

Statement of The Honorable C. Richard D'Amato  
Commissioner, U.S.-China Economic and Security  
Review Commission

**Conference on Promoting China-U.S. Business Relations**

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I want to thank Dr. Murray Weidenbaum and the Center on the Economy, Government, and Public Policy for inviting me to participate as a panelist today. I had the honor of working with Dr. Weidenbaum when he served as the Chairman of the U.S. Trade Deficit Review Commission in 2000. I currently serve on the U.S.-China Economic & Security Review Commission and am the immediate past Chairman. In this role, I have developed a heightened understanding of U.S.-China relations and am reminded daily of the many issues our country faces as China continues to rise as an economic and military power. China is scouring the globe for investments, energy resources, technology, and markets for its exports. This is an extremely important topic and I look forward to discussing China's acquisition practices and what this means for the U.S.

**I. China's Rise**

In the past twenty years, China has become a far more active participant in the global economy. Consequently, the U.S.-China economic relationship is expanding at a rapid pace. New U.S. foreign direct investment in China totaled nearly \$4 billion in 2004. The trade relationship grew markedly, although unequally 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 grew to over \$200 billion in 2005.

With the new economic relationship comes problems. U.S. manufacturers in a broad array of industries are under increasing competitive pressures from China-based manufacturers. Although each U.S. industry has a unique set of competitive concerns with China, the principal crosscutting issues are China's undervalued currency, an extensive system of government subsidies, weak intellectual property rights protections, and repressive labor practices as well as weak environmental enforcement. Many of these provide a strong inducement for U.S. and other foreign firms to invest in or relocate to China, either to serve the Chinese domestic market or to use China as a cost-saving manufacturing and export platform. These incentives tend to overwhelm other market forces becoming more structural and persistent.

China has also adopted an overt 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.

## **II. The Acquisition of Foreign Investment**

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 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. In 2005, Chinese firms ranked second to U.S. firms in funds raised through global IPOs. Chinese firms attracted over \$15 billion in 2005 and are seeking to raise over \$20 billion in 2006, compared with approximately \$14 billion in 2004 and \$8 billion in 2003.

In 2005, no Chinese firms listed 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. It should be noted that a variety of Chinese firms, including banks and state-owned enterprises, are increasingly listing on the Hong Kong Exchange.

Chinese firms have not been listing on European exchanges with any regularity. In 2005, only a handful of relatively small Chinese companies sought to list on the Singapore, London, or German exchanges. In the long term it seems unlikely that these exchanges, with the possible exception of the London Stock Exchange, will attract a significant volume of Chinese IPOs.

The Tokyo Stock Exchange has also begun to attract Chinese firms, and has been making marketing visits to Beijing to promote its “public offering without listing” or POWL. This offering structure essentially allows Chinese companies to conduct public offerings without having to submit to the burdens of publicly listing. Several of the recent large Chinese privatization offerings – some totaling several billion dollars – have been conducted through this mechanism.

### **III. China’s Acquisition of Energy Resources**

China’s outreach is not limited to obtaining foreign investment. The Chinese treat energy reserves as assets in the same way a 19<sup>th</sup> century mercantilist nation-state would. Its goal is to lock-up energy reserves around the world and secure delivery to China. To do this, it is willing to pay premium prices in order to gain exclusive control over oil and gas wells, and to alter its foreign policies for commercial gain. China believes it can only

achieve energy security through direct control of reserves as opposed to purchasing oil and gas on international markets. This “hoard and control” approach conflicts with the efforts of the U.S. and other countries that participate in the International Energy Agency to develop fungible, transparent, and efficient oil and gas markets. Worse yet, it could lead to direct conflict should disruptions occur in the world energy markets.

The Chinese have used state-owned oil companies to acquire oil fields and assets in many countries, including countries sanctioned by the U.S. For example, China is a major energy partner with Iran. China’s Sinopec has purchased a 50 percent stake in a major oil field, the Yadavaran oil field, and signed a \$70 billion deal to buy Iranian oil and gas over the next three decades. As an apparent quid pro quo, China complicates international pressure on Iran regarding nuclear weapons development and other issues. At the same time, Chinese companies have been cited by Washington as having aided Iran’s missile programs.

Another Chinese company, the China National Petroleum Corporation (CNPC) has invested heavily in Sudan, a country labeled as a terrorist state by Washington. It is estimated that China now takes 50 percent of Sudan’s oil exports. In apparent reciprocity, China has blocked UN Security Council action against Sudan’s genocidal practices.

China is also looking at Venezuela, which is a top oil supplier to the U.S., for its energy needs. China will develop 15 Venezuelan oil fields and buy 1.44 billion barrels of oil a year from that country. China is considering paying a high price to upgrade a pipeline through Panama to the Pacific to ensure continued access to Venezuelan oil. There are many other examples of China’s paying premium prices and making uneconomical, questionable investments to secure energy resources. This includes building a pipeline to export Kazakhstan

crude directly into China. China has also attempted to persuade Russia to route a pipeline from Siberia directly to China.

**a. The Proposed Acquisition of Unocal by CNOOC**

China's obsession with acquiring energy-related resources at the wellhead has also led it to American shores. Last year, the Chinese National Offshore Oil Corporation (CNOOC), a largely state-owned energy company, sought to acquire Unocal, a U.S. energy company. Despite the rhetoric of the Chinese Foreign Ministry that described it as a purely commercial transaction, this essentially was the purchase of a U.S. energy company by the Chinese government. The Chinese Foreign Minister "demanded" that Congress not interfere. Many members of Congress were extremely concerned about the national security implications of this proposed acquisition and CNOOC eventually withdrew its bid when it became apparent it would likely be blocked by Congress.

It is important for this audience to be aware of some facts about CNOOC:

First, CNOOC is 70 percent owned by the Chinese Government.

Second, the company was created by the government of China in 1982 to be a joint venture partner with foreign oil companies exploring for offshore oil reserves. It is considered to be one of the top 50 state-owned companies, a place of high privilege in the Chinese government hierarchy.

Third, the CEO of the company, Mr. Fu Chengyu, also happens to be the Chinese Communist Party secretary of CNOOC.

Fourth, the purchase of Unocal was approved by the State Council, China's cabinet, and the governor of the State Central

Bank helped assemble the financial purchase package. The company has elite access to large cash reserves held by the Chinese government.

Fifth, the loan package for the acquisition was heavily subsidized. Seven billion dollars came from CNOOC's parent. Of that amount, \$2.5 billion dollars was interest free, and the rest was a 30-year loan at 3 percent. The parent company, China National Offshore Oil Corporation, is 100 percent owned by the Chinese government, and Mr. Fu is also the CEO of the parent company. Mr. Fu was appointed to both posts by the Communist Party of China. Six billion more dollars came from a State-owned bank, an exceptionally large figure. Without this generous state-guided credit, CNOOC, a company worth \$22 billion, could not possibly have offered \$18.5 billion for an acquisition of this type. As demonstrated by the level of Chinese government support of CNOOC, this was no ordinary take over attempt. Beijing was viewing the deal through a strategic lens.

CNOOC is one of three Chinese state-owned oil companies created by the Chinese government to “go out and get oil for China.” The other two companies are Sinopec and CNPC. They are searching the world for reserves of oil, gas, tar sands and other energy related assets to acquire. In August 2005, CNOOC, under pressure, withdrew its offer and Unocal merged with U.S. company, Chevron Corporation.

### **b. China's Lack of Reciprocity in Investment Opportunities**

In key sectors, such as energy, when foreign firms want to conduct business in China, Beijing requires them to form joint ventures with Chinese companies; equity ownership of Chinese firms by foreigners is restricted to a minority share. In other words, a U.S. corporation cannot go to China and buy SINOPEC

or CNOOC. It isn't allowed. In this and other fields, there is a lack of reciprocity with China. China should not be free to acquire U.S. companies or technology while the way U.S. companies conduct business in China is restricted or conditioned.

### **c. Strategic and Political Questions**

The proposed acquisition of Unocal by CNOOC was the largest international transaction to date attempted by a Chinese company. Unocal holds reserves extending from the Gulf of Mexico to the Caspian region to Southeast Asia, as well as in Africa, Europe, and South America. Its acquisition would have doubled CNOOC's worldwide reserves of oil and gas. Unocal's energy assets are estimated to be 1.75 billion barrels of oil and oil equivalent reserves, and another 1.5 billion barrels of undeveloped oil and gas fields.

It should be noted that a Chinese takeover of these assets would have introduced or increased Chinese political influence in all the regions where Unocal assets are located, some of which are of political and strategic importance to the U.S. The deal would have displaced the influence of an American company with American standards.

There have been public reports that Unocal possesses certain technologies, including those for deep-sea exploration and drilling, that have national security implications and should not have been transferred to China.

## **IV. China's Acquisition of Intellectual Property**

Another problem is China's piracy of intellectual property. Intellectual property piracy in China is rampant and continues to remain a paramount trade concern for a broad array of U.S. firms whose intellectual property is central to their business success. U.S. producers, not to mention producers in other countries, are

concerned about having to compete against Chinese firms that produce low cost products using pirated intellectual property.

Despite some improvements to China's intellectual property laws, enforcement remains an issue and intellectual property rights (IPR) violations in China continue virtually unchecked. Piracy rates in China remain above 90 percent across all copyright industries. Counterfeiting in China has reached such epidemic proportions that two-thirds of the counterfeit products in the world are of Chinese origin. Of the \$94 million worth of counterfeit goods seized at the U.S. border in 2003, 66 percent originated in China. China cannot expect to be a respected nation without effectively policing such problems.

#### **a. Software Industry**

The U.S. software industry, an industry that should be enjoying enormous market opportunities in China, is at war with Chinese firms pirating its technology. The Business Software Alliance estimated that losses to the U.S. software industry due to piracy in China amounted to \$1.47 billion in 2004. According to industry testimony at a January 2005 Commission hearing, U.S. software sales to China have stalled due to IPR concerns:

*Rampant piracy has effectively stalled growth in U.S. software exports to China, despite China's escalating use of computer and software technologies. Consider that in 1996 China was the sixth largest market for personal computers and the twenty-sixth largest for software; it is now the second largest market for personal computers but still only the twenty-fifth largest market for software. This growing gap between hardware and software sales is the inevitable consequence of a market that does not respect intellectual property rights or reward the significant investment required to develop and market innovative software products.*

This is a key sector for U.S. economic growth and Washington cannot allow Chinese infringement to obstruct it.

### **b. Entertainment Industry**

The U.S. entertainment industry is another economic sector whose competitiveness has been heavily affected by the current IPR situation in China. The Motion Picture Association of America (MPAA) reports that China's piracy rate reached 95 percent in 2004 and that during 2003, 69 percent of the VCR tapes and 85 percent of the DVD discs manufactured in China were pirated products. The industry estimates that U.S. film companies have lost over \$1 billion in revenue due to piracy in China over the past seven years, with \$280 million of those losses coming in 2004. Particularly troubling is the MPAA's finding that exports of pirated goods from China to the United States, the United Kingdom, and other countries have increased steadily over the past several years. Commenting on its competitive concerns, the MPAA told the Commission that "[n]o legitimate supplier of films, whether local or foreign, can compete with pirates who pay no taxes, endure no censorship obligations, and bear none of the costs of running a studio."

This past July, the Motion Picture Association (MPA), an international association with which the MPAA is affiliated, entered into an agreement with China's Ministry of Culture (MOC) and its State Administration of Radio, Film and Television (SARFT). Every three months the MPA will submit to the MOC and SARFT a list of movies scheduled to be screened in China by its member companies. In turn, the Chinese agencies will focus IPR enforcement efforts on seizing and prosecuting pirated videos of these movies that enter the market before their video release dates. Both the industry and the Commission await evidence that these promises are being fulfilled. It is a troubling sign that the IP

industry had to negotiate for its own protection and indicates that the U.S. government has failed in its role as guarantor of the economic rights of its citizens and companies.

While China's domestically produced films also suffer from piracy, there is evidence that when the Chinese government has chosen to do so, it has been able to control piracy in certain areas. In the case of domestic films, where the government has a financial stake in the films or the theaters showing them, the government reportedly has been able to control piracy so the films can be viewed only in theaters, resulting in a large theater viewership. This suggests that the Chinese government has considerably more power to enforce IPR protections than it has exerted to date with respect to the intellectual property of foreign firms.

### **c. U.S. Industrial Firms**

IPR violations in China go well beyond the software and entertainment industries, with many U.S. industrial firms now heavily affected. General Motors is suing the Chinese automaker Chery for illegally copying the design of one of its models. IPR infringements have also affected products from pharmaceuticals to fuel gauges, raising health and safety concerns. The Commission heard testimony on this from a U.S. fuel gauge manufacturer in 2005:

*For the first time, to the best of my knowledge, Chinese counterfeiters have approached domestic customers for our product in an attempt to sell them copies of our instruments. I recently came into possession of one of these counterfeit gauges. These clones bear our name and address, as well as a label on it certifying that the product has passed a battery of tests that are required in order for the product to carry this designation and be exported to the EU. In addition, the label on the case of the fake gauge also carries our catalog part number,*

*and the initials of a calibrator as well as a final tester—all misrepresentations. When the product was checked on a test station it was found to be grossly inaccurate. One of the ramifications of this, beyond solely the ethical consideration, is that of creating a potential safety issue for whoever uses the faulty instrument.*

China's lack of adequate IPR protections also gives Chinese firms a competitive advantage over U.S. firms by allowing many of them to obtain key technology and design inputs – from software to assembly line designs – at a fraction of the cost to their U.S. competitors. Removing the need to shoulder comparable production costs gives Chinese firms in many sectors the ability to heavily under-price U.S. firms, in capital-intensive as well as labor-intensive industries. Author Ted Fishman contends that for these reasons the Chinese government views a lax IPR enforcement regime as part of its industrial policy:

*China's failure to police its intellectual property rules often looks less like ineffective government than a conscious policy to shift the highest value goods from other economies into the country. It is, in essence, the largest industrial subsidy in the world, and brilliantly, it costs the Chinese nothing. In 2005, China will most likely be the world's third-largest trading nation, and counterfeiters give the country's increasing number of globally competitive companies the means to compete against powerful foreign rivals that pay for their use of proprietary technologies.*

The U.S. government has spent the last 15 years working with China to improve its IPR protection and enforcement regime with little to show in the way of concrete results. This has been the case despite the execution of bilateral agreements on IPR with China in 1992, 1995, 1996, China's accession to the WTO, an agreement on Trade-related Aspects of Intellectual Property

Rights, and high-level IPR enforcement commitments by China in the 2004 and 2005 meetings of the U.S.-China Joint Commission on Commerce and Trade (JCCT). Improving China's enforcement of IPR was again the major topic of the JCCT talks that took place this past July. The Commission remains skeptical that China will make any substantial progress in curbing its level of IPR violations without aggressive U.S. efforts under U.S. law and in international venues to force China to live up to its commitments.

Certain industry groups, such as the MPAA have concluded that the only way to deal with the Chinese, at this time, is to file cases in the dispute settlement system of the WTO. Legal remedies in China are simply not an option because of a weak judicial system. Internationally, injured industries need to use legal mechanisms such as the WTO to encourage Chinese government action to correct this problem. The good news: the U.S. Trade Representative's office has told the Commission it has "no hesitation" in bringing an IPR case to the WTO if it is believed to be a winning case. Per its last annual report, released in November 2005, the Commission recommended such cases be brought before the WTO.

## **VII. Instruments of U.S. Government Action**

In order to level the uneven playing field that currently benefits China, Washington must employ the tools at its disposal to protect U.S. economic stability and promote open-market competition. One tool the Commission supports is the Committee on Foreign Investment in the United States, otherwise known as CFIUS.

In 1975, President Ford established CFIUS by presidential order. The Secretary of the Treasury was designated its Chairman and the interagency Committee was charged to "have the primary continuing responsibility within the Executive Branch for

monitoring the impact of foreign investment in the United States, both direct and portfolio, and for coordinating the implementation of United States policy in such investment.”

Overall, CFIUS seeks to serve U.S. investment policy through thorough reviews that protect national security while maintaining the credibility of the U.S. open investment policy and preserving the confidence of foreign investors here and of U.S. investors abroad that they will not be subject to retaliatory discrimination.

The CFIUS process, as developed by the Exon-Florio Provision of the Defense Production Act provides the President the authority to suspend or prohibit any foreign acquisition, merger, or takeover of a U.S. corporation that is determined to threaten the national security of the United States. Essentially, the President can block an acquisition or merger only if he finds:

- (1) There is credible evidence that the foreign entity exercising control might take action that threatens national security, and
- (2) The provisions of law, other than the International Emergency Economic Powers Act, do not provide adequate and appropriate authority to protect the national security

Currently, Exon-Florio requires a 45-day investigation in any instance in which an entity controlled by or acting on behalf of a foreign government seeks the acquisition of a U.S. entity. The law also requires the President to submit a report every four years on whether any foreign government has a coordinated strategy to acquire U.S. companies involved in research development or production of critical technologies.

The Government Accountability Office (GAO) in September 2005 noted that some of the statutory mandates have been stymied by the Treasury Department's insistence that investigations can be conducted only if there is "credible evidence" that the foreign controlling interest may take action to threaten our national security.

A CFIUS review was undertaken in connection with the proposed 2005 merger of Chinese computer manufacturer Lenovo with IBM's PC division. Lenovo hoped to expand into Western markets through this acquisition. CFIUS reviewed the deal and allowed the merger to occur only after certain key changes were made in the acquisition plan. The merger was completed on May 1, 2005 and Lenovo subsequently became the third largest PC manufacturer in the world. As a result of the acquisition, Lenovo's product line includes the ThinkVision, ThinkPad, ThinkVantage, ThinkCentre, Aptiva and Net Vista computers.

Of the over 1500 cases CFIUS has considered since 1988, only a few dozen have been the subject of intense examination, and only one was denied.

The U.S.-China Commission, in its 2005 Annual Report to Congress, recommended:

- (1) That Congress explicitly provide in statute that the term "national security" in the Exon-Florio provision be broadened to include "national economic security."
- (2) That the chairmanship of CFIUS be transferred from the Treasury Department to the Commerce Department.
- (3) That Congressional oversight of CFIUS be expanded, that CFIUS be required to disclose all relevant CFIUS information in each case to Congressional

Committees, and that Congress be able to veto any transaction.

### **VIII. Conclusion**

Our nation is facing new challenges from a globalized economy. The U.S.-China economic relationship, in particular, is so large that the future trends of globalization will be influenced by how the United States manages its economic relations with China. We need to keep this in mind when administering our investment policy and ensure we are not sacrificing industries important to our economy and our national defense.

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