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Routing

U.S.-China Relations in the Wake of CNOOC

by James A. Dorn

Executive Summary

Congress set a dangerous precedent when it interfered with Hong Kong-based CNOOC, Ltd.'s bid for Unocal. Supporters of the intervention argued that CNOOC, a subsidiary of state-owned China National Offshore Oil Company, could pose a threat to U.S. economic and national security. Yet Unocal was only a small player in the U.S. energy market and had no technology that might pose a real threat to U.S. security. Nonetheless, congressional pressures prompted CNOOC to withdraw its \$18.5 billion bid, paving the way for Chevron to acquire Unocal for \$17.7 billion.

The increasingly confrontational approach Congress is taking toward China is leading to “creeping protectionism,” often in the guise of protecting U.S. national security. Although it is proper to criticize China for its human rights violations and its lack of a transparent legal system, we should not ignore the substantial progress China has made since it embarked on economic liberalization in 1978.

A policy of engagement—or what Hu Jintao, president of the People's Republic of China, calls “peaceful development”—is a necessary condition for constructive U.S.-China relations. Although China's competitiveness does pose a threat to certain U.S. economic interests, it also benefits American consumers and exporters. Protectionism would harm both the United States and China and would increase the likelihood of conflict. Hardliners would gain at the expense of more reasonable voices.

To avert the risk of conflict, the United States needs to treat China as a normal great power, not as an adversary; ensure that only those commercial transactions that genuinely threaten national security are blocked; and recognize that by increasing economic freedom we increase personal freedom. Our economic security, as well as China's, will depend on sound free-market policies, not on destructive protectionism.

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Introduction

In its 2005 *Annual Report to Congress on the Military Power of the People's Republic of China*, the Pentagon described U.S.-China relations as “cooperative, candid, and constructive.” The report stated, “The United States welcomes the rise of a peaceful and prosperous China” but warned that with growing wealth the PRC will be able to modernize its military and could pose a “credible threat” in East Asia and beyond.¹

One growing concern voiced both by the Pentagon report and by Congress is that China's demand for direct ownership of oil and gas and other “strategic assets” will pose security risks, particularly if China acquires U.S. energy companies. In a congressional hearing on July 13, Frank Gaffney Jr., president of the Center for Security Policy, told the House Armed Services Committee that the sale of Unocal Corp. to CNOOC, Ltd. (hereafter CNOOC), a Hong Kong-based subsidiary of China National Offshore Oil Company, “would have adverse effects on the economic and national security interests of the United States.” He pointed to “the folly of abetting Communist China's effort to acquire *more* of the world's relatively finite energy resources” and warned of “the larger and ominous Chinese strategic plan of which this purchase is emblematic.”²

Such fears are evident in the flurry of anti-China resolutions and bills introduced by members of Congress around the time of the CNOOC-Unocal bid. On June 30 a nonbinding House resolution (H.R. 344) recommending presidential review of the CNOOC deal passed by a vote of 398 to 15. In a letter to President Bush, House Energy and Commerce Committee chairman Joe Barton (R-TX) declared, “We urge you to protect American national security by ensuring that vital U.S. energy assets are never sold to the Chinese government.”³

When the China hawks in Congress joined forces with the protectionists, a strong (and dangerous) coalition was formed to effectively end any chance that CNOOC would be successful in its bid to acquire

Unocal. After Congress amended the Energy Policy Act of 2005 (H.R. 6) in late July—to require a lengthy review of the proposed takeover—CNOOC abandoned its \$18.5 billion bid for Unocal on August 2.

Although Congress used national security arguments to justify the close scrutiny of the proposed CNOOC-Unocal deal, the relatively small size of Unocal convinced most experts that the security card was really just a ploy to tilt the deal in favor of the other suitor—California-based Chevron. Indeed, Chevron is located in the congressional district represented by the chairman of the House Committee on Resources, Richard W. Pombo, the very person responsible for amending H.R. 6 to require that the Department of Energy, along with the Departments of Defense and Homeland Security, conduct a 120-day study on the economic and security implications of China's growing demand for energy. An important provision of that amendment was that the White House could not approve the CNOOC offer until 21 days after the DOE study was completed. By adding as much as 141 days to the takeover process, Congress undermined CNOOC's incentive to continue the bidding war with Chevron and convinced Unocal's board to accept Chevron's cash-and-stock offer valued at \$17.7 billion.⁴

In scrapping its bid, CNOOC management said that “unprecedented political opposition” made it impossible to successfully compete with Chevron by “creating a level of uncertainty that presents an unacceptable risk to our ability to secure this transaction.”⁵ That complaint reflected an earlier statement by the Chinese foreign ministry: “We demand that the U.S. Congress correct its mistaken ways of politicizing economic and trade issues, and stop interfering in the normal commercial exchanges.”⁶

Although Chevron is the clear winner, congressional interference in what should have been primarily a market transaction sets a dangerous precedent and could jeopardize U.S.-China relations. The firestorm on Capitol Hill surrounding the CNOOC bid for Unocal is merely one case in the rising anti-China trend.

Indeed, as Albert Keidel, a senior associate at the Carnegie Endowment for International Peace, writes, “Those who would build a Great Wall of America to fend off China’s influence could end up jeopardizing everyone’s long-term peace and prosperity while doing little to improve prospects for political change in China.”⁷ By politicizing the takeover market and weakening the private property rights of Unocal’s shareholders, Congress violated the very free-market principles it is supposed to uphold.

The Politicization of CNOOC’s Unocal Bid

Congress is right to criticize China for its human rights violations, its failure to protect intellectual property rights, and its lack of a genuine rule of law. Nevertheless, in more than two decades of economic reform, China has made significant progress in reducing poverty and opening to the outside world. Capitalists are now free to join the Chinese Communist Party, people can own private property, and the PRC Constitution has been amended to better protect the private sector. Article 13 of the constitution now reads, “Citizens’ lawful private property is inviolable.”⁸ In contrast, “under Mao, large public notices everywhere had urged people to ‘Strike hard against the slightest sign of private ownership.’”⁹

China has a long way to go before it is a full-fledged market economy and a free society, but preventing China from entering U.S. markets, whether for capital or for goods and services, will not ensure “peaceful development”—the professed goal of President Hu Jintao of the PRC.¹⁰ Washington’s interference with the CNOOC-Unocal deal might have been warranted if there had been a legitimate threat to national security, but in this case that possibility seems remote. As energy economist Phillip Verleger said: “There’s no national security issue here—zero. Unocal doesn’t have technology that needs to be kept secret.”¹¹

What may concern Congress more than the so-called security threat, which was never clearly defined in the case of CNOOC, is the idea that China may gain control of energy sources, crowd out American buyers, and use the “oil weapon” to undermine U.S. influence in East Asia and elsewhere. The logic, as stated in House Resolution 344, is simple:

1. Oil and natural gas are “strategic assets critical to national security and the Nation’s economic prosperity.”
2. China is an authoritarian regime “strongly committed to national one-party rule by the Communist Party” and owns about 70 percent of CNOOC’s stock.
3. Subsidized loans will be used to help finance the proposed takeover.
4. CNOOC may ship oil and natural gas directly to China rather than sell it in world energy markets, which “would result in the strategic assets of Unocal Corporation being preferentially allocated to China by the Chinese government.” That “would weaken the ability of the United States to influence the oil and gas supplies of the Nation through companies that must adhere to United States laws.”
5. The acquisition “could provide access to Unocal Corporation’s sensitive dual-use technologies that the United States would otherwise restrict for export to China.”
6. The CNOOC deal therefore threatens “to impair the national security,” and “the President should initiate immediately a thorough review of the proposed acquisition, merger, or takeover.”¹²

In fact, the Congressional Research Service reports that Unocal is an insignificant player in the U.S. energy market, accounting for only 0.8 percent of U.S. production of crude oil, condensate, and natural gas liquids. Unocal’s U.S. production of petroleum is a miniscule 0.3 percent of U.S. consumption. The CRS report also notes that “because oil is a fungible commodity in a world market, it can be

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argued that it matters little where oil supplies originate.”¹³ CNOOC will pay the going world price for oil no matter where it is produced, and oil will flow to the highest bidders.

Moreover, if CNOOC acquired Unocal and directly shipped oil to China, instead of buying it on the open market, there would be no net change in the world price of oil—so the United States would not be “crowded out.” China would buy less oil on the market and there would be more available for other countries to purchase. Congress ignored that obvious reality in H.R. 344.

Even so, CNOOC had agreed not to divert Unocal’s U.S. production of oil and gas to other markets. Rather, since most of Unocal’s production of oil and natural gas is located overseas, particularly in Southeast Asia, it would be logical for China to tap those more proximate sources. Just as the United States is searching worldwide for new energy sources, so is the PRC. If Congress prevents Chinese firms from acquiring U.S.-based companies such as Unocal, the Chinese will look elsewhere—including friendly states such as Canada as well as rogue states such as Sudan and Iran. If we want China to open its capital markets, we should open ours. Limiting Chinese investments in the United States—when there are no obvious risks to national security—could backfire if Beijing decided to retaliate. Lee Raymond, chief executive of Exxon Mobile Corp., which has invested heavily in China’s energy sector, said that the United States would make a “big mistake” by blocking CNOOC’s bid. “You have to have free trade,” he said. “If you start to put inefficiencies in the system, all of us eventually pay for that.”¹⁴

The United States should pay attention to possible security threats posed by foreign acquisitions of U.S. companies, but in the CNOOC-Unocal case such a threat looked rather remote. True, Indonesia’s Bontang liquefied natural gas (LNG) refinery was expected to buy 40 percent of its gas from Unocal over the next decade and sell most of it as LNG to Taiwan, Korea, and Japan. Consequently, critics such as the American Enterprise Institute’s

Thomas Donnelly and Melissa Wisner, writing in the *Weekly Standard*, argued that CNOOC’s control of Unocal’s Indonesian assets would have increased China’s influence in East Asia and allowed the PRC to exert even more leverage over Taiwan, which depends heavily on LNG from Indonesia. In their view, China’s energy strategy is to increase its sway not only in Asia but worldwide, “with the effect (and almost certainly the intent) of undermining the United States.”¹⁵ However, it is also true that China could blockade Taiwan at any time but has not done so because it would be prohibitively costly to China’s development strategy. Instead, it is more likely that CNOOC would honor long-term contracts and strive to increase production.

China’s strong-arm tactics and threats against Taiwan easily generate criticism and make China “the piñata of American politics,” as AEI’s Kevin Hassett has noted. However, the more serious issue is that “such responses create a very big problem for free traders in the U.S.” and “demonstrate that protectionists have a large group of influential new allies.”¹⁶

Protectionism in Disguise?

Currently, foreign companies are free to invest in U.S. energy assets. British Petroleum and Royal Dutch Petroleum (Shell) have sizable stakes in the United States, and Venezuela’s national oil company, PDVSA, was allowed to acquire CITGO, which controls nearly 7 percent of U.S. refining capacity. Meanwhile, many U.S. energy companies have joint ventures in China.¹⁷ Ultimately, energy security will depend on market-based pricing and free trade.¹⁸ Those are the policy issues that Congress should be focusing on, not on a bogus security threat from an acquisition that would give CNOOC control over a small U.S. company that accounts for only a tiny fraction of global oil production.

China, through joint ventures and production-sharing agreements, already has access to current technologies for exploration for oil and gas and for production and refining.¹⁹ Unocal’s expertise in deep-water drilling no doubt would

be of value to CNOOC, but selling that technology is not equivalent to selling MIRV (multiple independently targetable reentry vehicle) technology to China. At the House Armed Services Committee hearings on the CNOOC-Unocal deal, Rep. Curt Weldon (R-PA) brought up the issue of MIRV technology as if it were somehow pertinent to the hearing. He accused Jerry Taylor, director of natural resource studies at the Cato Institute, of minimizing the security threat of a CNOOC takeover of Unocal. Taylor replied: “Chinese acquisition of military technology would be worrisome, but I’m not aware that Unocal has [that] technology, nor am I aware that it has the technology you’ve discussed. My understanding is that there is nothing Unocal has in the oil sector that isn’t available through contractors, or private vendors, or whatnot—that there’s nothing proprietary there. If there were, I’d be happy if the United States government were to provide some restrictions.”²⁰

Indeed, there was no need for Congress to get involved in the security issue because that is the job of the secretive Committee on Foreign Investment in the United States, a 12-member multiagency panel headed by the secretary of the treasury. CFIUS was created by the Exon-Florio amendment to the Omnibus Trade and Competitiveness Act of 1988 to deny foreign acquisitions of U.S. companies if it can be shown that “other U.S. laws are inadequate or inappropriate to protect the national security” and that there is “‘credible evidence’ that the foreign investment will impair the national security.” Once the committee decides to investigate a case, it has 45 days to make a recommendation to the president, and the president must act within 15 days. Although evidence is difficult to obtain because of the secrecy surrounding CFIUS, it appears that, of the 1,560 cases reviewed since 1988, only 25 were fully investigated, and of those only 12 were sent to the president, who can either accept or reject the committee’s recommendations. In only one case was the challenged acquisition denied on national security grounds. In 1990 President George W. H. Bush prohibited China National Aero-Technology Import and Export Corpor-

ation, a state-owned enterprise, from acquiring Mamco Manufacturing Company, an aerospace company with dual-use technology.²¹

Given the facts of the CNOOC-Unocal case, it is unlikely that it would have gone all the way to the president, and if it had, it is highly unlikely that he would have denied CNOOC’s bid for Unocal unless there were serious security concerns unearthed by CFIUS. A judicious use of CFIUS is warranted. The committee’s lack of transparency poses problems for a country whose allegiance is to the rule of law.

Congress’s decision to amend the energy bill to prolong the review process was the final straw that was intended to break the back of the CNOOC-Unocal deal. As Pombo admitted in an interview, “If we hadn’t put the amendment in the energy bill, they [CNOOC] might have succeeded.”²²

Ironically, the energy bill itself purported to “ensure jobs for our future with secure, affordable, and reliable energy.” And Pombo’s amendment may have had that effect—if only in his district. It was a political act grounded in narrow self-serving economic concerns, not broader U.S. prosperity or security.

But Pombo was not alone. The anti-China hyperbole that was evident on Capitol Hill prior to the CNOOC pullout is exemplified by Rep. Tom Tancredo (R-CO), who stated, “By itself, this takeover may seem small, but a few more deals like this one and America could find itself held hostage not just to the energy brokers in the Middle East but to China as well.”²³

The reality is that the bidding game for Unocal was primarily market driven and Congress should have let CNOOC fight it out with Chevron so that shareholders got the best price. Congressional critics overlooked the fact that most of Unocal’s overseas production of oil and natural gas was already contractually committed and would not be available for the Chinese market. Moreover, they ignored the obvious economic reality that, regardless of who won the bidding battle for Unocal, the allocation of energy supplies ultimately depends on global competition and proximity to markets.²⁴

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If China did try to restrict the supply of oil to the United States—that is, to use the so-called oil weapon—it would hurt China as much as the United States because China is now a net oil importer and must pay market prices. It might even cause greater harm in the PRC because, as Taylor pointed out in his testimony before the House Armed Services Committee, China’s energy usage is much less efficient than that of the United States, and “the Chinese economy is less able to efficiently adjust to price shocks.” Hence, “there is no reason to worry about the impact that a merger between CNOOC and Unocal might have on domestic energy prices or America’s access to oil. Unocal would not provide China with an ‘oil weapon.’”²⁵

There is little doubt that CNOOC’s bid would have prevailed if not for congressional interference. In June the spread between CNOOC’s bid and Chevron’s was nearly \$2 billion, and CNOOC was prepared to increase its offer price. However, after the intervention of Congress and the amendment to the energy bill that increased transaction costs to CNOOC, the tables turned. Jason Putman, an energy analyst with KeyCorp’s Victory Capital Management, which holds a large number of Unocal shares, estimated that the increase in risk due to Congress’s actions resulted in a \$513 million decline in the value of CNOOC’s all-cash bid, which was enough to make the proposed deal untenable.²⁶ In a letter to Unocal’s board, Peter Schoenfeld of P. Schoenfeld Asset Management, which also controls a block of Unocal shares, reminded the board that it was their “duty to maximize value for stockholders.”²⁷ Indeed it was. But Congress inserted itself in the middle of the CNOOC-Unocal deal and, in so doing, became an overseer rather than a protector of shareholder rights.

Although CNOOC’s bid was to be partly financed by the Chinese government, which holds more than \$711 billion in foreign exchange reserves, that would have been a gift to Unocal shareholders—not a concern for Congress or U.S. energy security.

Even without a legal prohibition on a deal, Congress can intimidate a foreign company

such as CNOOC by imposing considerable costs on the takeover process and using the secretive Committee on Foreign Investment to breed uncertainty. That is not to say we should let foreign companies have totally free access to assets of all U.S. companies. In some cases, especially in the area of sensitive technology with military applications, there may be legitimate risks. Going through a government vetting process would then be warranted.

Congress Should Promote Engagement, Not Protectionism

The CNOOC-Unocal deal must be considered within the broader context of U.S.-China economic engagement. The rising U.S. trade deficit with China, which will approach \$200 billion this year, has roused the ire of Congress—even though U.S. consumers have saved billions of dollars through expanded access to Chinese imports and American producers have gained from the growth of the Chinese market (exports to China have doubled since 2000).

Many members of Congress and other people tend to think of trade with China as a zero-sum game: China wins, the United States loses. That mercantilist mindset naturally leads to the perception that China’s growing wealth—wrongly called “economic power”—is a threat to U.S. economic and national security. Gaffney was explicit on that point, telling the Armed Services Committee, “I believe the PRC’s aim is inexorably to supplant the United States as the world’s premier economic power and, if necessary, to defeat us militarily.”²⁸ Likewise, Randall Schriver, a former top China official at the State Department, told Reuters that the United States and China could be on a “collision course” due to Beijing’s willingness to seek out rogue states to ensure sufficient energy supplies to meet its huge demand and to maintain high economic growth.²⁹ Of course, the United States may be pushing China in that direction by effectively denying it access to U.S. companies like Unocal.

There are many signs of growing hostility toward China, with the PRC often used as a scapegoat for U.S. domestic problems. Representative Tancredo has introduced legislation (H.R. 1450) calling for “additional tariffs” on “any nonmarket economy country until the President certifies to the Congress that that country is a market economy.” He would then earmark those tariff revenues for the “Social Security trust funds.”³⁰

Likewise, the passage by the House on July 27 of the U.S. Trade Rights Enforcement Act (H.R. 3283) is a step backward for U.S.-China relations. Although that act is unlikely to become law, it “authorizes the application of the U.S. countervailing duty [CVD] law to exports from nonmarket economies such as China.” Nonmarket economies are already subject to anti-dumping law, which in most cases unfairly penalizes China by using prices in other developing countries such as India to determine if China is selling at “below cost.” Penalties are then assigned. The arbitrary and discriminatory nature of this practice is well known.³¹ Using CVD law would simply increase protectionism in the global economy, not advance China’s march toward a true market economy.

Another prime example of protectionist legislation aimed directly at China is Congress’s threat to impose punitive tariffs of 27.5 percent on Chinese exports to the United States if Beijing does not revalue the yuan by that amount. Action on the Schumer-Graham bill (S. 295) has been temporarily delayed because of the recent change in China’s exchange rate regime, in which China allowed the yuan to appreciate by 2.1 percent and moved to a managed float by pegging to a basket of currencies. Many members of Congress, however, still feel that China is engaging in unfair trade practices by undervaluing its currency. So we can expect Sen. Charles Schumer (D-NY) and his colleague Sen. Lindsey Graham (R-SC), along with other members of Congress, to renew their efforts.

China’s new exchange rate regime is a far cry from the free-market system advocated by U.S. Treasury Secretary John Snow, but it is in

line with Premier Wen Jiabao’s goal of developing “an exchange rate system that is more market-oriented and flexible.”³² Its success will depend on whether China relaxes exchange and capital controls and liberalizes interest rates. Washington should be patient with China. Only 13.5 percent of U.S. imports in 2004 came from China, so even a 20 percent appreciation of the yuan would reduce the trade-weighted value of the dollar by less than 3 percent. Slapping prohibitive tariffs on the Chinese, on the other hand, would injure American firms operating in China, harm U.S. consumers, slow economic growth, and endanger U.S.-China relations over the medium to long term.

Engagement versus Confrontation

The combination of animosity toward China and ignorance about energy markets witnessed on Capitol Hill poses a serious risk to the policy of engagement that has worked to advance China’s private sector and given millions of people the opportunity to exit the state sector and escape poverty. Eventually, the growth of China’s middle class will create still more pressure for political reform that will advance fundamental human rights. Indeed, that is already occurring, as evidenced by the recent amendments to the PRC Constitution that give greater protection to private property rights.³³

Alarm over China’s economic and military rise is often justified by reference to China’s poor human rights record, but that record will not be improved by denying the Chinese people the right to trade, which itself is an important human right.³⁴ Countries that are left outside the global trading system, such as Cuba and North Korea, have shown no interest in advancing human rights and have perpetuated poverty. Do we want that for China?

What China needs is less government and more markets. And the surest way to achieve that result is to strengthen the policy of engagement, not to threaten China with sanc-

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tions if it supplies Americans with cheap textiles and apparel or to use dubious national security arguments to deny China the right to bid for U.S.-owned energy companies. Denying China access to our markets while requiring it to open its markets is hypocritical and will only play into the hands of hardliners who already distrust the United States.

Yet politicians on both sides of the aisle in Congress see China as a major threat to U.S. jobs and view trade as a form of economic warfare rather than a mutually beneficial arrangement that increases the wealth of nations. They forget that, as Alan Greenspan said before the Senate Finance Committee in June,

In the decades ahead, it is in our interest and that of the global economy that China continue to progress toward becoming a more market-based, productive, and dynamic economy in which individual initiative, not government decision making, is the fundamental strength behind economic activity. For our part, it is essential that we not put that outcome, or our future, at risk with a step back into protectionism.³⁵

Even before joining the World Trade Organization at the end of 2001, China had made substantial progress in moving toward a market economy and liberalizing trade. Most prices are now determined by demand and supply rather than by central planning, and, as Nicholas Lardy, a scholar at the Institute for International Economics, told a congressional committee, "China is certainly one of the most open, perhaps the most open, of all emerging market economies."³⁶

Since 1978 China has dramatically transformed its economy and increased economic freedom. Congress should see China's prosperity as a positive development, not a threat to U.S. security. In 1980 China's economic freedom score, based on the Fraser Institute's *Economic Freedom of the World: 2005 Annual Report*, was 3.8 out of a possible 10; by 2003 it had risen to 6.0.³⁷ That score is still low in

comparison with Hong Kong's, which was 8.7 in 2003 (the latest data), but China is moving in the right direction.

Although China is by no means a free society, the advancement of economic liberty, as an important component of U.S. foreign policy, will help promote overall freedom. The process may be painfully slow at times, but what is the alternative? Institutions and new ways of thinking do not emerge overnight—or because Congress wills them to. Erik Gartzke, a political science professor at Columbia University and a member of the Saltzman Institute of War and Peace Studies, writes, "Since prosperity is necessary for stable democracy and sufficient to produce peace, the best foreign policy is one that enhances and extends capitalism."³⁸ If the United States is to maintain a "cooperative and constructive" relationship with China, the first order of business should be to adhere to a policy of economic engagement.

China is an emerging market economy, but that does not mean it can dismantle its large state-owned enterprises overnight. While outright privatization has been slow, the party leadership has allowed the nonstate sector to grow rapidly so that it now accounts for the bulk of China's economy. That transformation of economic life—from a centrally planned economy to an emerging market economy—has given the Chinese people new opportunities and has exposed them to Western ideas and culture. To shut off trade because China does not revalue its currency according to the dictates of the U.S. Congress would be foolish. Likewise, denying a joint-stock company like CNOOC, which is listed on Hong Kong and New York stock exchanges, the opportunity to acquire a small U.S. company like Unocal interferes with the rights of U.S. shareholders and with the freedom of international capital markets.

Of course, if CNOOC were a truly private firm, Congress would not have been so concerned. China's challenge is to move more rapidly toward privatization and the rule of law. Future cross-border transactions will then be less costly and more successful, and U.S.-China relations should improve.

President George W. Bush calls U.S.-China relations “good” but “complex.”³⁹ Lately the emphasis has been on “complex.” Yes, U.S.-China relations are “complex,” but they have always been so. Allowing Congress to steer those relations only adds to the uncertainty and complexity. The United States needs a firm commitment to engagement, and China needs to adhere to “peaceful development.” Little will be gained by constantly treating China as a threat, on the basis of presumed intentions. At the same time, we must not underestimate the willingness of hardliners in the Chinese Communist Party—who have little regard for the rule of law and want to retain their monopoly on power—to revert to military means to achieve their ends, especially in the case of Taiwan. Consequently, we need to be realistic and cautious, but not unreasonable.

The administration appears to be moving in that direction. In a pathbreaking speech to the National Committee on U.S.-China Relations in New York on September 21, Deputy Secretary of State Robert B. Zoellick avoided confrontation and instead called upon the PRC “to become a responsible stakeholder in the international system.”⁴⁰ At the same time, the United States must recognize that China is a rising normal power and will pursue its own interests. As Liu Jianfei, a journalist with the *China Daily*, recently wrote: “Currently the biggest obstacle in Sino-U.S. ties comes from misgivings held by some Americans towards China and their Cold War mentality. If such an outdated view is overcome, the two nations can build a strategic mutual trust and open new co-operation in the future.”⁴¹

It is a grave mistake to use the national security card to deny Chinese firms the right to purchase natural resources in the open market when there is no credible security risk. Beijing will view such behavior as yet another attempt by the United States to widen its power at the expense of China’s development, further increasing anti-American sentiment.

China’s thirst for oil and natural gas has driven world demand upward and increased prices, and that trend is likely to continue. Over time, production and consumption will respond to higher prices as producers search

for new supplies and consumers conserve and switch to cheaper alternatives. If the U.S. government interferes with the market process, future production will suffer, and U.S. energy companies will find it more difficult to operate in foreign countries.

Washington would be wise to heed the advice of Prime Minister Lee Hsien Loong of Singapore, who in his July 12 speech to the U.S.-ASEAN Business Council said, if the United States values its influence in Asia, it must take “a considered, long-term approach, upholding its commitment to free markets, free trade, and international rules.” However, “if it yields to short-term political pressures and turns protectionist, the damage to U.S. interests in Asia and its standing worldwide will be long lasting.”⁴²

Instead of centering foreign policy on hypothetical “intentions,” it would be more fruitful to rely on observed actions and fulfilled promises. In the case of CNOOC, there was no energy security threat, nor was there any significant risk to national security. Derek Butter, an energy analyst with Wood Mackenzie in Edinburgh, argues that CNOOC’s bid for Unocal had “little to do with security of supply for China.” Instead, it had to do with the Chinese wanting to create a company that “can compete with the other international companies, and has the skills in the future to negotiate its way into large projects.”⁴³

People who would deny China access to U.S. markets or assets on the basis of “economic security” would do well to remember what AEI director of economic policy studies Kevin Hassett has noted—namely, that “any economic harm we do to China by impeding it will be as harmful to our own citizens as it is to the Chinese.” In his view, U.S. foreign policy should support, not oppose, economic engagement with the PRC. The reasons are straightforward: (1) “free trade is a powerful force for economic good”; (2) “our policies can’t do enough economic damage to China to be politically meaningful”; and (3) “China is too small economically to corner the market in anything significant.”⁴⁴

Sticking to our free-trade principles, rather

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than sacrificing them piecemeal to special interest groups, would be the best defense of freedom, peace, and prosperity. The United States and China are both net importers of oil; and both depend heavily on imports from Saudi Arabia, which is neither a democratic regime nor one that respects human rights. China is not a centrally planned economy like the former Soviet Union or North Korea. It is one of the most liberalized economies in the developing world. The United States has more to gain from a “cooperative and constructive” policy of engagement with the PRC than from one based on the premise that China wants to and can dominate the world. Such an attitude shows a lack of confidence in the institutions that have made America great—namely, limited government, the rule of law, and freedom of choice in a market system.

Those liberal values should be practiced at home, and free trade with China is the best way to transmit them abroad. As Montesquieu wrote in his classic treatise *On The Spirit of the Laws* in 1748: “Peace is the natural effect of trade. Two nations who traffic with each other become reciprocally dependent; for if one has an interest in buying, the other has an interest in selling; and thus their union is founded on their mutual necessities.”⁴⁵

Even if commercial engagement does not preclude conflict, it clearly reduces the likelihood of conflict. China’s growing commercial relations with Taiwan are a case in point.⁴⁶ With massive investments in China, Taiwanese business owners and politicians have an incentive to take a cooperative rather than a confrontational approach in dealing with Beijing, and China has an incentive to avoid conflict that could cause a significant loss of trade and wealth. Stability requires that China continue to grow, which, in turn, requires peaceful international trade and the ability to attract foreign investment.

Peaceful Development

President Hu’s term “peaceful development,” as a way to describe China’s rise and as a strategy for dealing with the United States

and other nations, has merit. It is certainly a better description of post-Maoist China than much of the heated rhetoric heard on Capitol Hill. China is less apt to cause trouble if it concentrates on wealth creation and poverty reduction rather than global dominance—the goal of the former Soviet Union.

Today, after more than 25 years of economic reform and liberalization, the Chinese people are far more prosperous than they were during the reign of Mao Zedong. It would be a tragedy if that progress were jeopardized by a confrontational U.S. approach toward China. U.S.-China relations ultimately should rest on adherence to a rules-based liberal trading order, which means that purely commercial decisions should be market driven, not politicized.

As congressional reaction to the CNOOC-Unocal deal shows, however, the rising U.S. hostility toward China could lead to a train wreck unless calmer voices prevail. As Joseph Borich, former U.S. consul general in Shanghai and now executive director of the Washington State China Relations Council, notes:

There is no question about the existence of an influential group in and outside of Congress (often called the “Blue Team”) that views China as a threat to the U.S. on the same order as the former Soviet Union. They see trade and virtually all other U.S. dealings with China as zero-sum, with no possibility for win-win relations with China. For the Blue Team, CNOOC’s bid to acquire Unocal is not simply a business transaction; it represents a direct threat to vital U.S. security interests.⁴⁷

If future U.S.-China relations are to improve, that zero-sum, mercantilist mentality must give way to a more positive way of thinking about economic relations and security. Chinese and American companies should be left alone to trade, unless there is a *legitimate* threat to national security.

We should not be blinded by the fact that China is a nominally communist country. There

are many reformers in the Chinese Communist Party who seek further changes, and there are many people outside the CCP who want a more liberal regime. State ownership is no longer widely admired in China, nor do most people take communist ideology seriously. Zheng Bijian, head of the China Reform Forum and a senior adviser to the CCP, is correct to emphasize that China's rise since it embarked on a policy of openness in 1978 has been peaceful—in the sense that it “has been driven by capital, technology, and resources acquired through peaceful means.” Indeed, “the most significant strategic choice the Chinese have made,” says Zheng, “was to embrace economic globalization rather than detach themselves from it.”⁴⁸

Much of China's economic reform has been bottom-up rather than top-down. The people themselves want a better life and greater economic and personal freedom. U.S. foreign policy must respect those desires and recognize that ultimately freedom for the Chinese people will depend on the choices they make.

Yasheng Huang, a professor of international management at MIT, has emphasized the weakness of China's institutions and has recommended strengthening private property rights. According to Huang:

The central government has consistently bet on the wrong horses. It supported the traditional SOEs [state-owned enterprises] which, despite their entrenched positions, early market leadership and abundant resources, have performed poorly. The resources that could have been used to finance efficient businesses have been wasted on the state-owned enterprises Massive investment booms have fuelled economic growth but the booms are not sustainable in the long term. China's leaders recognise this. Now they need to encourage privatisation.⁴⁹

Conclusion

The message that Congress should send China is the message Liu Junning, an inde-

pendent scholar in Beijing, underscored when he wrote,

Whether China will be a constructive partner or an emerging threat will depend, to a very great extent, on the fate of liberalism in China: a liberal China will be a constructive partner; a nationalistic and authoritarian China will be an emerging threat.⁵⁰

Needlessly politicizing U.S.-China trade and bashing China will result in the rise of crude and anti-American nationalism, and the threat of war could become a reality. That would be a tragedy for world peace and prosperity.

To avert that disaster, policymakers should

- treat China as a normal great power, not as an adversary;
- ensure that only those commercial transactions that truly threaten national security are blocked, which means a judicious use of CFIUS and legislative power;
- continue to liberalize U.S.-China relations and help China meet its WTO commitments, including protection of intellectual property rights;
- recognize that advancing economic freedom in China reduces the possibility of conflict and increases personal freedom; and
- deepen the U.S. commitment to free trade as a fundamental human right.

The United States can do more to spread the ethos of liberty by setting high standards at home than by looking for an enemy abroad. Our energy security, as well as China's, will depend on sound free-market policies, not on destructive protectionism.

Notes

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