CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

DARK CLOUDS ON THE HORIZON:
THE CNOOC-UNOCAL CONTROVERSY
AND RISING U.S.-CHINA FRICTIONS

THE CARNEGIE ENDOWMENT
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SPEAKERS:

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Transcript by:
Federal News Service
Washington, D.C.
MINXIN PEI: (In progress) – working in a think tank. First of all, it’s very similar to the business in the media. That is, bad news sells. Conflict, fear will get you bigger audience than good news. (Laughter.) So in thinking about the top title for this subject, I talked with my friend and my colleague Bert (sp), and I said what about “Relationship Adrift.” He said, no, no, that’s not dramatic enough. (Laughter.) So I came up with very catchy phrase, “Dark Clouds on the Horizon.”

The second secret is that out of selfish interests, people like us also are much more reassured when the relationship is not doing as well as most people want it to be because, as I said, bad news sells. Fear and conflict will justify the livelihoods of people like us. So our job security increases even though bilateral relationship may deteriorate. So you can see, but it does not mean that people like us have an inherent interest in making sure the relationship goes south. And so I think I ought to thank the CNOOC management for creating this opportunity – (chuckles) – for all of us to get together. And I think, given the expansion of China’s economy and also the growing frictions in this relationship, such opportunities will come our way more often in the future.

I think on a more serious note, the CNOOC controversy cannot come at a better time. Most people would believe that this deal cannot come at a worse time in U.S.-China relations because on several fronts, this relationship is on the severe strain, as we will see and hear in the next hour and a half. But I think this controversy forces us to think hard and more seriously about the long-term prospects of U.S.-China relations. I think, for a long time, both Washington and Beijing have been quite successful to isolate their very productive economic engagement with each other from their potential security rivalry. But I think increasingly it is becoming more difficult to do so. And the CNOOC deal may be the harbinger for things to come. So I think this is a very serious opportunity for us to look at this relationship, look at the implications of the CNOOC deal from all facets.

And I think this kind of concern with China’s rise and with this specific deal are widely shared among the American public. If you read today’s Wall Street Journal, you will find that 73 percent of the public surveyed does not like the deal, and nearly half – the precise figure is 49 percent – of the American public regard China as an adversary. So I think given the complexity of this deal and given the changing political dynamics in both countries, we should approach this controversy with all the care that we can have.

So we are very lucky today to have three very knowledgeable speakers who can help us to understand both the specific deal to concerns surrounding this deal, and also the large issue of U.S.-China relationship. Leading off the discussion will be Carolyn Bartholomew who is the commissioner of Congressional Commission on U.S.-China Security Review. Following Carolyn’s presentation will be my colleague, Bert Keidel. And then my other colleague, Michael Swaine, will conclude with a look at the larger issue of China’s military expansion. So I’ll now yield the floor to Carolyn.

CAROLYN BARTHOLOMEW: Thank you very much. There are a whole lot of new faces here, so we presume that some of you are directly here as a result of questions
about the CNOOC deal and probably have positions on one side or another of it, but I welcome you all. I understand now more clearly why I’ve been invited if conflict is the name of the day. I suspect we will be having a rather spirited discussion amongst us, and in fact, some of the people I know told me that I was walking into the lion’s den, so – (chuckles) – I expect it will be lively and hopefully we can come to some sort of agreements or consensus or at least where we agree to disagree.

I’d like to thank particularly Pei Minxin and the Carnegie Endowment for the opportunity to participate in the discussion today, and my fellow panelists Bert Keidel and Michael Swaine, whose reputations precede them. It’s an honor for me to appear with them and, as I mentioned, we’ve actually already started having a rather spirited discussion on some of the topics up here. I hope that our host and moderator will forgive me for sharing a personal comment. But when he invited me to speak today, Minxin noted that he had been a beneficiary of the Chinese Student Protection Act, legislation developed by my former boss, Congresswoman Nancy Pelosi, after Tienanmen Square, to protect the many Chinese students who, by virtue of having been students at that time in the United States, were presumed by the Chinese government to have been pro-democracy and therefore a threat. The values and principles for which those students and workers in China stood over sixteen years ago are no less important and no less inspiring today. We as a nation have benefited from the contributions of the students who were not free to return home, and I’d really like to acknowledge Minxin and the many others who have made the United States their home and embraced wholeheartedly the freedoms that we so easily take for granted here. So thank you.

Now, on to the contentious topics, starting with the title of today’s panel, Dark Clouds on the Horizon. From the perspective of benefits to the U.S. of the status quo in U.S.-China relations, I’m not sure that the clouds are actually on the horizon. The sun has really not been shining in this relationship for a number of years. And that’s the starting point for examining the state of U.S.-China relations, as well as for assessing what troubles lie ahead.

Fundamentally, it appears that our approach to dealing with China has not been particularly effective in the pillars that are often used by administrations, and I use that plurally on purpose, to define foreign policy objectives – the benefits of trade, halting the proliferation of weapons of mass destruction, and promoting democratic freedoms. We do not in this country have any consensus on how we should define our relations with China, or even how we perceive the Chinese government. Is it a friend, an ally, a strategic competitor, a strategic partner, a potential enemy, an enemy already? There is agreement only that China is a member of the United Nations Security Council and that it is a large and growing economy situated in Asia.

There is also a huge gap between the perceptions of the American people and the policy elite about everything to do with this relationship. And while the United States approaches its dealings with China on generally an ad hoc basis, the Chinese government has a strategic vision for what it wants to accomplish. It is no surprise that we are consistently out-negotiated and out-maneuvered on a number of issues of concern.
This time last year, I testified on behalf of the U.S.-China Commission before the House Armed Services Committee to present the findings of the Commission’s annual report, which I note was unanimous and bipartisan, no small feat given the political climate and the broad range of backgrounds, interests, and constituencies the commissioners represent. I mention this testimony not because I want you to know that I testified before Congress, but because I went back and revisited what I said then and realized that none of the trends that we identified one year ago have improved, and in fact, many of them have worsened. So I thought that I would review a few of the findings from last year, giving a little bit of update, and see where we stand.

On economic security, China is not adhering sufficiently to its WTO trade commitments. Market access is still a problem for U.S. goods and services and rampant piracy of intellectual property rights continues. True, there was yet another new agreement with the Chinese government just announced on IPR protections. But the headlines say it all. In the Post, for example, the headline was China makes more pledges on piracy. New pledges and agreements to tackle this problem have been announced going back to the day of Carla Hill’s service at USTR, well over ten years ago. The other agreements have, for the most part, been ineffective or ignored. Why should we expect more from this one?

Back to the commission findings last year, the U.S.-China trade relationship continues to be heavily imbalanced with a skyrocketing trade deficit of $124 billion in 2003. All right, that one has changed. The deficit for 204 was $162 billion. Two days ago, the Post reported that China’s exports surged in June while import growth slowed, resulting in, according to Chinese government figures, a $9 billion overall Chinese trade surplus with the world, its third largest monthly surplus on record. Also according to the Post, over the first six months of this year, China’s exports worldwide rose 33 percent over the same period last year.

Another finding, China continues to be heavily dependent on the U.S. market with 35 percent of its exports coming to the United States. At the same time, only 4 percent of U.S. goods exports go to China. The deficit has grown at over 20 percent per year since 1990. All of these factors and others, including China’s poor labor practices, are contributing to the erosion of the U.S. manufacturing base and the loss of jobs.

On national security, some of our findings last year – despite claims that China is helping to halt the proliferation of weapons of mass destruction and related technology, numerous examples of such proliferation from China continue. Serious allegations have been made that North Korea is using Chinese facilities as trans-shipment points for North Korean WMD exports to third countries. Despite claims that the Chinese government is helping with the North Korean crisis, and indeed some credit is due for their assistance in getting North Korea’s participation in the six-party talks, serious questions exist about why China is not exerting its considerable leverage on North Korea.

China is channeling its economic strength into rising political influence and military power in Asia at a time when Asian countries perceive that the United States is
focused on challenges elsewhere in the world. China is also ratcheting up its military modernization programs aimed at Taiwan and frictions continue to grow. Last year, for the first time, the commission also focused on energy security and reported that – these will all sound familiar – China moved past Japan to rank second behind the United States in global energy consumption. It is the world’s second-largest oil consumer and its third-largest oil importer. China’s rising energy demand has put added pressure on global petroleum supplies and prices. Recent escalations in gas prices here at home have been attributed in part to the impact of China’s growing pressure on world oil markets. Energy needs have driven China closer to the Middle East and Africa as well as neighbors in Central Asia, Russia, and the Pacific, and China seeks to lock in secure energy supplies, especially new sources of gas and oil not subject to potential disruption in a time of conflict. It also seeks to control the resources at the wellhead of the source, bypassing world market mechanisms. China has sought energy cooperation with countries of concern to the United States including Iran and Sudan, which are inaccessible by U.S. firms. Some analysts have voiced suspicions that China may have offered weapons of mass destruction-related transfers as a component of some energy deals.

The trend line on many of these problems is not improving. Add to this mix the concern of Americans across the country about their own job security and the uncertainty of the economic future for their children, their perception that everything they buy is made in China – and my colleague Bert and I have already had a slight disagreement about this comic strip. I just wanted to make sure – this is a cartoon that appeared in the comic strip pages of the Washington Post on July 4th. For those of you at the back, I’m not sure that you can see it. Some people at a barbecue, the dominant feature of course is the American flag. But more prominent than that even is the fact that the American flag is made in China; continuing frustration about China’s currency valuation and gasoline prices that are spiking up as much as ten cents a gallon in a week. This is the climate in which CNOOC’s bid for Unocal has been made.

It would be a mistake to dismiss the questions and concerns about the implications of this potential deal as simply an emotional response. Labeling a policy disagreement an emotional response does the debate no service. Indeed, just yesterday, Senators Grassley and Baucus, the chair and ranking member of the Senate Finance Committee, two men not know for their emotional responses on trade issues, wrote to President Bush urging that CFIUS undertake a serious review of the national security implications of a CNOOC takeover of Unocal. We should all insist that serious consideration be given to the full range of real issues, which have been raised.

A number of my fellow commissioners, although not all, agree that economic security is an integral part of national security. I offer your consideration on that point, a comment made by Dr. William Schneider, chairman of the Defense Science Board, at a recent commission hearing on the defense industrial base. Responding to a question, Dr. Schneider said, and I quote, “of course, it’s the national economy that is ultimately the source of our military power. There are very few precedents for a country being able to do much in the way of maintaining a comprehensive military capability without a strong national economy.” End quote.
And while on the topic of the interconnectedness of economic and national security, let us look to the argument that we hear from some quarters that we cannot do anything to upset the Chinese government because if we do, they will stop financing our misguided fiscal policies to the current tune of $277.6 billion. Of course, the specter of economic blackmail in this case is specious, given that China holds only 6 percent of publicly-held U.S. debt and the United States continues to hold, but neither recognize nor exercise its leverage in the U.S.-China economic relationship, the reality that the Chinese government needs continued unfettered access to the U.S. market in order to fuel its economic growth.

And finally, what is the realistic likelihood the Chinese government is going to take its money and invest elsewhere, in Euro bonds, for example. Technically, of course, the Committee on Foreign Investment in the U.S., CFIUS, is supposed to address only national security concerns, although national security is not defined and is open to interpretation. What are the national security concerns raised by CNOOC’s acquisition of a private American oil company? Economic security and energy security are directly linked, as are energy security and national security. A lot of you know these facts. I’m going to review them. Hopefully, we’ll just get them out on the table. Bear with me on this.

CNOOC is 70 percent owned by the Chinese government. It is one of three Chinese state-owned oil enterprises. The purchase of Unocal was approved by the Chinese State Council, China’s Cabinet, and the governor of the state central bank helped to assemble the financing package. The enterprise has direct and special access to the unlimited, deep pockets of the Chinese government’s reserves. Calling the transaction a free market activity is absurd and a distortion of the notion of free markets. The loan package is heavily subsidized - $7 billion dollars from CNOOC’s parent, China National Offshore Oil; $2.5 billion of that is interest free and the rest is a 30-year loan at 3 percent. Six billion dollars more is coming from a state-owned bank. Such heavy subsidization would make possible the $18.5 billion acquisition by a company worth only $22 billion itself. News reports indicate that the offer could and probably will be increased.

China National Offshore Oil, the parent company, is 100 percent owned by the Chinese government. The CEO of CNOOC and its parent, Mr. Fu, is one and the same person, and was appointed to both posts by the Communist Party of China. And in response to those who would argue that the Communist Party has no role in the company, I point out from CNOOC Limited’s annual report, its 20F filing, here is the description of the newest board member, Mr. Wu. Quote “in 2001, Mr. Wu became the director of the ideology affairs department of CNOOC. Mr. Wu was appointed president and chief of discipline and inspection group of CNOOC in 2003.” Unquote. The sole function of the Communist Party discipline and inspection group at CNOOC is to assure that the party members presently assigned to CNOOC follow party direction fully and faithfully. That is the expertise Mr. Wu brings to CNOOC’s governance. Interestingly, the party disciplinarian, Mr. Wu, was named to the board following the departure of a former Swiss ambassador who, it has been reported, objected to CNOOC’s pursuit of Unocal.
And let’s lay to rest the notion that CNOOC is just another company that responds to world energy prices. The majority of Unocal’s holding in Asia are liquefied natural gas. In the PRC, the price of LNG is subject to national price holdings, an exception carved out in its WTO accession agreement. A 70 percent, government-controlled company will be receiving $7 billion in subsidies to purchase a raw material that is traded domestically under centrally dictated controls. Where is the free market in that equation?

It is reasonable to ask why the Chinese government is so interested in acquiring Unocal. One reason, of course, is that its strategy to achieve energy security is based on direct control of reserves, rather than competing on the open market. This approach is in direct conflict with the efforts of the U.S. and other countries in the International Energy Agency to develop fungible, transparent, and efficient energy markets. We already know that China’s approach to energy security has foreign policy consequences for the United States as Chinese government oil companies purchase major stakes in Iranian and Sudanese oil fields, complicating efforts to deal with other U.S. foreign policy interests, including Iranian nuclear weapons and missile programs and the genocide in Sudan.

Why should the Chinese government’s control of CNOOC matter? Unocal holds reserves from the Gulf of Mexico to the Caspian, in Southeast Asia, Africa, Europe, and South America. Its 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. On our own territory, Unocal’s assets include offshore platforms in Cook, Alaska and the Gulf of Mexico. Do we want the authoritarian government in China to control critical energy resources on American territory, and what do we think about giving them control over U.S.-based pipelines and refinery facilities?

Some would say this is no problem because Unocal provides only a small portion of U.S. oil needs. If that is the case, where is the line where the portion is too large? Is there such a line? We are not the only country confronting these issues. The Canadian Parliament is now considering legislation to tighten its investment laws to block foreign takeover of any Canadian company for national security reasons in response primarily to concern about Chinese acquisition of Canadian raw materials and natural resources.

Then there is the question of our national security interests in other regions of the world, particularly in Asia, both hard power and soft power. Unocal’s natural gas facilities in Indonesia provide a significant amount to Taiwan, Japan, and South Korea. How would that be used as leverage in a conflict in the Taiwan Straits or to influence events in the region, or a political process, or as leverage over any of our allies there? We are already seeing a diminution of U.S. influence in Southeast Asia as the Chinese government engages in natural resource cash diplomacy. Are we willing to cede further our presence and influence in Thailand and Vietnam? Unocal’s annual report notes that 15 percent of Bangladesh’s natural gas requirements are supplied by Unocal and that number is expected to reach 35 percent by 2008. If those resources are provided by the Chinese government, does that have any implications for the United States?
And finally, but central to a national security analysis is the question of Unocal’s possession of certain materials, technology, and equipment including cavitation, deep-sea exploration and drilling, with national security implications. Some oil exploration and drilling equipment, including software, is controlled for export because of its dual-use potential, in some case for nuclear testing, in others for detecting submarines. Unocal is also the owner of the last U.S. source of rare earth minerals. Rare earth minerals are a critical component of magnets used in JDAMs, Smart Bomb technology, and other vitally important military applications.

We first saw China’s interest in acquiring rare earth minerals and bounded magnet technology when a Chinese state-owned company purchased Magnequench in 1995. Just six weeks ago, Magnequench, now a Chinese company, announced its intention to acquire AMR Technologies in Canada. With this acquisition and the acquisition of Unocal, the Chinese government will have cornered the supply of rare earth materials, used not only in military technologies, but also essential to virtually all electronic devices, including computers, mobile phone, and plasma LCD displays.

CNOOC has made some pledges as part of its bid, pledges, for example, to maintain American jobs. But when Magnequench was purchased by a Chinese company, promises were made to the employees that the parent would not take the plant to China and that it would guarantee employment for a number of years. Well short of that guarantee, however, the plant was closed, the facility was dismantled, and shipped to China, and the workers lost their jobs. How do we know that CNOOC’s promises would be upheld, and what recourse do we have I they are not?

We know from recent articles that a number of people, some quite eminent, are representing the Chinese government’s interests in this bidding process. But as is often the case in so many aspects of U.S.-China relations, we must ask who is looking out for U.S. interests? The only answer in this case would be the members of CFIUS, but I think we need to think about is the CFIUS process broken? It certainly looks like it could use some substantial reform. Since 1988, CFIUS has reviewed some 1,530 transactions and required only one divestment through presidential determination. The process needs a better and more expansive definition of national security. It needs transparency, and it certainly could use some Congressional oversight.

The House of Representatives has weighed in overwhelmingly twice recently, with close to 400 people voting each time to raise serious questions about this deal. Dismissing the import of these votes is foolish, while reflecting the cumulative frustrations of policy failures regarding China for the past years; they are also shaping the storm clouds in the years to come. Thank you.

(Applause.)