commission's previous Annual Report (issued in June 2004), China has become the world's second largest national consumer of petroleum (behind the United States).

Certain international activities by China throw a shadow on its global rise. China continues to be a source of WMD- and missile-related technologies to countries of concern such as Iran. Despite China's enactment of tougher export control laws and constant complaints and sanctions by the United States, Chinese companies and organizations have continued to proliferate. All countries, including China, should be concerned about the grave consequences should WMD be acquired by countries of concern or terrorist groups, but China gives evidence that this is not among its highest concerns. In part in order to obtain access to energy resources and raw materials, China has utilized and expanded relationships with nations such as Iran, Sudan, and Zimbabwe that have earned international opprobrium for objectionable human rights, terrorism support, and other activities. In these interactions, China focused on its narrow interests while dismissing international concerns.

China's actions pertinent to the North Korea nuclear crisis have been contradictory, but offer some basis for optimism. Because it is Pyongyang's principal patron and provides significant amounts of fuel and food to North Korea, China has considerable leverage with

the North Korean regime. During 2004, in fact, the two countries enjoyed an historic level of bilateral trade. Yet China has failed to use its leverage effectively to obtain denuclearization by North Korea. In the latter half of 2005, China took welcome steps to achieve progress in the Six-Party Talks aimed at eliminating North Korea's nuclear weapons and nuclear weapons programs but has not yet exerted its full leverage over Pyongyang to solve this problem. Now it is critical that Beijing exert as much influence as will be needed to ensure that North Korea eliminates its nuclear threat.

The future success of China's economic and political policies is tied to the success of its energy policies. Two thirds of China's energy needs are met by coal, but China's demand for oil resources needed to fuel its economic growth is rapidly increasing, putting China on course to compete with the United States and other oil importing nations for global supplies. China's policy of attempting to obtain control of oil resources at the wellhead rather than participating in the international petroleum market threatens to exacerbate tensions with the United States and other countries that are market participants. The attempt by a Chinese oil firm partly controlled by the central government to purchase California-based Unocal exemplified its policy and caused considerable U.S. concern before the attempt was abandoned.

Findings:

- China has increased its presence in many geographic regions during the past decade.
- China's decisions to become involved in specific countries and regions, the nature of its involvements, and its regional and multilateral goals appear to be frequently influenced by its need for resources, particularly energy-related resources, the search for export markets, and a desire to increase its geopolitical leverage and influence and advance national objectives. Diplomatic aims include marginalizing Taiwan and increasing China's leverage in multilateral institutions by strengthening relations with other countries.
- China's regional strategies generally appear to be complementary and consistent and to reflect a larger global foreign policy strategy.
- China's regional approaches appear to be value-neutral; they are not influenced by ideology or human rights concerns and focus only on achieving China's practical objectives. China approaches countries that have histories and reputations of behavior and activities objectionable to the world community—such as proliferation, human rights abuses, aggression against other nations or less direct efforts to undermine their interests, support of terrorism, etc.—without requiring or even exerting pressure for changes in policy or behavior.
- China's proliferation activities are broad ranging; it continues to provide equipment and technology, including dual-use goods and technologies, related to WMD and their delivery systems to countries such as Iran as well as conventional armaments to countries like Sudan.

- China continues to be governed by a Communist party hierarchy that controls major aspects of the government, society, and economy. Party cadres are selected by the leadership to serve as key executives of state-owned corporations and many smaller firms and subsidiaries and to enforce the leadership policy. Beijing is also placing more party members in the ranks of newer private companies. Through this and other methods, many proliferation actions of Chinese companies are either effectively controlled or tacitly condoned by certain levels of the central government. In a number of cases, China uses proliferation to raise revenue or gain diplomatic influence.
- Continuing proliferation undermines the public commitment Beijing has made by becoming a party to, or participating in, various multilateral nonproliferation treaties, regimes, and organizations, and by promulgating strengthened export control laws.
- As China improves its nuclear and missile capabilities, the potential damage from its proliferation action increases. Given China's poor track record on preventing proliferation, the presumption is that it will continue to allow transfers of improved WMD- and missile-related technology to countries of concern.
- Numerous U.S. sanctions have been imposed to punish Chinese companies for their proliferation activities, but they appear to be largely ineffective. A significant reason for this is that many sanctions regimes do not extend penalties to a parent company, which may have business connections in the United States, for the proliferation activities of its subsidiaries unless a parent company had demonstrable knowledge of the transaction.
- The extent of Chinese cooperation in the Six-Party Talks to achieve a complete, verifiable, and irreversible dismantling of North Korea's nuclear weapons and nuclear weapons programs is a critical test of the U.S.-China relationship.
- China is North Korea's principal patron and has very substantial economic leverage with that country. It is important for China to use its considerable influence with North Korea, including economic and energy assistance, as leverage to press Pyongyang to dismantle its nuclear weapons, nuclear weapons programs, and long-range delivery systems. China's recent efforts to bring North Korea back to the Six-Party Talks and its circulation of a now-agreed set of principles that the parties signed in September 2005 are new and commendable steps. However, the effort to get North Korea to abandon its nuclear weapons programs, nuclear weapons, and nuclear weapons material has a considerable distance yet to go. It is imperative that China, with its leverage over North Korea, take substantial responsibility for the ultimate success of this effort.
- China's energy demand continues to grow at a rapid pace as its economy expands. Roughly 40 percent of all new world oil demand is attributable to China's rising energy needs.
- The United States and China currently follow different energy security policies regarding oil procurement. The United States secures its supplies via open international markets while China wants to own oil at the wellhead.

- China's energy acquisition efforts are expanding internationally, and specifically in Africa, the Western Hemisphere, Central Asia, and the Middle East.
- China appears to trade influence and assistance, including weapons technologies, arms, and other aid, for access to oil and gas in terrorist-sponsoring states such as Sudan and Iran, greatly compromising U.S. efforts to combat terrorism, weapons proliferation, and human rights abuses.
- The United States should seek to influence China's energy policies and lessen the potential for future energy-related conflict by conducting joint research and development (R&D) programs with China to improve its energy efficiency and protect the environment.
- Both China and the United States are self-sufficient in coal. Clean coal and coal-to-liquids technologies are possible areas for mutually profitable joint R&D efforts and areas where the United States could provide technological assistance that could benefit both nations and enhance environmental protection.

China's Media and Information Control

The Chinese government's extensive and persistent controls over the flow of information in the media and over the Internet pose an ongoing security concern for the United States. Through these controls, which have grown markedly in size and sophistication over the last two years to become the most sophisticated Internet control system in the world, China's government plays a commanding role in forming public opinion about the United States and U.S. policies, which can in turn undermine U.S. diplomatic efforts. These practices also risk creating an environment prone to misunderstanding and miscalculation in the bilateral relationship, particularly during times of crisis.

China's control of information media exacerbates and perpetuates a xenophobic—and at times particularly anti-American—Chinese nationalism. The long-term effects of these practices on a new generation of Chinese citizens, who have been persistently subjected to a highly controlled and manipulated information environment, may be deleterious to U.S. efforts to prevent the U.S.-China relationship from becoming hostile.

Findings:

- China's economic reforms have not led to fundamental changes in its policy of controlling the flow of information. The government's Internet filtering system is the most sophisticated in the world, and uses numerous techniques to minimize Chinese citizens' exposure to topics the Chinese Communist Party sees as threatening to its rule, including official corruption, freedom, and democracy, or to its standards of decency. In addition to technical controls, China discourages free expression by encouraging collective responsibility and self-censorship, reinforced by occasional high-profile incarcerations.
- The Chinese government encourages nationalist sentiment in the news media and online. Anti-U.S., anti-Japanese, and anti-democratic views are rarely censored while anti-government senti-

ments are heavily monitored and removed as soon as they are spotted by the government Internet police.

- Some U.S. firms that wish to establish, maintain, or expand their presence in the Chinese market have assisted the government in its effort to control speech and have assisted in official actions against Internet users. The companies have defended their involvement in these actions by indicating they must comply with Chinese law and the dictates of China's government.