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**Foreign Policy
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THE CHINESE ECONOMY: A NEW SCENARIO

A Conference Report

Edited by

Murray Weidenbaum

and

Harvey Sicherman

February 1999

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THE CHINESE ECONOMY: A NEW SCENARIO

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Avery Goldstein, Director, Asia Program, FPRI; Associate Professor of Political Science and Director of Christopher H. Browne Center for International Politics, University of Pennsylvania

Gregory Chow, Professor of Economics, Princeton University

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Mark Groombridge, Associate Director, Asian Studies, American Enterprise Institute

Howard Perlmutter, Emeritus Professor of Social Architecture and Management, Wharton School of Business, University of Pennsylvania

Arthur Waldron, Lauder Professor of International Relations, University of Pennsylvania; Director of Asian Studies, American Enterprise Institute; and Senior Fellow, FPRI

Introduction

by Murray Weidenbaum and Harvey Sicherman

In September 1997, the World Bank met in Hong Kong, marking the occasion with a major study of the Chinese economy. "China 2020" seemed to confirm the conclusion of many observers: the explosive economic growth of the People's Republic of China was destined to continue for many years. The rate of growth, estimated to be at least 8 percent annually for some time to come, would transform the world's largest nation into the world's second-largest economy.

This scenario also fueled the growing American debate over whether China would be a future partner or an adversary. Beijing seemed poised to enjoy a geopolitician's paradise, able to afford both guns and butter, swelling from regional power to great power, perhaps even superpower status.

But even as the World Bank celebrated China's growth rate, two other events threatened to curtail it. When PRC president Jiang Zemin consolidated his authority at the People's Congress in March 1998, he pledged an economic reform program that would resolve the growing problem of inefficient state-owned enterprises (SOEs), which were still the backbone of the economy. The SOEs employ most urban Chinese and consume an estimated two-thirds of the country's domestic investment, but produce barely one-third of its gross domestic product. A reform of this magnitude would obviously pose important problems. Yet the World Bank and other models projected 8 percent growth regardless of the course of the reform, its success or its failure.

The second event was the financial panic in Asia. The problem arose first in Thailand and then quickly spread to other East Asian nations, especially Korea, Indonesia, and Malaysia. The key manifestations of financial distress were plummeting currencies, failing banks, massive layoffs, and a wholesale flight of foreign capital. Because the mainland Chinese currency, the renminbi, was not fully convertible, it was thought to be immune to the "contagion," but this was a shortsighted and overly narrow estimate of the impact. Other areas with important links to the Chinese economy were clearly affected. The newly established Hong Kong Special Administrative Region, China's experiment with the "one country, two systems" concept, came under speculative pressure to devalue its currency, long pegged to the U.S. dollar. Taiwan, a major source of investment for the mainland despite the conflict over sovereignty, was also linked to the American currency. And the overseas Chinese trading communities, often the conduit directing foreign capital to the PRC, were heavily invested around the region. This "bamboo network" would not be untouched by Asia's financial travails.

We therefore began to consider a "new scenario," one very different from the straight-line projections of 8 percent growth. The outlook for China, in our view, was not that of bust or boom, but rather a slower expansion and probably a more jagged trend line. To understand the impact of this change, it would be necessary to examine how the different parts of the network that influenced China's growth—Hong Kong, Taiwan, the overseas Chinese—were reacting to the Asian crisis. We would analyze the potential changes in Chinese domestic and foreign policy that could be anticipated from lower growth forecasts. Finally, we wanted to see what impact all of this might make on U.S. policy, not least Washington's handling of its trade deficit with the PRC.

When FPRI's conference on the "New Scenario" assembled on September 16, 1998, some of our speculations had already become reality. Hong Kong had been badly hurt by the panic over Asia's economic prospects, defending its dollar "peg" with high interest rates and Beijing's pledge to support it with its own foreign reserves. Taiwan had devalued its currency. Overseas Chinese were reeling from falling property values and stock markets, compounded by political upheaval in

Indonesia. The United States and the International Monetary Fund were under heavy pressure to rescue the region and then, after Russia's financial collapse, to rescue the entire global economic system. In Beijing, Jiang Zemin and Prime Minister Zhu Rongji promised not to devalue the renminbi, while agreeing with President Clinton that Japan had to do more to prevent further damage. The PRC was still insisting that it could achieve 8 percent growth for 1998, but clearly all bets were off for the years to come.

These developments made our new scenario less a matter of debate than a baseline for analysis and informed speculation. To this end, we commissioned papers by eminent experts and then subjected them to a wide-ranging discussion by distinguished panelists. These included analysts with backgrounds in economics, politics, and business. Dr. Charles Wolf, Jr., the senior economic advisor at the RAND Corporation, gave the first paper on "The Greater Chinese Economy in Its Regional Settings." Dr. Nicholas Lardy, a senior fellow at the Brookings Institution, presented the second paper on "Chinese Economic Reform and Sources of Growth." Dr. Avery Goldstein, the director of FPRI's Asia Program and an associate professor of political science at the University of Pennsylvania, presented the third paper, "China's Changing Domestic and Foreign Policies." Finally, Dr. Murray Weidenbaum, chairman of Washington University's Center for the Study of American Business, delivered a keynote address entitled "U.S. Policy Toward China: Impacts of a New Economic Scenario."

The papers were reviewed and discussed by panels of experts including Professor Gregory Chow of the Department of Economics at Princeton University; Professor Thomas Christensen of MIT's Political Science Department; Dr. Theodore Friend, senior fellow and Indonesian expert at FPRI and former president of the Eisenhower Exchange Fellowships; Dr. Mark Groombridge, the associate director of Asian Studies at the American Enterprise Institute; Dr. Howard Perlmutter, Emeritus Professor of Social Architecture and Management at the Wharton School of Business; and Dr. Arthur Waldron, the Lauder Professor of International Relations at Penn and the director of Asian Studies at AEI.

In addition, an audience of other scholars, business executives, and economists participated in the discussions. Those present included Mr. C.C. Chang and Mr. Ezra Chen of the Taipei Economic and Cultural Representative Office in Washington; Mr. Raymond Fan, director of the Hong Kong Economic and Trade Office; Ms. Gao Jian, counsellor at the Chinese Embassy; Mr. Wang Qi, third secretary at the Chinese Embassy; and Mr. Jimmy Wang, senior information officer, and Dr. Yuh-Chao Yu, director of information division, at the Taipei Economic and Cultural Office in New York.

We made no attempt to achieve a consensus among the participants—the individual essays contained in this report speak for themselves. Nonetheless, some common themes did emerge:

1. THE IMPACT OF THE ASIAN "CONTAGION" ON CHINA IS ONLY DELAYED, AND MORE BAD NEWS IS LIKELY TO COME. The PRC is the least affected by the crisis thus far. Indeed, China and Taiwan are now the only growing economies in East Asia. Yet the Chinese economy has serious financial weaknesses likely to be aggravated by the turmoil in world markets and new caution on the part of foreign investors. These include the excessive growth of credit and its attendant problems—excess industrial capacity, negative returns, and nonperforming loans. Related to this is the overreliance of business on bank credit and weak central bank control. Corruption—the Chinese version of "crony capitalism"—could also aggravate the problems. Some participants argued that a crisis in China could be triggered by credit contraction as the government attempts to reform the system.

Taiwan's position is strong in part because its business structure is not as highly leveraged as the others.' Unlike South Korea, it follows the U.S. model of economic development more than the Japanese version. Taiwan's economy also consists in large part of small to medium-sized businesses—this was a factor in the government's decision not to defend the link to the dollar with high interest rates that might have produced a recession.

The Asian financial crisis has also exposed Japan's key role in the region's prospects. Tokyo, more than any other capital, could set the framework for the recovery of the rest of East Asia by cleaning up the ailing Japanese financial system and preventing a disastrous deflation. But the Japanese seem slow to act, and the political system appears impervious to outsiders. Meanwhile, the Chinese have made clear that their own policy will be heavily influenced by Japan's efforts to recover, given Japan's role not only as regional investor but also as a key export market for Chinese goods.

2. CHINA'S FUTURE GROWTH DEPENDS ON REFORM OF ITS FINANCES, ESPECIALLY THE STATE-OWNED ENTERPRISES. On this issue, discussants diverged into several camps: those who foresaw greater or lesser degrees of both economic reform and growth, and those who admitted no specific prediction other than the fact of palpably slower growth. The optimists cited Beijing's long-term commitment to its reform process and the pragmatic nature of its leadership. In their view, the authorities in Beijing were well aware of the contrast between the poor performance of the SOEs and the relative success of the privately and foreign-owned enterprises. Jiang Zemin and Zhu Rongji had steadily reduced the role of the SOEs and were experimenting with novel solutions to financing, including stock ownership plans. They also understood the important role of town and village enterprises which, along with export industries, were the engines of growth. Some argued that growth could actually accompany reform, if led by reform in the banking sector. The optimists are persuaded that reform is proceeding about as quickly as possible and quickly enough to spare China from economic disaster.

The pessimists reminded us that China's fast growth proceeded from a very small base, and that growth covered up many mistakes. The most notable are the accelerating bank loans to SOEs, few of which can be repaid, thus threatening banks' solvency. These loans have come from the savings of the Chinese people. Indeed, it can be argued that one reason for China not to devalue was fear that domestic savers might lose confidence in the banking system. The resultant asset bubble continues to grow, thus making a "soft landing" increasingly difficult. It was noted that, in part, the poor performance of the SOEs results from the many expensive social welfare costs—housing, health, education—imposed on them. While it would be desirable to shift these unrelated financial burdens from business enterprises to government, as yet no such "safety net" exists. The Chinese also face growing pollution problems, especially in the energy sector, and this summer's disastrous floods opened Beijing to charges of serious environmental mismanagement that could harm China's potential growth.

The pessimists concluded that China's economic reform would persist, but was too slow to arrest the problems now being aggravated by the international economic crisis. The most pessimistic took this a step further, being skeptical that the reform itself would really continue. In this view, the Chinese were likely to take the easy way out by continuing to prop up the SOEs, avoiding an unemployment problem even at the risk of further enlarging the bubble. This made an eventual credit contraction likely, triggering recession and a potentially huge devaluation.

In addition to the optimistic, the pessimistic, and the most pessimistic, there was another view—the "mystic." In this scenario, we simply cannot expect to forecast the future with precision. What counts is the fact of a slowdown itself. In a system expecting continued boom, a drop from 8 percent to 5 percent growth would constitute quite a shock. The best that can be expected is that the shock takes place in slow motion rather than in the form of a sudden, dramatic downturn.

3. CHINA HAS REAPED SOME IMPORTANT DIPLOMATIC BENEFITS FROM THE CRISIS. President Clinton and Secretary of the Treasury Rubin have hailed Beijing's refusal to devalue its currency as a major contribution to regional stability. China has thus gained in stature compared to Japan's paralysis and Taiwan's sudden devaluation. This appears to reinforce what some analysts viewed as the PRC's latest strategic shift.

Following the Taiwan Strait crisis of 1996, Beijing had begun to mend fences in both Washington and the region. This included two summits with the Americans, the Russian border agreement, and the PRC's behavior in the financial crisis. The objective seems to be to promote Jiang Zemin's government as both responsible and benign, giving outside powers a stake in good relations. The Asian economic distress allowed Beijing to score points over its rival in Taiwan, but it has also been promoting a cross-strait dialogue concerning crude military threats. Similarly, China has gained ground vis-à-vis Japan, but has not been inclined to persist with "Japan bashing." All of this reflects a newfound Chinese interest in multilateral cooperation that would be overlaid on a developing U.S.-PRC "strategic partnership." It is the international counterpart to a domestic policy that stresses stability and growth while carefully controlling the pace and extent of political change.

Thus far, the economic slowdown would not seem to have altered this picture. Yet, depending on its severity, it could affect important parts of the scene: relations among China's top leaders, China's entry into the World Trade Organization, and reliance on a perhaps saturated export market to the United States. The regime has also placed enormous prestige on its pledge not to devalue the renminbi, a pledge it might not be able to keep.

Other analysts saw Beijing coming up against hard choices. Simply put, slower growth would make the guns-plus-butter policy difficult or impossible to sustain, and guns might win out. One of the chief problems is the weakness of the regime's legitimacy. With communism discredited as an ideology and abandoned in all but name, the government's authoritarian system now relies on economic growth, prestige abroad, and the occasional use of brute force to maintain its monopoly on political power. The Chinese government has long stressed the mantra of "stability," partly to counter demands for political change. In the event of financial crisis, however, widespread unemployment, increased poverty, and resentment of corruption could disrupt the social peace and produce enormous pressure for greater democracy—pressure which has remained, for most of the last decade, largely latent in the face of economic improvements. This could shatter the post-Tiananmen Square strategy of accelerating economic growth and selectively opening the political system, which could in turn force the leadership to choose between drastic political change and widespread repression.

In dealing with the United States, China might revert to the tactic of the "double-edged sword," arguing that the American desire for regional stability should outweigh its revulsion over Chinese policies. Elsewhere, the government might attempt to bolster its legitimacy by mobilizing aggressive nationalism—which to some extent is already shared even by the younger generation—on the issue of Taiwan, to take the most dangerous example. Thus, any gains in China's diplomatic stature may be only temporary, and today's apparent domestic calm may in fact mask a set of dangerous pressures.

Finally, it was pointed out that the entire international economic system is undergoing rapid change. One analyst argued that the magnitude of this change, while unpredictable, would at the very least "shake out" the noncompetitive players in international trade. The Chinese leaders certainly had a vision of their country as a major part of the global economy, but if their understanding of that economy turns out to be too limited, then none of the policies enunciated thus far would be adequate to boost China into such a role.

4. THE U.S. FACES IMPORTANT NEW STRAINS WITH CHINA. The United States has experimented with various policies toward the PRC in the Clinton years, emphasizing human rights, then economic relations and, more recently, a "strategic partnership." In Washington, the Chinese often appear to be simultaneously part ally and part adversary. The U.S. political system has great difficulty in finding a consistent approach. Still there is general recognition that a good relationship between the two countries is a paramount objective given their respective impacts on world events.

From the U.S. point of view, bringing a historically isolated China into constructive international relations with the rest of the world is a major priority. Yet the fact remains that this has not yet happened—a modernized China still does not belong to key organizations such as the World Trade Organization and it does not participate in the annual economic summit of the G-7.

While mainly complementary, the U.S.-China economic connection is still lopsided. "Partner" is a euphemism: the U.S. imports four times the dollar amount from China than it exports to China, far more out of balance than comparable data for Japan. This trade is also not a significant portion of the American economy. In contrast, the United States, as the destination of one-third of China's exports, is key to Beijing's acquisition of modern technology and accumulation of foreign exchange.

The relative unimportance of China to the U.S. economy may explain why opposition to China trade has, until now, come from human rights critics and others with noneconomic agendas. Nor, despite much debate, has an American consensus emerged over whether continued opening of the Chinese economy will help to spawn greater democracy.

A slowdown of Chinese economic growth could ease several points of tension. Beijing might choose "more butter and fewer guns," relieving fears of its intentions in the region. Slower production could mean less environmental pollution and less potential for trouble over energy resources in the South China Sea.

Two problems, however, are likely to challenge both governments under a scenario of slower growth. The first is relatively recent: the Kyoto treaty over global warming. The U.S. Senate is unlikely to approve such a treaty unless the less-developed countries—China, above all—are willing to do their part.

The second is that new political pressure will develop in the U.S. over the uneven nature of U.S.-China trade if Beijing's reaction to a slowdown is to increase barriers to imports from the United States. Such protectionism is already evident in the growing Chinese subsidies to exporters, a kind of hidden devaluation; greater informal restrictions on imports; financial actions that discriminate against foreign investors, such as the recent bankruptcy of non-bank institutions operated by provincial governments; and lack of progress on legal reforms that protect foreigners and foreign investment.

These pressures argue for a new political scenario in the United States. The president should organize a consensus around these points:

- (1) the importance of continuing the policy of "including" China in international arrangements;
- (2) a public diplomacy that avoids "hectoring" or preaching but still reminds the Chinese that Americans honor democratic values they are bound to defend, and that disdain for such values will make enduring relationships more difficult;

(3) emphasizing that the answer to the current crisis does not lie in greater Chinese barriers to U.S. exports or a retreat from economic reform, which will simply increase pressure in the U.S. to restrict trade; and

(4) making clear that our permanent interests in Asia require a substantial U.S. military presence that also reinforces regional stability.

Finally, the international economic crisis should remind American policymakers that the United States alone does not have all the answers. Last year, leaders in Beijing, Taipei, and Tokyo indicated their willingness to participate in a "regional rescue fund." It was a mistake not to have pursued this idea when it first appeared, and the United States should explore the concept further.

To sum up: the old scenario of a steady, high-growth Chinese economy is out of date. Both domestic and international developments are replacing it with a new scenario of slower growth—perhaps much slower—and this creates new uncertainties about China's modernization, political evolution, and foreign policy.

As a consequence, both Beijing and Washington will face new difficulties and narrower margins for error. China's leaders may be tempted to delay necessary actions, but only at the price of postponing full membership in the global marketplace and foregoing opportunities for modernization. The United States will have to sustain a balance in its policy that does not allow any single dimension, be it human rights or economics, to override long-term security interests.

We wish to acknowledge the support of all those who made the conference and report possible, especially our trustees Mr. William H. Wurster and Mr. Bruce H. Hooper, and Halpern Associates.

Three Systems Surrounded by Crisis

by Charles Wolf, Jr.

The question I have been asked to address concerns the "Greater Chinese Economy in its Regional Setting"—more specifically, the impact of Asia's recent economic crisis on mainland China, Hong Kong, Taiwan, and the overseas Chinese communities throughout the region. This is an extraordinarily ambitious task and, at most, I will only be able to deal with parts of it. What is more, it should be noted at the outset that the term "Greater China" is not regarded with favor in any part of the region! And with good reason: the term seems to imply a Chinese hegemonic domain—a role which Beijing eschews, Hong Kong and Taiwan (in ascending order) deny, and the rest of Asia, including Japan, views with varying degrees of trepidation. I will therefore avoid the use of the term altogether, my marching orders notwithstanding.

Of the four parts of this discussion, the first addresses the "storm"—that is, Asia's economic turmoil, its breadth and depth, and at least some of its explanations and causes. The second considers the relatively limited impact of Asia's economic turmoil on China, Taiwan, and Hong Kong, all of which (though to varying degrees) would seem to constitute the "eye" of the storm. The third section directly addresses China's medium- to long-term growth prospects and both the positive and negative factors affecting these prospects. Finally, I conclude with some observations about other issues and "wild cards," including the possible devaluation of the Chinese renminbi, Japan's recent and current role in the Asian financial turmoil, and security issues in the Asian environment as a whole.

THE ASIAN ECONOMIC STORM

Lest excessive confidence be placed in evaluations of profoundly uncertain matters by putative experts, it is well to make passing reference to the errors they have made in previous pronouncements on the Asian economies. For example, until one month before the onset of the storm with the collapse of Thailand's baht in early July 1997, experts at the International Monetary Fund and the World Bank were forecasting continued high single-digit real growth in gross domestic product (GDP) for the Asian economies for the rest of the decade. Even after the onset of the chain reaction of currency devaluations and stock market free-falls throughout the region, another putative expert, Ezra Vogel at Harvard, characterized the ongoing situation in Asia as "an economic hiccup" of only transient significance, an interpretation embraced by President Clinton himself early in the post-crisis stages of the turmoil.

In reality, the situation has been far more severe than the experts' erroneous forecasts suggested, as illustrated by Table 1, which summarizes changes in the market capitalizations and in the corresponding currency values of the principal economies of the Asian region from June 1997 through August 1998. The first column is fairly straightforward: for example, the Indonesian stock market capitalizations lost over 40 percent of their rupiah value in the indicated time period, Korea's market lost 45 percent during that period, and so on. The "dollar value of currency" column indicates that the dollar value represented by the decline in own-currency market capitalization was further reduced by the percentages shown in the last column of the table. For example, the 41 percent decline in Indonesia's own-currency market capitalization means that a stock that was worth 100 rupiah in June 1997 was worth about 59 rupiah at the end of August. Because the value of the rupiah decreased by about 80 percent against the dollar (as shown in the second column of the table), the dollar equivalence of the 59 rupiah fell by another 80 percent. That is, at the end of August 1998, the asset originally worth 100 rupiah retained only 12 percent [.59(1.00-.80)] of the dollar value it had in June 1997. An approximate averaging over all of the Asian economies and currencies suggests that, as a general order of magnitude, an Asian asset worth 100 dollars in June 1997 was worth only 25 dollars at the end of August 1998.

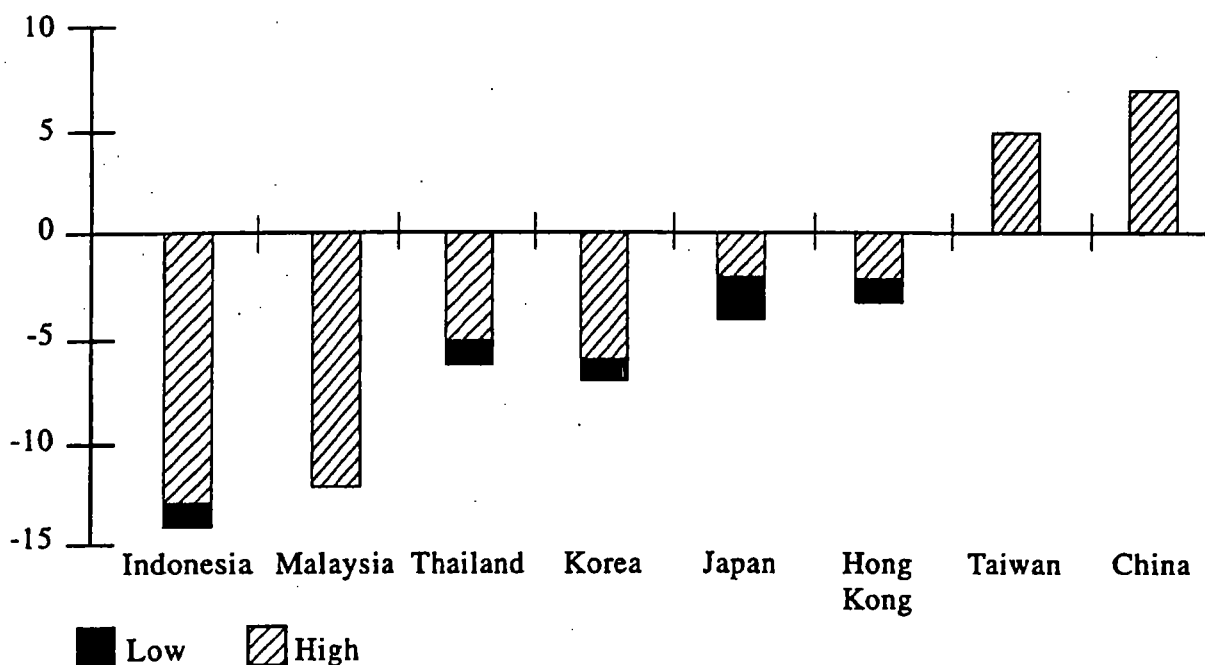
Table 1
Percentage Changes in Asian Stock Market Capitalizations and Currency Values,
June 1997 - August 1998

	<u>Own-Currency Value of Stock Market Capitalization</u>	<u>Dollar Value of Currency</u>
Indonesia	-41	-80
Malaysia	-69	-40
Thailand	-56	-40
Korea	-45	-32
Japan	-25	-20*
Hong Kong	-49	0
Taiwan	-12	-20
China	-16	0

*From early 1995 to August 1998, the yen depreciated by 40 percent; between August and October 1998, the yen recovered about 15 percent of its value relative to the U.S. dollar.

Source: The Economist (London), Financial Times, Wall Street Journal (various issues, 1997-1998).

Figure 1
Consensus Estimates of GDP Growth, 1998-1999
(in percentages per year)



Sources: as in Table 1, and author's conversations

One way of measuring the depth of Asia's economic reversal is to compare it with historic market crashes in the United States. For example, in the period from 1929 to 1932, the Standard & Poor's Index decreased by about 87 percent, in 1962 by about 28 percent, and in 1987 by about 34 percent. Note also, however, that the three entries displayed at the end of Table 1 plainly show that the severity of the economic reversals in China, Taiwan, and Hong Kong has been notably less than that experienced elsewhere in Asia.

This contrast is reinforced by Figure 1, which shows the consensus estimates of annual GDP growth for 1998 and 1999 in the same Asian countries.

In summary then, while China, Taiwan, and Hong Kong have not been unscathed, the "scathing" they have experienced is markedly less than that suffered elsewhere in East Asia.

That various explanations have been advanced for the intensity and extensiveness of Asia's economic turmoil is neither surprising nor unwarranted, in light of several factors. First, short-term borrowing by Asian corporate as well as government entities from money-center banks in Europe, Japan, and the United States was used in turn to provide still more loans or investments of dubious quality and/or longer pay-off periods. (This process of arbitraging between low borrowing rates and high lending rates was analogous to the experience of the Savings and Loan debacle in the United States in the mid-1980s.) Secondly, assumptions about the stability of semi-pegged foreign exchange rates of the Asian currencies were demonstrably mistaken. Thirdly, extraordinarily high levels of foreign debt-to-equity ratios in the private commercial sector of the Asian economies suggest contributory negligence by the principal money-center banks most responsible for the short-term foreign debt.

Another fundamental explanation that has received much less attention is the accumulated drawbacks of the so-called Japan model of development and its variants elsewhere in Asia. The essence of this model is that market mechanisms are manifestly imperfect in allocating resources. These mechanisms allegedly fail to take adequate account of such "market failure" phenomena as economies of scale, "path dependence" (which means that those who get into the market first will acquire market power with which latecomers cannot compete), and externalities that benefit the economy as a whole, but do not reward the cognizant economic actor.

Consequently, this model, which later came to be referred to as the "Asian model," urged recourse to government—that is, nonmarket mechanisms—for targeting where and to whom resources should be allocated, rather than allowing these decisions to be principally determined by market processes. In Japan, the result was a mercantilist "industrial policy," in which the Ministry of International Trade and Industry and the Ministry of Finance guided resources into targeted export industries while protecting the domestic Japanese market from import competition. The Korean variant of the Japanese model also involved collusive arrangements between the *chaebol* commercial conglomerates, the government, and financial institutions. And in Indonesia, the model was adapted and applied through the oversight and guidance of President Suharto and his family.

No doubt the Asian model had notable successes in the 1970s and 1980s. Japan attained world-class economic performance in the automotive, consumer electronics, and semiconductor industries. Korea realized similar industrial developments, as well as major capabilities in construction equipment, semiconductors, and computers. And Indonesia made significant progress in light industry and consumer goods manufacturing.

However, the cumulative negative effects of the Asian model were enormous, and indeed they underlay and accounted for the severity and pervasiveness of Asia's recent and continuing economic turmoil. These effects have included:

an enormous waste of resources, due to the non-market, "personalistic" allocative decision making in Japan (in steel, shipbuilding, and aircraft), Korea (automotive industry, steel, and shipbuilding), and Indonesia (the "Timor" car and an aborted commercial airplane industry);

structural imbalances reflected in overemphasis on exports, neglect of the domestic economy, and stunted development of domestic markets;

excess capacity in export industries, resulting in downward pressure on export prices, deterioration in the terms of trade for export industries, and eventually in currency depreciations; and

corrosive social and political effects of the personalistic favoritism embedded in the Asian development model.

The conclusion to draw from this admittedly abbreviated characterization of Asia's economic turmoil is that while the market mechanisms that the Asian model sought to correct are indeed real, invoking nonmarket remedies often leads to nonmarket failures. Personalistic decision making and governmental intervention can lead to failures that are more serious and more distorting than the original market failures themselves. It is the accumulation of these nonmarket failures and resource misallocations that underlies the sharp economic reversals experienced by Asia since the middle of 1997.

THE RELATIVE STABILITY OF THE "THREE CHINA SYSTEMS"

As previously indicated (see Table 1 and Figure 1), mainland China, Hong Kong, and Taiwan have all been affected by the Asian turmoil, but notably less so than the rest of the region. Their relative stability, however, is attributable to such sharply different policies and institutions in the three cases that it is more accurate to refer to them as "*three* systems," rather than two systems within (or potentially within) "One China." Moreover, all three systems differ markedly from the several variants of the Japanese model discussed above.

Mainland China has managed to sustain significant, though somewhat reduced levels of economic growth and productivity. This record has been abetted by substantial capital inflows (over \$30 billion annually) mostly in the form of foreign direct investment, a relatively small amount of short-term debt, a large current account surplus, and the second-largest foreign exchange reserves in the world (currently over \$140 billion). China's continued progress toward a more market-oriented system and its large, if excessively protected, domestic market have also contributed to its sustained growth. Yet the Chinese system retains a considerable legacy of centrally planned, restrictive economic policies, most notably the massive subsidization of state-owned enterprises, misguided and distorted credit allocations to the state sector at the expense of nonstate enterprises, nonconvertibility of the renminbi on capital account, and restricted foreign access to the Shenzhen and Shanghai securities markets.

Taiwan's record of relative stability, by contrast, has resulted from prudent and sophisticated macroeconomic policies (Taiwan's money supply increased only 10 percent on a year-over-year basis compared with 127 percent in mainland China), near-zero inflation, flexible foreign exchange rates, a high ratio of foreign direct investment to portfolio investment, a low level of foreign debt, and especially heavy reliance on small and medium-sized business enterprises rather than large, government-linked businesses. Taiwan has also used portions of its current account surplus for investing abroad, thereby hedging against depreciation of its own currency.

Hong Kong, formally a Special Administrative Region within China, has a system that is quite different from both the mainland and Taiwan. Its Currency Board, overseen by the Hong Kong Monetary Authority, assures that Hong Kong's money supply is firmly anchored in the U.S. dollar backing provided by Hong Kong's large (\$88 billion) foreign exchange reserves. Until 1998, Hong Kong experienced sharp inflation in both its property and capital asset markets. In part, this was due to the actual and anticipated inflow of large amounts of capital from the mainland in the form of "red-chip" stocks, which are listed on the Hong Kong Exchange but issued by mainland parent organizations. To deflate this asset "bubble," asset prices have been brought downward through extraordinarily high interest rates (above 12 percent), because the alternative means of deflating assets through currency depreciation has been precluded by the Currency Board.

In sum, while mainland China, Taiwan, and Hong Kong have all found shelter from Asia's economic typhoon, their relative stability has been achieved through very different paths, policies, and institutions, reflecting three quite different systems. Looking toward the imminent problems of reconciling sustained growth with increased openness and participation in the global economy while preserving relative stability in the face of international volatility, their respective experiences hold useful lessons.

CHINA'S GROWTH PROSPECTS

Every observer of American politics is familiar with the sometimes bizarre rhetoric of the "spin doctors" playing the "expectation game." Discussions of global economic growth are by no means immune to such obscurantism. Thus, in 1997 when Russia experienced about 1 percent real growth, that record was characterized as a highly "encouraging" performance, which, incidentally, preceded the current year's so-called "free fall" in Russia's economy. For Germany and the European Union, a prospect of about 2.4 percent GDP growth has been termed "buoyant" and "nice." For the United States, a 1997 growth rate of something slightly over 3.5 percent was termed "strong and robust," while the prospect of about 2.5 percent growth in 1999 has been referred to as "slow." By contrast, an annual growth rate of about 7 percent in 1998 and 1999 for China has been termed "weak" in light of its government's frequently enunciated goal of 8 percent.

Needless to say, therefore, the terminology typically employed in discussions of economic growth is diverse and imprecise. In part this may reflect the fact that the underlying data themselves are often unreliable and imprecise. Yet, it is also true that we tend to view growth in different regions through very different lenses: a growth rate that in one country or region is viewed as encouraging may, in another country or region, be disappointing. The same words—or numbers—mean different things in different contexts.

In considering growth prospects in China, note at the outset that RAND's 1995 long-term annual growth forecast for China (1997–2015) varied between 3 and 6 percent, depending on which of two scenarios was adopted (an "interrupted growth" or a "sustained growth" scenario).¹ In retrospect, from the vantage point of 1998, these 1995 estimates remain reasonable, although at the time they were made they represented an appreciable downscaling of the buoyant estimates made by the World Bank, Organization for Economic Cooperation and Development, and other institutions and individuals. These latter estimates predicted continued high real growth (8–9 percent) in China over the next decade or two—estimates that were made at the same time as the 1995 RAND monograph referred to above.

In fact, there are numerous reasons why mainland China's growth rates in the next decade are likely to slow down, though probably remaining strong relative to growth in other parts of the global economy.

(1) The inflow of capital, particularly in the form of foreign direct investment (FDI) and its associated technology and management, will probably diminish. In the first seven years of the 1990s, China received an annual average of about \$30–35 billion of FDI from Japan, the United States, and the European Union. This enormous inflow would have been expected to decrease even in the absence of Asia's financial turmoil since July 1997 and foreign investors' heightened aversion to risk.

(2) China's capital-to-output ratios for new investments will increase, especially due to heavy public investment in infrastructure projects (about which, more below).

(3) The government might have to declare an explicit policy of redistributing income from relatively high growth, high productivity coastal regions toward central and western provinces that continue to experience slow growth and low productivity.

(4) Operating and production costs of state-owned enterprises will rise as a result of the reform and privatization of the state sector. Of course, to the extent that this effort is effective and successful, there may be downstream benefits that will offset the initial costs and could even contribute to more rapid growth in later years.

(5) Resource allocations for military forces and technology must increase in order for the military to finally undergo Deng Xiaoping's deferred "Fourth Modernization."

Although these factors would likely have slowed China's growth in the future under almost any conditions, the regional financial turmoil will magnify their adverse effect on China's own growth in the next decade.

To offset these influences, China's top leadership has focused on an infrastructure-building strategy to "guarantee" an 8 percent annual growth rate through public investment and publicly financed economic stimuli. This strategy runs a considerable risk of squandering resources. While China certainly needs enhanced investment in infrastructure, attempting to accelerate it in the absence of adequate engineering studies, feasibility studies, and prudent implementation plans will inevitably mean that, in a hasty effort to provide employment and boost GDP growth, roads will be built from somewhere to nowhere. Excessive infrastructure outlays combined with the existing oversupply of commercial buildings will result in inflation and slower real growth in the future.

A preferable alternative would involve reallocation of credit extensions, which have in the past been granted mainly to the state sector as a form of policy-guided subsidy, at the expense of the more productive, dynamic, but relatively credit-starved nonstate sector.² Such reallocations toward private and quasi-private borrowers would have positive effects on future Chinese economic growth.

OTHER ISSUES AND "WILD CARDS"

It goes without saying that the Asian environment and its impact on growth prospects for mainland China, Taiwan, and Hong Kong are fraught with uncertainty. Some of the sources of uncertainty were omitted from the previous assessment but may reinforce it, while others may offset or modify it. One such influence would stem from possible devaluation of the Chinese renminbi. This appears unlikely, at least through the early to mid part of 1999. Devaluation would confer at best limited benefits on China because much of China's export value in turn depends on imported inputs. Furthermore, inflow of capital is more likely to be discouraged than encouraged by devaluation. Still, were the economic situation in the Asian region to deteriorate further (including appreciable weakening of the Japanese yen), possible devaluation by China could not be ruled out, and this in turn could lead to competitive depreciations of the other Asian currencies and a more protracted regional recession.

Another important potential influence might be exercised by the cross-strait discussions between China's "Association for Relations Across the Taiwan Straits" (ARATS) and Taiwan's "Straits Exchange Foundation" (SEF). If these discussions, which resumed in October 1998 after a hiatus of several years, go well in the coming months, capital flows from Taiwan to China should increase along with other bilateral economic relations. Should discussions reach another impasse, however, the effects on China's economic prospects would be detrimental.

Japan's economic prospects—and their repercussions throughout the Asia Pacific region—constitute another "wild card" adding to the region's multiple sources of uncertainty. While it may be a serious exaggeration to say that the region's economic recovery depends entirely upon Japan, there is no doubt that Japan's profoundly disappointing economic performance and ineffective efforts to improve it thus far have severe repercussions throughout the region. These efforts consist of three components: financial stabilization through a \$500 billion relief package for Japan's ailing banks, a fiscal public spending stimulus program, and economic deregulation. The package hardly addresses the Japanese economy's fundamental structural imbalance resulting from four decades of unrelenting mercantilism. Japan's heavy reliance on export-led growth and its excessive promotion of the economy's export sectors have strangled development of the domestic market and limited its accessibility to foreign exporters and investors.

Instead, from the standpoint of its own future economic growth, as well as that of China and the surrounding Asia Pacific region, Japan's economic reforms should place greater emphasis on what I have referred to as an "import-accommodating" strategy, in contrast to its long and excessive emphasis on exports.³ Without a more developed domestic market, Japan's own economic growth will be limited, as will its ability to support the recovery of the rest of Asia and the sustained growth of China.

Finally, the region's myriad security and defense problems may have severe impacts on the economic performance of China and the entire Asia-Pacific region. Potential contingencies may arise from the perennial instability on the Korean Peninsula, the possible recurrence and even escalation of confrontation in the Taiwan Strait, such as occurred in the spring of 1996, or increased tensions on China's borders with India. If such conflicts occur, they may significantly alter China's and the region's prospects.

China, Taiwan, and, to a lesser extent, Hong Kong have so far escaped the destructive winds of the Asian storm, and while their problems and challenges are numerous, their potential to cope with them effectively is great. Still, as Mark Twain observed, "It's dangerous to make predictions, especially about the future." One could add: especially about Asia.

Endnotes

¹ Charles Wolf, Jr., K.C. Yeh, et al., *Long-Term Economic and Military Trends 1994-2015: The United States and Asia* (RAND MR-627-OSD, 1995).

² Charles Wolf, Jr., "China: An Emerging 'Economic Superpower'?" in *China in the New Millennium: Market Reforms and Social Development*, ed. James A. Dorn (Washington, D.C.: CATO Institute, 1998), pp. 11-24.

³ Charles Wolf, Jr., "Japan Can't Export its Way to Prosperity," *Wall Street Journal*, May 20, 1998.

The Imperative of Financial Reform

by Nicholas R. Lardy

Creation of a modern financial system is essential if China is to achieve the central goal of its economic reform program: improving the efficiency with which capital is allocated and utilized.¹ In the pre-reform era, the rate of investment increased from about 25 percent of gross domestic product in the first Five-Year Plan (1953-57) to an average of just over 30 percent in the 1960s and 1970s. But the average annual rate of real economic growth fell from about 7 or 8 percent in the 1950s to only about 4 percent in the 1960s and 1970s. Deng Xiaoping began the process of economic reform in the late 1970s in order to improve economic efficiency and place China on a path to more sustainable growth.

The most critical step in improving efficiency of resource allocation and utilization is the creation of a modern, commercially oriented banking system. The reasons are simple. China's existing financial system revolves around banks: their share of financial intermediation is almost nine-tenths, a portion exceeding even that found in almost all other Asian countries, a region where banks generally dominate financial systems. Secondly, the development of capital markets obviously depends on a healthy, commercially oriented banking system to process payments and act as custodians. But China's banks today are financially so fragile that the government cannot allow unfettered competition for funds. The availability of significant alternative financial assets would tempt savers to withdraw their funds from bank savings accounts, thus exposing the insolvency of much of the banking system and creating the potential for a financial crisis.

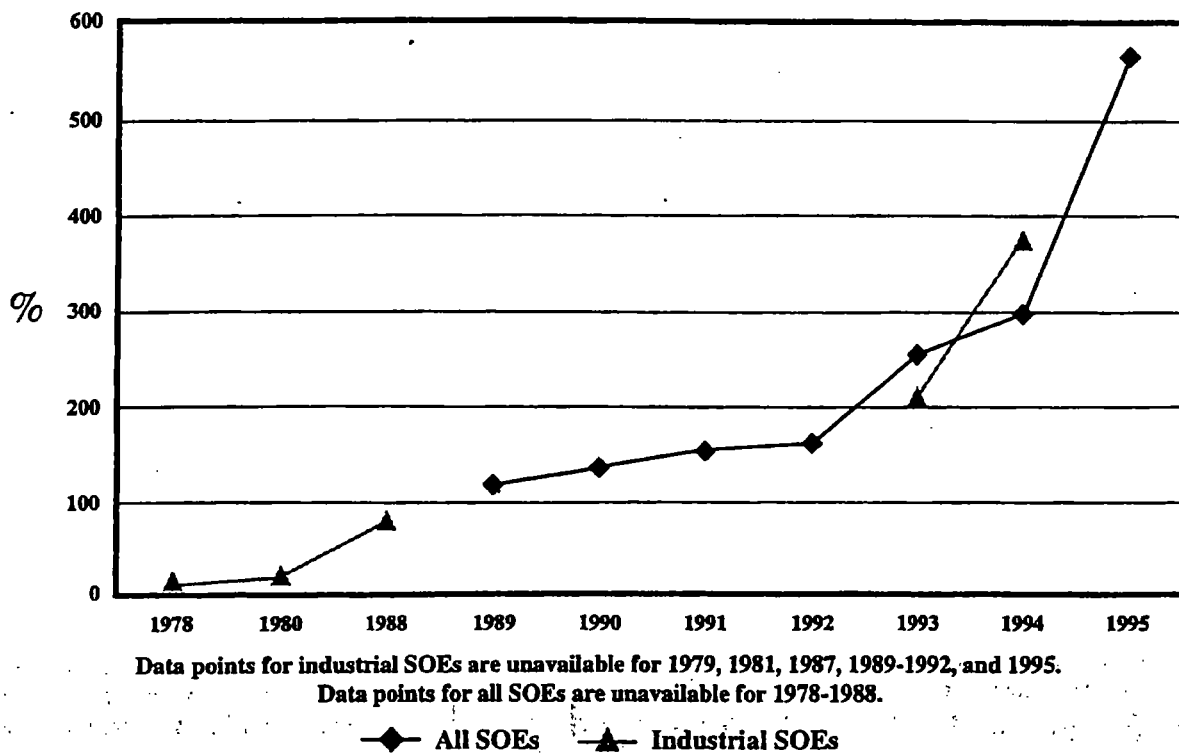
China also needs to create a capital market to supplement the role of banks in the allocation of capital. Bonds can be a more effective instrument than bank loans in providing long-term capital for infrastructure and other projects with long gestation periods, since banks are usually geared more to providing short-term funding. Equity markets can supplement bank financing for enterprises, thereby allowing them to achieve a more balanced financing structure. Bonds and equities can also offer better returns to savers, helping to maintain high savings rates. Under institutional arrangements in some economically advanced countries, the role of capital markets is quite large, even exceeding that of banks. But even when capital markets are small, their presence can increase competition in financial markets and stimulate banks to allocate capital more efficiently.

DECLINING EFFICIENCY OF RESOURCE ALLOCATION AND UTILIZATION

The failure of China's present economic system to allocate and utilize investment funds efficiently is reflected in trends both in manufacturing and in the financial sector. In manufacturing the most notable trends are the continuing long-term decline in the rate of return on assets and the increasing leverage of firms.

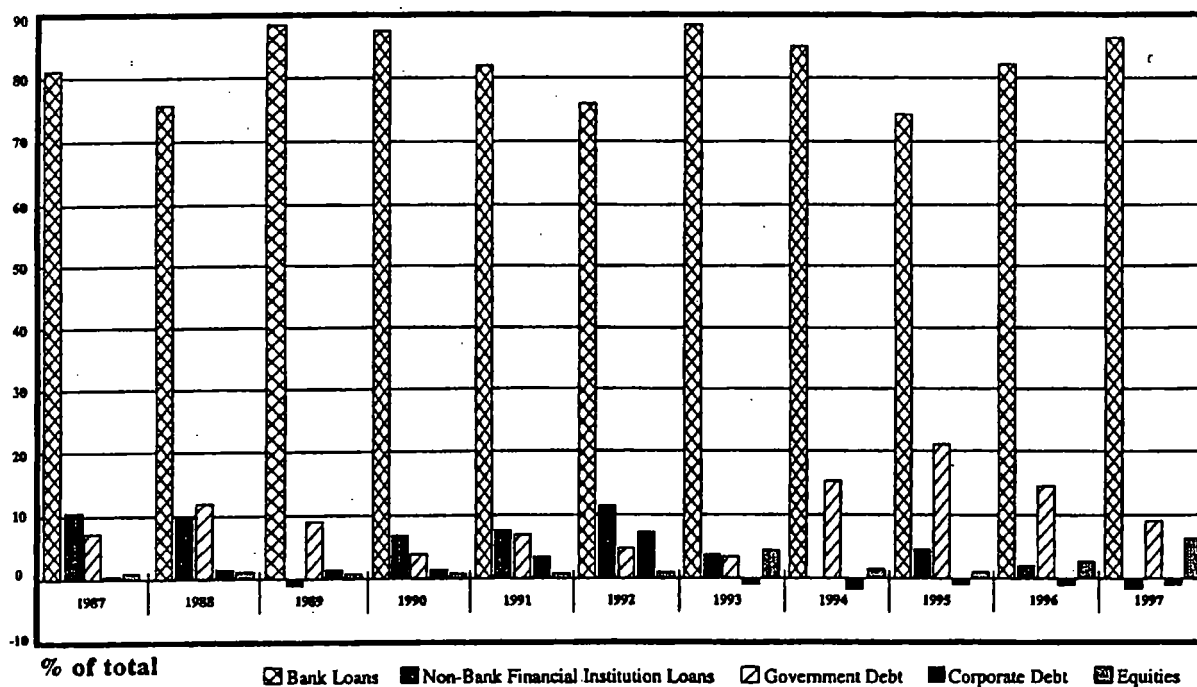
At the outset of reform, the rate of return on assets in the state-owned manufacturing firms was 25 percent, an unusually high rate that reflected the systematic underpricing of agricultural inputs used in manufacturing.² For example, low prices for raw cotton led to inflated profits in the textile industry (69 percent in 1980) and low prices for tobacco led to inflated profits in the cigarette industry (326.9 percent in 1980). During the 1980s the prices of most agricultural goods were liberalized, whereupon the average rate of return on assets in state-owned manufacturing firms abruptly fell to 17 percent. That decline largely reflected the shrinkage of supernormal profits earned in sectors that processed or utilized agricultural products. But rather than stabilizing, the rate of return continued to fall after that, reflecting the increasing inefficiency in the allocation and utilization of capital. By 1996 the rate had fallen to only 6.5 percent, relatively low for a rapidly growing, low-income economy.³

Figure 1: Debt-to-Equity Ratio of State-Owned Enterprises (1978, 1980, 1988-1995)



Source: Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Washington, D.C.: Brookings Institution Press, 1998), pg.41.

Figure 2: Domestic Financial Intermediation in China, by Type



Source: Nicholas R. Lardy, "China's Financial Sector: Evolution, Challenges, and Reform," prepared for the Asian Development Bank, August 1998.

A second indicator of declining economic efficiency, particularly in the state-owned sector, is the long-term increase in the average debt-to-equity ratio of state-owned companies. These data are summarized in Figure 1.⁴ At the outset of reform, the debt of state-owned industrial firms was minuscule since, in the pre-reform era, state-owned industrial firms remitted most of their profits to the state treasury in return for state budgetary grants that financed most of their fixed investments and their working capital needs. State-owned firms did not have to repay, or even pay any interest on, the grants; hence they had little need to borrow from banks, and their financial liabilities were extremely modest. This was reflected in an extraordinarily low 12 percent debt-to-equity ratio for state-owned industrial firms.

In the reform era these arrangements for financing investment were scrapped. The state began to curtail budget financing of working capital for state-owned firms as early as 1983, and in late 1984 the central government announced that budgetary financing for fixed asset investment would be phased out as well. Thereafter, enterprises did begin to borrow significant amounts from banks, and their average debt-to-equity ratio increased to 82 percent by 1988 and 120 percent in 1989. Ratios at these levels are not dissimilar to those characteristic of many market-oriented economies.⁵ Here, however, the reforms failed to stabilize, and the debt-to-equity ratio of state-owned companies continued to climb to 156 percent by 1991, then 300 percent by 1994, and 570 percent in 1995, the last year for which data that form part of a consistent time series are available.

The vast majority of enterprise liabilities, 85 percent in 1994, is debt to banks. This simply reflects the fact, discussed below, that corporate bonds are still an insignificant source of enterprise finance. In addition to loans from banks and a tiny value of bonds and commercial paper outstanding, the balance of the liabilities of state-owned enterprises consists of unpaid taxes and unpaid levies to social insurance and unemployment funds.

The Chinese do not include unfunded pension liabilities on the balance sheets of state-owned enterprises. The World Bank has estimated that at the end of 1995 these were the equivalent of 50 percent of gross domestic product (GDP). Nor do the Chinese include in their measures of enterprise assets the value of worker-occupied housing owned by firms or the value of land-use rights. The World Bank has estimated that over time the proceeds from the sale of urban housing and land-use rights would be sufficient to finance the implicit pension debt of state-owned firms. Thus, they are not considered further in the analysis below.

The official data on assets and liabilities result in a significant understatement of the debt-to-equity ratio of state-owned firms for several reasons. First, the data on debt exclude interenterprise debt. Since one firm's receivable is another firm's payable, the omission of interenterprise debt does not affect the debt-to-equity ratio for the economy as a whole. But our focus here is not the whole economy but the state-owned sector. State-owned firms have significant net debt to the nonstate sector, suggesting that it is easier for a state firm to refuse to pay a nonstate firm than vice versa. At the end of 1994, the net indebtedness of state-owned firms to nonstate firms amounted to renminbi (RMB) 440 billion, about two-thirds of all interenterprise debt. Adding this to the debit side of the balance sheet of state-owned firms increases the debt-to-equity ratio in 1994 from 300 to 490 percent. (The data required to make a similar adjustment for 1995 or 1996 are not available.) Secondly, compounding the understatement of liabilities, enterprise assets appear to be overstated. This arises primarily because depreciation rates used by Chinese firms are too low. Thus the depreciated value of plant and equipment, the single largest component of enterprise assets, is overstated. Thirdly, the large accumulation of inventories, a significant portion of which is likely to be unsalable, also contributes to an overstatement of assets. Whether inventories are held by the producer or by state-owned commercial firms, the result is the same—an overstatement of assets of state-owned firms. In the former case the inventories are reflected directly in the inventory line on the firm's balance sheet. In the latter case they are reflected in the accounts-receivable line.⁶

All these factors—the exclusion of net triangular debt to nonstate firms in liabilities, the overvaluation of plant and equipment, and carrying unsold inventories at their full price (whether as inventories or receivables)—result in an understatement of the debt-to-equity ratio for state-owned enterprises as a group. Moreover, the understatement probably has increased over time, because both inventories and triangular debt grew rapidly in the years up to the mid-1990s.

The rapid rise in the debt-to-equity ratio of state-owned firms and the precipitous levels they have recently reached have several important implications. First, a significant share of Chinese state-owned firms are insolvent. As early as 1994, for example, when the ratio stood at 300 percent, liabilities exceeded assets for more than one-quarter of all state-owned enterprises and another fifth were said to have assets barely greater than liabilities. In short, without taking into account net debt to nonstate firms, unfunded pension liabilities, or overstatement of assets, almost half of all state-owned firms were at or beyond the brink of insolvency. They remained in operation only because of their access to additional bank loans. A second implication of the continuous rise in the debt-to-equity ratio is that many firms incur continuous operating losses, which is to say that their output is worth less than the cost of the labor and other inputs required to manufacture it. The debt of these firms rises relative to their assets because borrowed funds are not used simply to finance fixed investment, but mainly to pay taxes, wages, and pensions, to build inventories of unsold (and, all too frequently, unsaleable) goods, and to finance the growth of accounts receivable associated with the sale of goods to state-owned commercial firms. A third implication is that state-owned enterprises are so highly leveraged that they are extremely vulnerable to an economic downturn. The average debt-to-equity ratio for these firms exceeds that of the highly leveraged Korean *chaebol* prior to the emergence of the Asian financial crisis. Korean conglomerates, which are notorious for their soaring debt, had debt-to-equity ratios between 300 and 400 percent at the end of 1996. In an economic downturn, many previously profitable Chinese firms would see a decline in their sales, with multiplied effects on operating income and net income. The operating income of more and more firms would likely fall below the level necessary to pay interest on their debts, subjecting them to the possibility of bankruptcy if their lenders were unwilling to roll over their loans. Just as importantly, an economic slowdown and the resulting increase in the share of loans on which banks receive no interest or principal payments could easily create liquidity problems for China's major banks.

The real indicators of the declining efficiency of resource allocation and utilization analyzed above are also reflected in the rapidly deteriorating condition of China's major financial institutions, particularly its largest state-owned banks. Consider that the reported profitability of China's four largest banks declined by five-sixths over the past decade, from 1.4 percent in the mid-1980s to 0.3 percent in the mid-1990s.⁷ The reality is far worse, since accrual of interest on nonperforming loans and the "evergreening" of loans (capitalizing interest payments on an existing loan when it is rolled over) are widespread. On generally accepted accounting standards, three of China's four largest banks—the Industrial and Commercial Bank of China, the Agricultural Bank of China, and the China Construction Bank—have been consistently unprofitable in recent years.

The deteriorating condition of the financial system is also revealed by the rapid buildup of nonperforming loans. The most complete data are for the four largest state-owned banks, which at the end of 1995 accounted for three-fifths of the assets of all financial institutions in China. According to statements of Central Bank Governor Dai Xianglong and other high-ranking officials in the financial system, nonperforming loans, as a share of total loans, increased from 20 percent at the end of 1994 to 22 percent after 1995, and to 25 percent by the end of 1997. Moreover, the share of nonperforming loans that is accounted for by the most impaired categories of nonperforming loans has increased. Specifically, the sum of the share of loans that are outstanding to firms that have already gone through bankruptcy and been liquidated without the banks recovering their loans (so-called dead loans) and loans that are two years or more overdue (so-called doubtful loans) increased by at least half between 1994 and the end of 1997.

Data reflecting the quality of assets at other major financial institutions, both banks and non-bank financial intermediaries, are more limited than those for the four largest state-owned banks. It appears likely, however, that the quality of assets in some of these institutions is even lower, and deteriorating even more rapidly, than in those four. For example, the Agricultural Development Bank, created only in 1994, has grown extremely rapidly and has emerged as China's fifth-largest bank, with assets in excess of RMB 710 billion by the end of 1996. But even as its assets have expanded, their quality has deteriorated more rapidly. The acknowledged share of nonperforming loans surged from 20 to 27 percent between December 1995 and February 1997.

Finally, the increasingly fragile condition of the financial system is reflected in the precipitous decline in capital adequacy (the ratio of a bank's own capital to its total assets) of the largest state-owned banks. The capital of the big four state banks declined from 13.2 percent of assets in 1985 to 3.1 percent of assets in 1996.⁸ The total capital of the Agricultural Development Bank is even smaller, only 1.85 percent of assets at year-end 1996.⁹ While China has embraced in principle the desirability of banks' achieving the Basle standard of 8 percent capital adequacy, the reality is that its capital adequacy has been falling steeply for years. Even the central bank's capital injection of RMB 270 billion into the four largest banks in the late summer of 1998 leaves them, as a group, far short of the standard, which is weighted to require banks to hold more capital against higher-risk assets.

Moreover, even this assessment is far too optimistic since it is based on official data. Bad debt still carried as assets on the balance sheets of the banks substantially exceeds the reserves available to finance write-offs, implying that such write-offs will have to come out of each bank's own capital. Secondly, except for the Bank of China, the largest state-owned banks do not report their financial results on a consolidated basis, which allows them to bury nonperforming assets in subsidiary companies. On generally accepted accounting standards, three of China's four largest banks are insolvent by a very wide margin.

A BANK-DOMINATED FINANCIAL SYSTEM

The dismal performance of Chinese banks would be of little concern if their role in the economy were modest. But by several measures, the efficiency with which banks allocate capital is central to sustaining China's economic growth. First, a large share of investment is financed with credit extended through the financial system. In 1996, for example, increased lending by banks and nonbank financial institutions was RMB 1.08 trillion, an amount equal to 40 percent of gross domestic capital formation that year. The dependence of the state-owned sector on bank credit to finance investment is especially acute. The declining rate of return on assets over the past two decades means that after-tax profits are of diminishing importance as a source of investment funds. In 1996, for example, the after-tax retained profits of state-owned manufacturing enterprises were RMB 149 billion, an amount equal to only 11 percent of the combined value of their fixed asset investment of RMB 703 billion and increased working capital investment of RMB 604 billion in the same year.¹⁰

Secondly, lending by banks, which goes almost entirely to the state-owned sector, has been financed overwhelmingly by household savings. The share of deposits in all financial institutions derived from households has risen continuously during the reform period, from 18 percent in 1980 to 57 percent at year-end 1997. The amounts involved are huge. By the end of 1997 household savings deposits in banks and rural credit cooperatives stood at RMB 4,628 billion, an amount equal to 62 percent of GDP.¹¹ If the efficiency with which banks allocate credit does not improve substantially there is an increasing likelihood of a banking crisis which would have substantial negative consequences for economic growth.

Finally, banks are the dominant institutions in financial intermediation. Figure 2 shows the relative importance of domestic financial intermediation through five different channels over the past decade: loans from banks and nonbank financial institutions, as well as markets for government debt, corporate debt, and equities. Between 1987 and 1997 banks consistently accounted for somewhere between 75 and 90 percent of all intermediation between savers and investors. Although there appears to be no trend in the bank share of intermediation, the figure for 1997 actually was 5 percentage points higher than in 1987. The role of non-bank financial institutions has been cyclical, reaching relatively high levels of around 10 percent in 1987 and 1988 and again in 1991 and 1992. Central authorities successfully curtailed that role during the period of austerity in 1989-90 and have done so on a more sustained basis since 1993.

Intermediation through the government debt market was modest until 1994, the first year in which the government was no longer allowed to finance its deficit by borrowing from the central bank. In the three years 1994-96, the government debt market accounted for an average of 17 percent of all intermediation, more than twice its average 7 percent share in the seven-year period from 1987 to 1993.

Funds raised through the issuance of corporate debt and equity not only remain extremely small, they actually shrank between 1992 and 1996. The peak issue of corporate debt, both in absolute amount (RMB 48.9 billion) and as a share of total intermediation (7.3 percent), was in 1992. Intermediation via the corporate debt market since then has been negative because the redemption of existing corporate debt exceeded new debt issuance starting in 1993. Consequently the stock of corporate debt outstanding, which stood at an historic peak of RMB 82.2 billion at the end of 1992, an amount equal to 3.4 percent of GDP, fell to RMB 59.8 billion at the end of 1996, an amount equal to only 0.9 percent of GDP!¹²

Prior to 1997 the peak role for equities was in 1993, when they accounted for 4 percent of all intermediation.¹³ In the three years after that, the relative importance of equity markets in intermediation declined by two-thirds. In the three years 1994-96, corporate debt and equities combined accounted for only 0.7 percent of all forms of domestic financial intermediation. Only in 1997, when they accounted for an estimated 6 percent of all intermediation, did equity markets surpass their relative role of 1993. Whether this is the beginning of a new, more prominent role for equity markets remains to be seen. The domestic (A Share) market was very strong in 1997, particularly in the first half of the year when the majority of the new issues and rights issues came to market. But the pace of issuance in the final quarter of 1997 fell off considerably as A Share prices tumbled, and the number of new issues remained low in the first half of 1998 by comparison to the same period in the previous year.

The corporate debt market had no honeymoon at all and continued to shrink in both 1996 and 1997. In 1998 the planned total issuance of corporate bonds was only RMB 30 billion.¹⁴ That is less than half of the issuance in 1992, the peak year, and just equal to the value of new issues in 1995. Based on past trends, it is likely that about RMB 22 billion in corporate bonds will mature and be paid off in 1998. Although that would make 1998 the first year of positive net corporate debt issuance since 1992, the corporate debt share of total financial intermediation is likely to remain trivial at about 0.5 percent.

IMPLICATIONS

Judged from the perspective of its financial system, China's economic reform is only half finished. To be sure, China has abandoned the heavy reliance on budgetary financing of investment characteristic of the pre-reform era, and investment, particularly in the state sector, is now financed primarily by banks. But the banking institutions are state owned and embedded in a financial system that impedes the efficient allocation of capital. The new system, moreover,

involves the buildup of enormous liabilities to households, the source of the savings that the banks channel to state-owned firms. However inefficient the allocation of resources was in the pre-reform system, at least investment through the budget was financed from current tax revenue and involved no accumulation of liabilities to households in the form of savings deposits. Today, every household's nest egg is at risk.

If China fails to complete the transformation of its banking system, the consequences are predictable. The intermediation of funds between savers and investors by banks would likely continue to be marked by the inefficiencies already apparent. As the contributions to economic growth of various one-time factors wind down, one would expect the long-term rate of growth of the economy to slow. An inefficient banking system also would impede the development of stock and bond markets which, as per capita output rises and appropriate regulatory structures are developed, normally come to play an important supplementary role in the allocation of resources. The continued fragility of the banking system would limit the ability of the People's Bank to use open market operations to dampen the fluctuations in economic activity that have characterized the reform era.

Ultimately, the failure to transform the banking system on a timely basis dramatically increases the probability of a domestic banking crisis. A crisis is most likely to be triggered when domestic savers lose confidence in the government's implicit guarantee of their bank deposits, the conceivable result of any number of events: a growth slowdown that obviously further weakened the domestic banking system; the prospect of a major devaluation in response to an emerging current account deficit or sharp fall in foreign direct investment; or a premature move toward capital account convertibility or opening up of domestic financial markets. Such a crisis would likely lead to an inflationary spiral, a dramatic curtailment of the growth of bank credit, and a sharp recession. It would also endanger the high rate of domestic savings that has been the major source of China's rapid growth in the reform era.

Endnotes

¹ This paper draws on Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Washington, D.C.: Brookings Institution Press, 1998), and "China's Financial Sector: Evolution, Challenges, and Reform," a paper prepared for the Asian Development Bank, Aug. 1998.

² The rate of return concept used here is pretax profits divided by the sum of the depreciated value of fixed assets plus working capital. Barry Naughton, *Growing Out of the Plan: Chinese Economic Reform 1978-1993* (Cambridge: Cambridge University Press, 1995), pp. 236-40.

³ Lardy, *China's Unfinished Economic Revolution*, p. 48.

⁴ In these data equity is defined as assets minus liabilities.

⁵ The debt-to-equity ratio of the companies in the Standard and Poor's 500 in 1998 was 42 percent, the lowest in 30 years.

⁶ These two items are usually the principal contributors to the line-item current assets in firm balance sheets.

⁷ These data are pretax profits expressed as a percentage of bank assets. Lardy, *China's Unfinished Economic Revolution*, p. 100.

⁸ *Ibid.*, p. 93.

⁹ *Almanac of China's Finance and Banking 1997* (Beijing: China Financial Publishing House, 1997), p. 502.

¹⁰ Lardy, *China's Unfinished Economic Revolution*, p. 238.

¹¹ People's Bank of China, *China Financial Outlook 98* (Beijing: People's Bank of China, 1998), p. 93.

¹² China Securities Regulatory Commission, *Zhongguo zhengquan qihuo tongji nianjian 1997* (Chinese securities and futures statistical yearbook 1997) (Beijing: Chinese Statistical Publishing House,

1997), p. 5; State Statistical Bureau, *Zhongguo tongji zhaiyao 1993* (A statistical survey of China 1993) (Beijing: Chinese Statistical Publishing House, 1993), p. 6; *Zhongguo tongji zhaiyao 1998* (A statistical survey of China 1998) (Beijing: Chinese Statistical Publishing House, 1998), p. 12.

¹³ Data on the funds raised in the equity markets include the value of both new listings and rights issues of already listed companies. Issuance of rights began in 1993 and in some years has accounted for a large share of the total amount of funds raised in equity markets. For example, in 1994, rights issues accounted for half of the RMB 10 billion raised in equity markets.

¹⁴ Wang Lihong, "New Era Predicted for Corporate Bond Market," *China Daily Business Weekly*, Nov. 10, 1997, p. 1.

Political Implications of a Slowdown

by Avery Goldstein

How will the economic turmoil in Asia affect China's domestic politics and foreign policy? This question is difficult to answer because doing so requires more knowledge than we now possess, knowledge about the nature of the current economic context and its probable evolution, as well as the links between economic forces and political outcomes. Yet insufficient knowledge, whether factual or theoretical, is a problem that usually bedevils policy analysts. The best that social scientists can do is to offer forecasts with varying levels of confidence, or provide competing hypotheses about causes and effects that may serve as alternative road maps for interpreting events as they unfold.

My effort in this vein begins with a necessary simplifying assumption about the nature of the economic causes whose political consequences will be considered. The premise for my analysis is that China has entered a period of slower growth. By this I mean only to rule out two among many alternative economic scenarios. The first alternative set aside is one in which the Chinese economy performs "much better than expected," quickly resuming the sort of rapid expansion that it experienced for much of the 1980s and 1990s. A return to nearly double-digit growth is unlikely in part because of the dampening effects of the economic reforms launched at the Fifteenth Chinese Communist Party (CCP) Congress in 1997, which address the shortcomings of state-owned enterprises (SOEs) and the financial system, and in part because of the dampening effects of the international economic crisis of the late 1990s, in which China's foreign trade and investment suffer because of reduced demand and nervousness about the viability of emerging markets.

The second alternative set aside is one in which China's economic performance is "much worse than expected," with the country entering a period of sustained stagnation or crisis replicating the troubles experienced in the late 1990s by Indonesia, South Korea, Russia, or Japan. The reasons for discounting this possibility are not as obvious, but China's performance since 1997 offers evidence that the current political leaders in Beijing, unlike their counterparts in the capitals of some of the other struggling economies, are both aware of the challenges they face (i.e., they do not seem prone to sustained denial or self-delusion) and within their authoritarian political system are able to respond in a reasonably timely fashion (i.e., they do not seem prone to policy immobilism). Neither realism nor decisiveness ensures success, especially given the many other defects of China's one-party system (most notably a seriously hampered flow of reliable information), but their absence would be a significant handicap.

Additional reasons for believing that China may be able to avoid the worst-case scenario are linked to the country's economic distinctiveness—especially the extent to which it is buffered from the effects of the international economy by a large domestic market that reduces dependence on foreign trade, a currency that is not fully convertible, and massive accumulated foreign exchange reserves. As with the political advantages, these economic advantages are no guarantee against collapse, but at least they provide China's leaders some breathing room to attempt a response to the domestic and international challenges of sustained growth.

Ruling out the extremes of boom and collapse, of course, still leaves a fairly wide range of possibilities in which China's economy performs somewhat better or worse than expected—for illustrative purposes perhaps falling in the range of 3.5–7.5 percent growth around an expectation of 5.5 percent. But anywhere within this range, China's political leaders face a more difficult context for formulating policy than has been the case for most of the 1990s. This context is distinguished from the boom scenario in which a rapidly expanding pie eases redistributive effects, as well as from the crisis scenario in which a fixed or even shrinking pie makes tough

decisions nearly impossible. Under the stipulated economic circumstances, which are more difficult but not disastrous, what domestic and foreign policy consequences can one anticipate? The effects on the ongoing economic reform program, elite politics, popular pressure for change, and China's more active diplomacy of the late 1990s are likely to be far reaching. But, as explained below, because the new situation creates both challenges and opportunities for China, the effects are likely to be mixed.

DOMESTIC CONSEQUENCES

Impact on the economic reform agenda. The economic slowdown is shaping the debate about the optimal path and pace for advancing economic reforms, though not the leadership's commitment to pursuing the fundamental changes it has clearly decided are necessary. By 1992, the discrediting of state socialism around the world greatly diminished the chances that China's current leaders would consider "reversing course." Nevertheless, in 1998 the tarnishing of the East Asian model of development began to have profound effects on what had become the real focus for debate in Beijing—not whether, but *how* to advance economic reform.

The vivid regional examples of the problems of the East Asian model of industrial policy, which had been obscured by success until they emerged with a vengeance late in the decade, underscore the challenges and opportunities the current crisis represents for China's current leaders. It is a challenge inasmuch as China's more ardent reformers had taken the East Asian model as a rough template they would adapt to their own national circumstances.¹ Yet the regional crisis is an opportunity for China's reformers inasmuch as their country may now benefit from being one of the last affected by the economic turmoil. Much as late-industrializing states have been able to benefit from what Alexander Gerschenkron termed "the advantages of backwardness," Beijing has the opportunity to learn from others' recent experience in industrial, trade, and financial policy. This advantage will not make it easy for the CCP to solve the massive problems in its heavy industrial and banking sectors.² It does, however, provide ammunition to officials determined to discredit painless solutions as illusory, since they can now point to their obvious failure elsewhere. In short, the timing of the Asian crisis, coming as it has at the dawn of the current wave of Chinese industrial and financial reforms, provides at least the opportunity for China to avoid newly identified pitfalls in the East Asian development strategy.

Impact on the central leadership. As the post-Deng leadership sorted itself out in 1997–98, a de facto division of responsibilities emerged between the country's top two political leaders—the president and party general secretary Jiang Zemin, and the government's premier, Zhu Rongji, who ranks third in the party hierarchy behind Jiang and retired premier Li Peng. Jiang is now most closely identified with China's newly activist foreign policy whereas Zhu is most closely identified with the new wave of economic reforms. How might the current economic slowdown affect the working relationship between these two leaders?

Although Jiang and Zhu have common political roots in Shanghai, this fact should not obscure their quite different reputations. Despite Deng Xiaoping's anointing of Jiang as successor in the wake of the June 1989 shakeup, many within China and abroad viewed him as a lightweight and had low expectations for his performance after his patron's passing. Most skeptics, however, have been surprised not just by his success at appointing his preferred candidates to key posts, but also by his competence as China's primary international representative. Jiang's busy diplomatic agenda over the past two years, especially the frequent high-profile summit meetings, has clearly enhanced his own stature. Even if few observers have altered their basic assessment of Jiang's credentials, many seem to believe he has exceeded the initially low expectations.

Zhu Rongji, by contrast, rose to national prominence saddled with high expectations. Credited with engineering China's soft landing after the bout of high growth and high inflation in the mid-1990s, Zhu was widely touted by 1997 as the right man for the tough job of finally tackling the weak, massive underbelly of China's economy, the unprofitable SOEs and the

politically encumbered financial institutions that support them. Yet this seemed to be at best a thankless task and at worst a politically suicidal one. What would constitute success? Who would credit Zhu if, as premier, he oversaw a process by which millions of people were thrown out of work and hundreds of thousands lost powerful managerial positions? Surprisingly, perhaps, Zhu's prospects may turn out not to have been quite as bleak as they seemed at first blush, in part due to the regional crisis. The changed circumstances provide a legitimate reason for lowering what otherwise might have been an impossibly high hurdle for him to clear (i.e., unrealistic expectations about growth rates and the speed of implementing painful reforms) in order to be judged successful. In other words, expectations have shifted in ways that require Zhu only to do the difficult, rather than achieve the impossible.

Even with Jiang riding the crest of respectability and with the bar lowered for the highly regarded Zhu, however, potential problems loom for this crucial relationship. On the one hand, if the economic crisis and difficult reforms result in a serious threat to social order, Jiang, following the pattern set by both Mao and Deng, may attempt to shift the blame to Zhu as the scapegoat who would be accused of mistakes in translating broad guidelines into actual policy.³ On the other hand, if Zhu's administrative touch again proves sure, he may well begin to eclipse the president, which the latter would hardly welcome.⁴ Under such circumstances, Jiang would probably look for some way to boost his own standing, most likely through a bold initiative for which he alone could take credit.⁵ In either case, the essential point is that the economic slowdown and the regime's response to it will unavoidably become key issues that determine the evolution of the Jiang-Zhu relationship over the next five years.⁶ Within a political system as weakly institutionalized as China's, the personal strength and qualities of such leading individuals have a far greater impact than in systems with well-established constitutional orders.

Impact on the military's role. Over the past decade, two trends in the relationship between the party-state and the military (the People's Liberation Army, or PLA) have been evident: efforts to distance the military from the bloody task of repression the party leaders assigned it in June 1989, and toleration of military-run businesses as a supplement to the PLA's inadequate share of the national budget. The thread connecting these two trends is military professionalization and modernization. The PLA's core mission is safeguarding China's security in an uncertain and dangerous world. This requires sustained funding for a decades-long effort to cultivate the personnel and procure the equipment adequate to a world-class fighting force. Tapping the PLA to preserve domestic political order or requiring the PLA to generate its own sources of funding is both an unwanted diversion from the military's core mission and a recipe for a loss of focus, if not endemic corruption, in the ranks. Recently the PLA's representation at the highest levels of the party has been reduced, and Jiang Zemin has announced a program to divest the military of its commercial activities. It is reasonable to believe that Jiang and his associates were able to secure the military's support for these changes by assuring the PLA's top leaders that they would provide the military with both the political insulation it needs to enable it to focus on its professional task and a steady stream of revenues from the national budget to offset lost revenues from the PLA's commercial enterprises. How might the economic slowdown interact with these efforts to reconstitute the PLA's position in the system? Among the possibly mixed effects are the following: (1) difficulties in fulfilling the commitment to provide increased funding for military modernization as the slowdown constrains the central budget; (2) a decline in the attractiveness of the PLA's commercial enterprises as a source of funding in difficult economic times, facilitating the regime's efforts to separate such ventures from military organizations; (3) renewed military resentment of the political leadership if it becomes necessary to call on the PLA, rather than just the People's Armed Police, to contain economically motivated social unrest.⁷

Impact on elite succession. The current central leadership in China is composed of individuals committed to reform, but whose intellectual background and formative political experiences are a product of socialization during the Soviet period (i.e., mostly pre-Cultural Revolution China). The Chinese refer to this group as the "third generation" and some analysts

have labeled them a technocratic elite. Indeed, they are likely to have advanced degrees and experience in technical fields, unlike their predecessors from the Mao and Deng "generations" who often had a meager formal education and made their mark by waging revolution or organizing political struggles. But most members of this more technocratic group still have one foot in the pre-reform past. While they understand the economic, political, and administrative shortcomings of the one-party, state-socialist system, it is difficult for them—more difficult for some (Jiang) than for others (Zhu)—to act on the implications of intellectual arguments alone, especially when doing so means admitting that most of what they had sincerely believed to be true about politics and society when they entered adulthood has now been revealed as misguided, if not utter nonsense.

No sophisticated understanding of cognitive dissonance theory is required to grasp the anxiety such an admission induces in individuals in the twilight of their careers. In the 1980s, China's reforms entailed an easy renunciation of the excesses of radical Maoism and a palatable whittling away at the trappings of the communist system. By the 1990s, the reform agenda was left with the most difficult tasks (dismantling SOEs, depoliticizing financial institutions, and devising legal and electoral methods for ensuring official accountability) whose completion would result in a system that would be communist in name only. This prospect troubles the current generation, as is evident in their ever more convoluted explanations about how each new reform measure remains true to "socialism with Chinese characteristics."⁸ The fourth generation, and those to follow, are unlikely to be so torn.

Many of China's leaders-in-waiting are individuals whose formative experience fundamentally differs from that of their predecessors. The older members of this cohort (those in their late forties and fifties) participated in a Cultural Revolution that inculcated a rebellious attitude, a disdain for Soviet socialism, and (as the movement degenerated) a deep cynicism about its Maoist alternative. Many of those who are younger, or whose lives were not destroyed in the 1960s and 1970s, have also benefited from exposure to advanced Western education. Thus, unlike their parents who have one foot in the 1950s, this cohort is more clearly part of the contemporary world. Their decisions about policy matters are much more likely to be guided by technical assessments about what will work and political judgments about what is best for their country than by worries about the need to preserve a failed ideological legacy. In the late 1990s, however, these future leaders seem surprisingly prepared to wait their turn, a patience that the recent international problems have reinforced.

Because they are sensitive to the risk that things can get much worse, China's successor elite is not inclined to press for "change at any cost." When they reflect on their participation in or support for the demonstrations in spring 1989, while never forgiving the brutality of the military crackdown, they are often self-critical about the movement's lack of sensible organization and its leaders' unwillingness to compromise. They wonder whether victory at the time might have resulted in a breakdown in social order such as occurred during the Cultural Revolution, or a slide into the sort of economic and political stagnation they observe in post-Soviet Russia. More recent events in Indonesia, Russia, and even Japan have added sobering lessons about the fragility of economic success and the risks of political weakness. An economic disaster in China that fostered a belief that things could not get much worse might prompt this group to push for radical solutions (though it is an open question whether the preferred solution would be support for wholesale liberalization or a temporary military junta). But the more likely scenario of a modest slowdown will encourage them to bide their time, allow nature to take its course, and continue to devise pragmatic plans for tackling the problems they expect their predecessors will bequeath to them.

Impact beyond the elite. In 1989 millions of urban Chinese voted with their feet in support of political change and against continuation of what they deemed a corrupt communist leadership that was insensitive to the hardship and insecurity many faced during the economic

troubles of the late 1980s. In the late 1990s, corruption remains pervasive, and for many urban Chinese the slowdown in economic growth combined with a new wave of reforms that is putting irreparable cracks in the "iron rice bowl" has again heightened anxiety and prompted some labor unrest. Whether such demonstrations are a portent of renewed popular pressure for change depends in part on the severity of the slowdown. If unemployment balloons beyond current expectations and the regime calls for repression that local leaders or military commanders are unwilling to carry out, all bets are off. But if the combination of carrots and sticks on which the regime presently relies is sufficient to prevent the formation of a better organized labor movement, then limited unrest is unlikely to catalyze broader social protest. The more circumspect attitude of China's younger elite, especially the intellectuals, limits the pool of talent from which leaders of such a movement would emerge. And, more importantly, some of the same influences that have tempered the radicalism of that elite also influence the average citizen. In the late 1980s, events outside China helped fuel support for the massive demonstrations. Increasing public awareness of the prosperity achieved by other East Asian countries and the political example set by Gorbachev's *glasnost* raised the bar for assessing the CCP regime. By contrast, events outside of China in the 1990s have progressively lowered the bar, beginning with the post-Soviet failures of Russia and culminating with the collapse of the very East Asian economies Chinese had envied in the 1980s. Those Chinese who follow the news no longer have many external examples that would inspire them to take the risks that activism entails. In 1989, many may have believed that change could only be for the better—but by 1998 there was plenty of evidence to the contrary.

In the near term, lowered expectations and fear of the unknown may benefit a CCP whose right to rule is now based essentially on its ability to deliver the goods. If even the lowered material expectations are unmet, however, danger looms. Absent concrete achievements, the current government cannot tap a reservoir of legitimacy based on an enduring belief that they are an ideologically sanctioned vanguard, or that they are the product of a constitutionally enshrined process of selection. Moreover, the CCP's margin for error is further limited because popular expectations about the regime's performance are no longer tied just to growing incomes, but to a host of challenging quality-of-life issues, many linked to the country's intolerable environmental degradation. The floods of 1998, and perhaps more importantly the assessment of responsibility that will follow, will be yet another crucial test of the regime's ability to fulfill the basic tasks of governing. Assuming it does not fail this test disastrously, the absence of a viable alternative to the current communist regime will continue to limit the prospects for an upsurge in popular demands for political change. Should such an alternative appear, however, most likely from among a respected faction within the party, few enduring bonds of loyalty would prevent "the masses" from shifting their allegiance.

FOREIGN POLICY

Just prior to the onset of the international economic crisis, China's foreign policy had entered a new phase as Beijing began to react to its initial failure to cope with the realities of the post-Cold War era. For the nearly four decades during which world politics were defined by bipolarity, China had aligned with one superpower to balance the threat posed by the other. But the demise of the Soviet Union gave birth to a new strategic landscape in which no combination of powers could match the capabilities of the United States. That did not mean that the "sole remaining superpower" could easily dictate outcomes around the globe, but it did mean that the Americans could act as they chose without much worry that their security could be fundamentally jeopardized by the reaction of a peer competitor. For China the advent of unipolarity presented a novel challenge. As realists would anticipate, Beijing was determined to offset U.S. power and the various difficulties it posed for China. At first, China's foreign policy emphasized self-strengthening and alliance formation, but that policy alarmed others and seemed to be triggering a self-defeating hostile reaction. Hence Beijing shifted to a more subtle approach under which it has sought to reassure others about its intentions and cultivate strategic partnerships with the system's major powers.

China's post-Cold War foreign policy: phase one. During the transition to the post-Cold War era, from 1989 through 1991, the leaders in Beijing had focused on surviving the collapse of communist regimes in Europe that followed closely on the heels of the massive demonstrations in China during the spring of 1989. Beleaguered at home and besieged by criticisms and sanctions from abroad, the regime saw politically motivated instability as the principal security threat at a time when external military pressure was not much of a problem. Suppressing dissent, restoring economic growth, and resisting the dangers of "peaceful evolution" were the components of Beijing's recipe for "weathering the storm." By 1992, the domestic crisis had passed. Yet, the emerging contours of American post-Cold War foreign policy jeopardized China's interests insofar as it emphasized the enlargement of the allegedly pacific democratic community. China's communist leaders correctly concluded that such enlargement put them in the cross hairs. Indeed, the two major options for U.S. China policy both seemed to spell trouble for Beijing: containment entailed revived East Asian military alliances and arms sales to Taiwan, while engagement attempted to pry open Chinese society through economic inducements (what in an earlier time the CCP had labeled the "sugar-coated bullets of the bourgeoisie").

Unsure about the purposes to which the unchecked power of a hostile United States might be put, China accelerated its military modernization and, to the extent feasible, attempted to cultivate improved relations with others nervous about American dominance. The resumption of rapid economic growth in 1992 provided the wherewithal to carry forward the program of reform and revitalization of the antiquated PLA begun in the 1980s. At the same time, the desperation of former Soviet arms producers provided an opportunity to supplement this national effort with the purchase of relatively advanced (though not state-of-the-art) Russian equipment. As a result, during the early 1990s China began to create a few "pockets of excellence" within the PLA. In the arena of international security competition, however, relative capabilities are what counts, and by this measure China's self-strengthening was at best a long-term project in its early stages.⁹ Since armaments could only slowly and modestly enhance China's security, Beijing also searched for allies. The only viable candidate, both in terms of capabilities and (ironically) a willingness to eschew the ideological litmus tests some Western powers imposed, was Russia. A series of Yeltsin-Jiang summits culminated in the April 1996 announcement that the two countries had established a "cooperative strategic partnership" based on common concerns about the way the United States was wielding its unprecedented power. Heading the list of concerns for Russia was the eastward expansion of NATO. Heading the list for China was the U.S. rejuvenation of its Cold War alliances in East Asia (especially with Japan) that seemed part of a de facto anti-China containment strategy.

To be sure, neither the Chinese nor the Russians were interested in a true anti-American alliance. The slight additional military payoff of an actual alliance would be more than offset by the damage it would do to the two countries' development strategies, dependent as they are on integration with the advanced industrial countries, especially the United States. But, in a modified revival of the Cold War's strategic triangle, the closer Sino-Russian partnership provided a source of leverage for improving relations with the United States.¹⁰ Although the "Russian card" was hardly an ace, for China no aces were available.

Unfortunately, China's initial effort to augment its own capabilities and search for a weighty international partner proved counterproductive. Beijing's behavior after 1992 had the effect of hardening the perception of a "China threat" that already ran ahead of any real increase in the country's capabilities. Many observers tended to ignore, or at least downplay, the fact that such equipment purchases were not sufficient to reverse the imbalance in fighting power between China and its plausible adversaries. They also tended to gloss over shortcomings in training that raise questions about the ability of even the best-equipped Chinese units to perform as advertised.¹¹ Nevertheless, concern about a presumed trajectory of Chinese economic growth that

would quickly and easily be translated into military power was aggravated in 1995-96 when Beijing decided it was necessary to reassert its claim to Taiwan by demonstrating a willingness to use force to preclude the island's independence.

China may have viewed its military exercises and missile firings in mid-1995 and early 1996 as a domestic crisis provoked by the devious Taiwanese president Lee Teng-hui and a duplicitous United States. But key regional actors interpreted the PLA's actions as a portent of China's general willingness to use force to pursue its international interests. The U.S. aircraft carrier maneuvers in response to the crisis, the Clinton administration's pledge to keep 100,000 troops in East Asia, and the final touches put on the American post-Cold War security arrangements with Japan and Australia led Beijing to conclude that China was the potential enemy against whom these powers were hedging their bets. The security benefits from the selective purchase of Russian military equipment and the comforting rhetoric of diplomatic agreements with Moscow were more than offset by what appeared to be the emergence of an encircling anti-China coalition. Beijing needed to devise a strategy that would forestall this unacceptable outcome.

The new strategy that has emerged since mid-1996 thus aims to reduce the exaggerated perceptions of Chinese capabilities and aggressiveness, increase the benefits others attach to China's development, and reduce the cohesiveness of any nascent anti-China coalition. To realize these aims and smooth out what had become a very rough path to great-power status, Beijing has adopted a more cooperative diplomacy designed to allay fears about China's aggressive unilateralism. It has also sought to improve bilateral relations with each of the major powers through "strategic partnerships" designed to introduce the dynamics of multipolarity into what remains basically a unipolar system.

China's post-Cold War foreign policy: phase two. China's diplomatic change of course after spring 1996 addressed the reaction to its growing capabilities and assertive regional behavior. To be sure, Chinese spokesmen had consistently argued that the "China threat theory" was absurd, that their national defense buildup was purely defensive in nature, and that the notion that China needed to be contained was groundless.¹² But however well articulated, "cheap talk" could not discredit the "China threat theory" by itself. To match words with deeds, China sought to cultivate a reputation as a cooperative and responsible actor, most notably through its new approach to multilateralism and its reaction to the international economic crisis that arose in East Asia during 1997.

In a departure from its previous hostility towards multilateralism, China began in the mid-1990s to evince a greater appreciation of its benefits.¹³ At a minimum, Beijing apparently concluded that accepting the constraints that come with working in multilateral settings was preferable to the risk of isolation and encirclement that its aloof stance and assertive behavior were creating.¹⁴ Indeed, a more receptive posture on multilateralism would not only dampen the "China threat" fever, but foster a positive perception of China as a responsible international partner. Agreeing to the Comprehensive Test Ban Treaty, cooperating with the effort to promote peace on the Korean peninsula, joining the international community in condemning the South Asian nuclear tests of 1998, demonstrating flexibility on settling its differences with the ASEAN states, and negotiating agreements on the disputed borders with its former Soviet neighbors are all reflections of Beijing's new belief that multilateralism can be a key element in its campaign to alter perceptions of an aggressive China.¹⁵

The effects of an economic slowdown on China's embrace of multilateralism are likely to be slight. It is possible that an interest in eliciting China's cooperation to help manage, if not solve, the international economic crisis may facilitate the negotiations for China's accession to the World Trade Organization (WTO) and its participation in other important multilateral economic entities such as the G-7/G-8. The net effect of the downturn on these negotiations is unclear,

however. The United States and European Union, while wanting to integrate China more fully, are unlikely to agree to the special developing-state status China demands if that is seen as unfairly restricting European and American trade and investment. And although China covets the political prestige of WTO membership (especially in its continuing rivalry with Taiwan) and the even loftier status that joining the G-7/G-8 would confer, the international crisis may reduce the economic attractiveness of membership. If China's current reforms slow growth and increase unemployment, it is less likely that Beijing will agree to terms of membership that expose its economy to stiffer international competition.

The connection between the economic slowdown and another key aspect of China's new foreign policy line, its currency policy, is more straightforward than the implications for its new multilateralism. As the East Asian financial crisis deepened and threatened to spread around the globe during 1998, Beijing's stance on its currency reflected the broader foreign policy goal of transforming the 1995-96 image of China as an irredentist, revisionist, rising power, into the 1997-98 image of China as paragon of international responsibility. What would constitute an economically sensible Chinese reaction to the currency devaluations undertaken by major trading states in East Asia is debatable.¹⁶ But Beijing's announcement and repeated assurances that it would not devalue the renminbi in an effort to maintain the competitiveness of Chinese exports is clearly politically sensible. Foreign analysts continue to speculate about the likelihood that China will devalue because declining exports are hurting economic growth at a moment when the regime is undertaking painful domestic reforms. The more they speculate, the greater the payoff for Beijing in terms of a reputation for selfless internationalism in contrast to the narrowly self-interested approaches of others in the region, and in terms of the increased credibility of its international promises in contrast to the unfulfilled or broken promises of others in the region. Even if the pressures build to the point that devaluation becomes an economic necessity, the longer China is able to delay the decision, the more likely it will be able to portray the step as a result of others' (e.g., Japan's) failure to assume their responsibilities while China shouldered more than its share.

Bilateral relations in a unipolar world. Steps to alter the interpretation of China's growing power were only part of the PRC's new approach to advancing its interests in the post-Cold War world. Beijing has also sought to recast its bilateral relations with each of the world's major powers in ways that anticipate the eventual emergence of multipolarity while recognizing the immediate need to reduce the likelihood that others might collaborate with the United States to oppose China. To accomplish this objective, in 1996 Beijing set out to build "strategic partnerships," a term first applied to the relationship it had recently cultivated with Russia.¹⁷

What are "strategic partnerships," and with whom are they being established? In practice, the essential elements of a strategic partnership are a commitment to promoting extensive economic intercourse, muting disagreements about domestic politics in the interest of working together on diplomatic matters of shared concern, and planning routine and frequent official visits, especially by representatives of each country's top military and civilian leaders. Thus far, China has declared that it is building strategic partnerships with Russia and the United States, but recent developments in China's bilateral relations with Europe and Japan suggest that it expects others to follow.

Such partnerships are designed to enhance the attractiveness of close relations with Beijing without requiring China firmly to align with any particular state or group of states. Asserting that the old categories of ally and adversary are relics of the power politics that defined the Cold War, Beijing now seeks to link itself to each of the world's other major powers in order to increase the costs they would face if they took actions contrary to China's interests.¹⁸ Improved

opportunities for foreign trade and investment with China and effective management of security problems such as weapons proliferation and terrorism are among the benefits strategic partners would put at risk if they chose to put pressure on China and sour bilateral relations.

Beijing values these strategic partnerships not only because they allegedly promote international peace, stability, and mutually beneficial economic relations, but also, as repeatedly emphasized in the Russian case, because they tend to foster the emergence of a multipolar international system in which the United States would no longer be so dominant.¹⁹ Moreover, cultivating strategic partnerships enables China to pursue this goal without resorting to the more directly confrontational (and given the current power distribution, probably futile) alternative of straightforward counterhegemonic balancing. Indeed, by eschewing alliances and cultivating strategic partnerships, Beijing not only avoids antagonizing others or exacerbating concerns about its intentions, it also gains a propaganda advantage. It can now portray U.S. foreign policy as stubbornly anachronistic insofar as it emphasizes efforts to reinvigorate, expand, and redirect Cold War alliances in Asia and Europe.²⁰

How might an economic slowdown affect these efforts to recast China's relations with the world's other major powers? China's strategic design seems tailor made for the current international situation. With so many important nations in crisis, China's "partners" are less likely to press Beijing very hard on issues ranging from trade to human rights. Even a troubled and imperfect China may in fact appear to be a reassuring pillar of stability that no one wants to upset. As the international economic crisis has unfolded, the new approach already seems to be shaping China's relations with the United States, Japan, and Russia.

Sino-American relations. Less than a year into the process of constructing the Sino-American strategic partnership, there were plausible indications that Washington's concern about the regional economic crisis was increasing China's leverage with the United States. By insisting that President Clinton make no side trips to American allies, especially Japan, in conjunction with the summer 1998 summit meeting, China not only sought acknowledgment of its special great power status, it also sought to elevate the status of Sino-American ties relative to the recently strengthened U.S. links to Japan. And, by successfully urging President Clinton to repeat one of the more explicit "one-China" mantras (the three noes) during his post-summit tour of the PRC, Beijing sought not only a confirmation of official U.S. policy, but also new leverage in the run-up to its resumption of talks with representatives from Taiwan.

Such matters might seem more symbolic than substantive. After all, Japan remains the principal American ally in the Pacific, as Secretary of State Albright assured leaders in Tokyo on her return flight from the China summit. And the public record of U.S. policy on cross-strait relations is defined not just by the "three communiqués," and now "the three noes," but also by the Taiwan Relations Act, the complex and wide-ranging history of commentary from leading spokesmen in the executive and legislative branches, and a track record of American action during the 1990s that includes arms sales (F-16s) violating the spirit of the communiqués and the U.S. show of naval force in March 1996. But in Tokyo and Taipei, if not in Washington, the symbolism of the Clinton-Jiang summit was alarming, mainly because it could be read as a portent of Washington's growing willingness to accommodate China's interests in the region.

Sino-Japanese and Sino-Russian relations. The international economic crisis is also affecting China's bilateral relations with Japan and Russia. Although these two neighboring powers are obviously different in many ways, there is an underlying similarity in China's vision about their future strategic significance.²¹ Even before the summer 1998 collapse of Japan's Hashimoto premiership and worsening of the situation in Russia, Chinese analysts did not expect Japan or Russia to recover quickly from the domestic problems that limited their international clout. In the near term, this means that neither will pose much of a threat to China's vital interests that would complicate mutually beneficial relations. But in the longer term, Japan and Russia will recover, and when they do, even China's more "liberal" foreign policy elites expect geopolitical

imperatives to result in rivalry and suspicion rather than trust and cooperation. Beyond this long-term strategic similarity, however, the current economic slowdown affects China's relations with Japan and Russia in different ways.

The economic slump in Japan has muted China's initial post-Cold War concern that Japan might quickly reemerge as an active and possibly threatening player in East Asia. Believing that the crisis has increased Japan's economic interest in good relations with China, Beijing hopes to parlay this interest into leverage on other issues. Since the mid-1990s announcements of China's strategic partnerships with Russia and the United States, Japanese delegations have asked their counterparts in Beijing why Sino-Japanese relations are not given this label. Part of Beijing's reluctance to establish a strategic partnership with Tokyo is Japan's limited international profile on many of the areas of security cooperation that define such a bilateral relationship. But another part may be a belief that Tokyo can now be made to pay a price as a sign of good faith.

Given China's long-standing conviction that Japan's past behavior remains a reliable guide to its future inclinations, China's asking price for upgrading relations seems to be a convincing display of contrition for Japan's behavior in China during World War II and iron-clad assurances that Tokyo will not become involved in any future Taiwan Strait crisis. China may have anticipated that an economically strapped Japan would so covet closer ties with China that it would be willing to meet these demands. But so far Japan has resisted. At the November 1998 summit in Tokyo, the Japanese refused to go beyond previous apologies for the country's wartime behavior, commit to anything stronger than their basic Taiwan policy recognizing Beijing as the sole government of China, or promise any specific responses to hypothetical future contingencies.²² Ironically, troubled Japan has thus far seemed less susceptible to China's pressure than the more secure United States. Why? One possibility is Tokyo's resentment of what it fears may be an emerging U.S.-Chinese condominium. Another is resentment of China's loud public suggestions (at times echoing similar ones from Washington) that Japan behave more responsibly and take the tough measures needed to get its economic house in order. Although it is too early to draw definitive conclusions, recent events suggest that Japan's economic problems are leading China to believe it can take advantage of the weakened country—even as Japan becomes increasingly wary of others, especially the Chinese, taking advantage of its vulnerability. If so, the regional economic turmoil would in part explain the failure to realize the hopeful expectation, expressed after Hashimoto's September 1997 visit to China, that 1998 would be the year for a decisive breakthrough in Sino-Japanese relations.

Economic difficulties in Russia, by contrast, have both benefited and bothered Beijing. Earlier in the decade, economic weakness encouraged Yeltsin's Russia to permit the sale of advanced military equipment to China. Weapons and weapons platforms were among the few Russian industrial products (oil and natural gas being the others) for which there was much of a demand. But arms and energy exports aside, Russia's economic weakness has limited the anticipated growth in bilateral trade. During the 1990s, both sides touted the potential for mutual economic benefit and lamented the failure to realize it.²³ Moreover, since 1994 Russian fears about the consequences of facilitating China's growing power have emerged, thereby reducing the desirability of large-scale arms sales, however economically profitable they may be.²⁴ Analysts I met in the summer of 1998 seemed resigned to the fact that Sino-Russian relations had hit a plateau. Russia would be a limited economic partner valued mainly as part of the solution to China's energy shortage, a limited military supplier whose wariness would constrain the quantity and quality of arms China could purchase, and a limited strategic partner who shared Beijing's apprehensiveness about U.S. international dominance, but whose overall value was diminished by improving Sino-American relations.

Effects on China's military power. Finally, what is the likely potential effect of the economic slowdown on China's military power? As noted above, what counts in international politics is relative power. Thus, one must consider not only the way in which constrained central

budgets may limit the resources that the regime can devote to military modernization, but also the extent to which China's plausible rivals are constrained. The effects of the slowdown are likely to be mixed. If China's ASEAN neighbors continue to suffer the worst effects of the crisis and, as has recently been the case, sharply cut their military spending, then even a somewhat slower PLA modernization drive may enable China to score relative gains.

China's most important theater of operations for the immediate future is not the South China Sea, however, but the Taiwan Strait. Will slower growth on the mainland significantly affect the cross-strait military balance? Here political motivations on both sides (determining what Chas. Freeman labels "the balance of fervor") seem sufficiently strong that economic considerations are unlikely to prove decisive. The mainland's drive to improve its power projection capabilities is more likely to be affected by the availability rather than the expense of superior foreign technology—not just from cash-strapped former Soviet states, but from lower-profile suppliers such as Israel and the major states with whom China is cultivating its strategic partnerships. Similarly, Taiwan's drive to maintain a defensive capability sufficient to dissuade the mainland from opting for a military solution is not likely to falter because of a lack of resources. A more probable obstacle would be decreased willingness on the part of suppliers such as the United States and France to risk losing the perceived benefits of their recently improved ties with Beijing by continuing to sell advanced weaponry to Taiwan.²⁵

The economic slowdown also seems unlikely to have a net effect on the military balance between China and the two major powers in East Asia for whom the PLA is no match. Japan's economic crisis would have to cut much deeper and last much longer before its qualitative advantage in military forces eroded significantly, although it is conceivable that even a slower-growing Chinese economy may enable PLA modernization to yield marginal and selective improvements relative to Japan. Indeed, Japan's economic woes might redound to China's benefit in the area of theater missile defenses (TMD). Tokyo's on-again, off-again plans to cooperate with the United States in developing TMD in East Asia (together with related U.S. projects linked to Australia and Taiwan) have been most alarming for Beijing because ballistic missile capability is one of the few aspects of military power in which China has some significant strength. Intensifying economic concerns as well as fears about alienating China have fueled Japan's second thoughts about cooperating with the Americans on TMD. Yet even on this dimension of the military balance, the net effects of recent international developments are unclear. Japan's rekindled interest in TMD (as well as in deploying its own reconnaissance satellites) following the September 1998 North Korean missile test should serve as a reminder that the link between narrow economic considerations and international security policy is tenuous at best.

Slower economic growth is also unlikely to alter dramatically the prospects for a shift in the military balance between China and the United States. China is so thoroughly outclassed by U.S. forces under the Pacific Command—not to mention those that Washington could make available if need be—that even a return to double-digit growth rates would not permit the PRC to become a peer competitor for at least several decades. Of greater importance, however, is the possibility that slower growth would prevent China from realizing its short-range military modernization objective—deploying forces that significantly raise the costs and risks to the United States should it attempt to intervene militarily on regional matters of vital interest to Beijing (especially Taiwan). This shorter-term objective is nearly within China's grasp, and the currently tightening economic constraints are not likely to affect its imminent realization. China's small contingent of advanced air and naval forces (especially the Russian Sovremennyyi destroyers, 636-class Kilo submarines, and Su-27 fighters), along with a growing arsenal of theater ballistic and cruise missiles, ensure that the PLA will soon be able to inflict massive punishment on, even as it is defeated by, superior American forces. Moreover, the capacity to ensure a sustained, intense engagement elevates the always small but terrifying risk of escalation to the nuclear level, an influence on crisis management that constrains both parties. Thus, the current economic crisis is unlikely to have a decisive impact on China's determined but measured pace of military

modernization. It will not prevent Beijing from achieving its short-term objective and, barring a disastrous economic decline, is only loosely related to its achieving more grandiose objectives in the long term. For the time being, the effect of a more lethal but still outclassed PLA on U.S. policy and action in East Asia will be determined by the balance between Chinese and American interests at stake and the price (blood and treasure) that each side is prepared to pay in support of those interests, but not by the prospect that China will be able to militarily defeat American forces in the region.

CONCLUSION

As noted at the beginning of this essay, policy forecasting is fraught with uncertainty. Predictions about even well-institutionalized political systems are difficult. Predictions about a weakly institutionalized, rapidly changing system such as China's may be an exercise in futility. Moreover, it is hard enough to identify the most important forces at work and their likely consequences when focusing on smaller pieces of the big picture in China—looking separately at domestic politics, foreign policy, economic reform, or foreign trade. Conclusions about the results that follow from the interaction of these and other pieces of the puzzle must be handled with care. Nevertheless, the broad conclusion offered here is that the consequences for China of the sort of economic slowdown postulated are likely to be subtle rather than dramatic. Along some dimensions I have indicated the ways in which the less robust international and domestic economic situation will pose challenges and perhaps problems for China's domestic politics and foreign policy, though most would seem to fall in a category best labeled "manageable." I have also suggested, however, that in some respects the currently gloomier economic context may yield benefits domestically and internationally for China's leaders. In general, these benefits are a consequence of lowered expectations and the fact that, so far, others are suffering more than China. This suggests two limitations to the usefulness of this analysis, beyond the obvious possibility that it may simply be incorrect on its own terms. First, an unlikely resumption of robust growth in China could introduce forces for change, especially those associated with rising expectations about performance at home and abroad, that exceed the regime's managerial talents. Secondly, a slide into an unexpectedly disastrous economic crisis could introduce different forces for change, especially those associated with desperation, that lead to elite or popular pressure for dramatic shifts in domestic or foreign policy.

Although it is sensible to frame policy based on analysis of the most plausible scenario, the degree of uncertainty in this particular case is high and the consequences of being wrong are not trivial. As policymakers consider how best to advance U.S. interests in a rapidly changing post-Cold War world in which China will play a significant role, the only policies that are almost certainly wrong are those that rely on simplistic historical analogies (e.g., with imperial China or the Soviet Union), or on excessive confidence in the indeterminate implications of social science theories. The foregoing analysis should therefore be considered not as a collection of specific predictions with ready-made policy implications, but as a modest attempt to highlight the key issues and the forces that may shape their evolution.

Endnotes

¹ In 1997, for example, there was much talk of recombining some of the SOEs into large-scale conglomerates that sounded similar to Korean *chaebol*. Within months, as the connections between this aspect of South Korea's industrial strategy and its economic crisis became evident, China's leaders seemed to abandon the *chaebol* as a model for emulation. A fraction of the largest SOEs would remain in public hands, but leaders understood the need for arrangements other than those that had already failed elsewhere in the region.

² See "Zhu Rongji Reform Programme Hampered by Floods, Asian Crisis," Agence France-Presse, Sept. 10, 1998, from ClariNet (clari.world.asia.China).

³ When price reform triggered inflation in 1987, Deng Xiaoping shifted blame to Premier Zhao Ziyang. On several occasions between 1949 and 1976 (most dramatically the Great Leap Forward, and more than once during the Cultural Revolution) Mao Zedong blamed his lieutenants for the disastrous outcomes that followed his unorthodox policy initiatives.

⁴ Such anxiety may partly explain Jiang's determination to boost his stature by taking credit for leading the battle against the tragic floods of summer 1998.

⁵ Two obvious candidates are relations with Taiwan and political reform. There are already some indications that Jiang would like to pursue these possibilities, though the former depends on internal Taiwanese developments he cannot control and the latter carries the risk of unleashing forces that have historically proven difficult to control. Because he embraced the soft line on Taiwan in January 1995 just prior to Lee Teng-hui's American visit, Jiang must remain sensitive to charges of appeasement, even as he encourages a resumption of cross-strait dialogue. Political reform is an undercurrent that many in the next generation are eager to advance; rumors of study groups and occasional publications discussing modest improvements in the legal and electoral systems suggest official patronage for these exploratory activities. The most famous political opening that spun out of the party's control was the 1957 Hundred Flowers Campaign, but cautious party leaders find similar lessons about the uncontrollable consequences of relaxed party leadership in the events of the Cultural Revolution, the Democracy Wall experience, and the 1989 demonstrations at Tiananmen Square.

⁶ By 2002, Jiang will have served his maximum two five-year terms as CCP general secretary, and Zhu Rongji will be past the informally agreed upon retirement age of seventy. If China's communist experience is a guide however, one or both may assume new positions that enable them to continue to wield power from behind the scenes.

⁷ Such use of the PLA contrasts with its use in disaster relief missions (e.g., during the 1998 flood season) that provide opportunities to refurbish the military's image as the "people's" army that was so tarnished during the military crackdown in June 1989.

⁸ The process of gradual redefinition is evident in the speeches of general secretaries at each of the party congresses since the early 1980s.

⁹ On China's arms purchases and their affect on PLA modernization, see Avery Goldstein, "Great Expectations: Interpreting China's Arrival," *International Security*, Winter 1997/98, pp. 36-73.

¹⁰ For the classic statement of the triangular logic, see Lowell Dittmer, "The Strategic Triangle: An Elementary Game-Theoretic Analysis," *World Politics*, July 1981, pp. 485-516.

¹¹ See Goldstein, "Great Expectations."

¹² See Chi Haotian, "Zou Fuhe Woguo Guoqing Bing Fanying Shidai Tezheng de Guofang Xiandaihua Jianshe Daolu" (Follow the path of modernizing national defense suited to our national conditions and the characteristics of our times), *Qiushi*, Apr. 1996, p. 10. For a particularly virulent attack on "China threat theory" as a latter-day version of the "yellow peril theory," as actually a "threat to China" theory, and as a "trick to intimidate and hold China back," see Li Jun, "On Strategic Culture," Foreign Broadcast Information Service (hereafter, FBIS) CHI-97-092, May 14, 1997, from *Zhongguo Junshi Kexue*, Feb. 1997.

¹³ China's hostility was rooted in the fear that multilateral institutions could be tools that the U.S. and Japan would use to pressure China. On China's new approach, see General Secretary Jiang Zemin's report to the Fifteenth CCP Congress in September 1997, published in "Hold High the Great Banner of Deng Xiaoping Theory for an All-Round Advancement of the Cause of Building Socialism with Chinese Characteristics into the 21st Century," *Beijing Review*, Oct. 6, 1997, pp. 10-33. See also Liu Di, "Deng Xiaoping's Thinking on Diplomatic Work and China's Diplomatic Policy—Interview with Liang Shoude, Dean for College of International Relations for Beijing University," FBIS-CHI-97-310, Nov. 7, 1997, from *Ta Kung Pao*, Nov. 2, 1997. On the change in China's approach to multilateralism, see Alastair Iain Johnston and Paul Evans, "China's Engagement with Multilateral Security Institutions" (unpublished manuscript), p. 44.

¹⁴ For this view of China's changing position reflected in the ASEAN Regional Forum, see the analysis by Masashi Nishihara of Japan's Defense University, "Aiming at New Order for Regional Security—Current State of ARF," FBIS-EAS-97-321, Nov. 19, 1997, from *Gaiko Forum*, Nov. 1997.

¹⁵ See "Roundup: China Becoming Active Force in Multilateral Cooperation," FBIS-CHI-97-001, Jan. 3, 1997, from *Xinhua*, Jan. 2, 1997. At every opportunity China proudly points to the April 1996 five-nation treaty (among China, Russia, Kazakhstan, Kyrgyzstan, and Tajikistan) on military confidence-building measures in the border areas as "the first multilateral treaty signed to build confidence in the Asia-Pacific region" and cites it as a "powerful rebuttal of the 'China threat theory,'" evidence that "instead of being a 'threat,' China actually plays a constructive role in preserving peace and stability in its peripheral

areas." See Xia Liping, "Some Views on Multilateral Security Cooperation in Northeast Asia," FBIS-CHI-97-074, Apr. 18, 1997, from *Xiandai Guoji Guanxi*, Dec. 20, 1996; "Five-nation Agreement Provides Model in Peaceful Conflict Resolution," FBIS-CHI-96-145, July 29, 1996, from *Jiefang Ribao*, Apr. 27, 1996.

¹⁶ Among the considerations that would determine the economic benefits of devaluing the renminbi are: the outcome of a competition in devaluation by China's trade rivals, the demand for Chinese goods at lower prices, secondary effects on the Hong Kong dollar and financial institutions, and the increased cost of foreign inputs for China's export industries.

¹⁷ China uses the "partnership" label with smaller states as well, but indicates that it reserves the term "strategic partnership" to define a "new way of handling relations between major countries in the post-Cold War period." See "China: Qian Qichen on 'Constructive' Strategic Partnerships," FBIS-CHI-97-307, Nov. 4, 1997, from *Xinhua*, Nov. 3, 1997; Lu Jin and Liu Yunfei, "New Analysis: From Beijing to Washington and From Moscow to Beijing—a Revelation of New-Type Relations Between Major Powers," FBIS-CHI-97-313, Nov. 12, 1997, from *Xinhua*, Nov. 9, 1997; Zhang Yifan, "From 'Playing Card' to Establishing Strategic Partnership," FBIS-CHI-97-364, Jan. 1, 1998, special interview with Yang Chengxu, director of the China Institute of International Studies, *Hsin Pao*, Dec. 25, 1997. Despite these published definitions, interviews I conducted in Beijing during June and July 1998 suggest room for disagreement about exactly what the term "strategic partnership" denotes.

¹⁸ For discussion of the varying content of these bilateral relationships, and a comparison between this strategy and that pursued by Bismarck in the nineteenth century, see Avery Goldstein, "An Emerging China's Emerging Grand Strategy: The Neo-Bismarckian Turn," unpublished paper prepared for the Penn-Dartmouth conference on "The Emerging International Relations of the Asia-Pacific Region," May 8-9, 1998, Christopher H. Browne Center for International Politics, University of Pennsylvania. On the alleged obsolescence of alliances in the post-Cold War world, see "Gouzhu Xin Shiji de Xinxing Guojia Guanxi" (Building a New Type of International Relations for a New Century), *Renmin Ribao*, Dec. 8, 1997, p. 6. On the opportunity costs others will confront if they fail to maintain their partnerships with China, see Shi Nangen, "1997: A Fruitful Year in China's Multi-Dimensional Diplomacy," *Beijing Review*, Feb. 16, 1998, pp. 6-7.

¹⁹ See "Yici Yiyi Zhongda Yingxiang shenyuan de Fanwen-Zhuhe Jiang Zhuxi Fang E Yuanman Chenggong" (A Trip Of Great Significance And Far-Reaching Influence—Congratulations On President Jiang's Completely Successful Russian Visit), *Renmin Ribao*, Apr. 27, 1997, from (www.snweb.com/gb/people_daily/gbrm.htm); "Li Peng Zai Mosike Jishou Zizhe Fangwen" (Li Peng's Interview with Reporters in Moscow), *Renmin Ribao*, Feb. 19, 1998.

²⁰ See Zhao Gangzhen, "Daguo Guanxi, 'Huoban Re'" (Big Power Relations, 'Partnership Fever'), *Renmin Ribao*, Apr. 21, 1998. Chinese defense minister Chi Haotian told U.S. defense secretary William Cohen during the latter's January 1998 visit to Beijing "that at present, relations between major powers are undergoing a strategic readjustment. In the new situation, neither expanding military alliances [i.e., NATO] nor strengthening military alliances [i.e., U.S. alliances with Japan and Australia] is conducive to maintenance of peace and security." See "China: Expanding Military contacts part of Diplomatic Strategy," FBIS-CHI-98-051, Feb. 23, 1998, from *Xinhua*, Feb. 20, 1998.

²¹ This section draws on interviews the author conducted with foreign policy elites in Beijing during June and July 1998.

²² Press reports suggested that Jiang Zemin postponed his state visit to Japan in September 1998 not because of the flood emergency in China (the official explanation), but because the two sides were unable to agree on a joint statement about Taiwan. See "Chinese President Jiang's Visit to Japan May Be Delayed to Next Year," Agence France-Presse, Sept. 10, 1998, from ClariNet. The subsequent, more public wrangling over both the Taiwan issue and a formal apology for Japan's behavior during the Pacific War lend credence to this interpretation of the postponement. China's disappointment with the summit communiqué's language on these matters was reflected in the decision not to sign the document. See Michael Zielenziger, "Talks Fall Short for China, Japan," *Philadelphia Inquirer*, Nov. 27, 1998.

²³ The frequently touted target of \$20 billion in trade by the end of the century is well out of reach.

²⁴ Geopolitical concerns compounded Moscow's fears about China's intentions in Russia's Far East, and resentment of a Chinese component to resurgent organized crime in Russia.

²⁵ In 1997 France officially announced it would discontinue such sales, though there have been reports of new deals in the works.

The Future of Sino-American Relations

by Murray Weidenbaum

An old Mandarin proverb states, "If you think you understand China, you don't." That warning also sums up the challenges that face Americans in dealing with this fascinating part of the world.

When viewed separately, each of the various aspects of policy involving China—economic, political, military, and environmental—while difficult, is perhaps manageable within a sufficiently tough-minded decision-making process. But no aspect can be approached in isolation from the others and, taken together, they involve ever more complicated interrelationships. For example, more liberal flows of trade and investment are likely to generate a higher living standard in China, but would also generate more environmental pollution, enhance China's ability to expand its military establishment, and increase political tensions.

The challenge of reconciling these factors becomes even more overwhelming when we introduce the possibility of significant change in the economic outlook facing China. But no matter how daunting that task, we must attempt it.

THE PARADOX OF U.S.-CHINA ECONOMIC RELATIONS

Let us begin with one of the more measurable clusters of U.S.-China relationships—the economic. From any statistical point of view, China is once again becoming an important economic power. Using the purchasing power parity form of measurement, the Chinese economy is now more than half as large as that of the United States and larger than Japan's.¹ (Conventional measures of international economic comparisons underestimate the economies of developing nations and thus show that Japan's economy is still the largest in Asia?)

The U.S. economic relationship with this rising power is marked by paradox. First, China is a major trading partner: over \$60 billion of commerce flows each year between the two nations. On reflection, however, the term "partner" is a euphemism for what surely is a very uneven set of commercial flows. The United States imports from China more than four times the dollar amount of American exports to China. That trading relationship is far more out of balance than the comparable data for Japan, which has been the object of so much intense public discussion over the years. Secondly, unlike the case of Japan, most of the opposition to continuing normal trading relationships with China does not arise from those who believe they are hurt by the large excess of imports. Rather, the pressure emanates from groups concerned primarily with noneconomic factors, notably the harsh treatment of religious minorities, political dissidents, and Tibetans. Thirdly, despite its status as a major trader with the United States, China's commerce is actually not a highly significant portion of the American economy, aside from low-priced clothing, toys, and electronic parts. However, the United States is the destination of almost one-third of China's exports, plays a key role in that nation's acquisition of technology, and generates a substantial part of China's large accumulation of foreign exchange.

It is in this atmosphere of paradox that we must consider the new economic scenario created by the prospect of slower growth in China's economy. Until very recently, most forecasters were projecting a continuation of the past impressive performance. The Chinese economy has been growing on average at about double-digit rates for the two decades since Deng Xiaoping began his noteworthy efforts toward liberalization. However, a similarly optimistic forecast for the next two decades is not realistic given the array of economic, political, social, and cultural barriers to China's continued rapid development, as well as the current economic difficulties on the part of China's trading partners in East Asia.

So far, China has emerged relatively unscathed from the financial problems besetting its neighbors, but that is more report than forecast. Other economies in the region suffered significant reductions in their exchange rates against the dollar between July 1, 1997, and May 1, 1998, ranging from 10 percent in Singapore to 70 percent in Indonesia, whereas China experienced a slight rise of 0.5 percent. In terms of growth in real gross domestic product, every other nation in the region reported slowdowns or recessions of various magnitudes. China's estimated 1998 expansion rate of 5 to 7 percent, although lower than recent years, maintains its position as the Asian growth leader.³ Important signs of weakness are nonetheless visible, including diminished export growth, stagnant industrial production, and continued financial losses in state-owned industries.

What would be the impact of a major slowdown in the still rapidly rising Chinese economy? Let us assume that China's gross domestic product in the coming decade will no longer grow at 10 percent a year, but at half that rate. Five percent, of course, is still quite respectable by the standard of the more mature Western economies, which average 2.5 percent economic growth annually. The initial impacts of such a new scenario would likely be negative for the American economy, but quite uneven and limited. U.S. exports to China, which are relatively modest to begin with, would rise more slowly than they do now. A limited number of sectors would be affected, mainly machinery and equipment, chemicals and plastics, aircraft, electronic equipment, and agricultural products. Not much change would occur at first in China's exports to us. On balance, the American trade deficit with China would increase only slightly, but enough to exacerbate increasingly contentious issues of American domestic policy. A more rapidly rising trade deficit with China would reduce the chances of Congress's approving "fast track" treatment of international trade treaties. Moreover, a larger import surplus might also tend to increase the opposition to providing more U.S. funding to the International Monetary Fund (IMF) to support weak economies in Asia and elsewhere.

As in other policy areas, the position taken by American business would hardly be uniform. Companies that export to or invest in China would continue to support open trade policies. On the other hand, American firms hurt by competition from low-cost imports of consumer products have not exactly been supportive of improved Sino-American relations, nor have their employees or adjacent communities.

AMMUNITION FOR THE CRITICS OF FREE TRADE

A rising trade deficit with China would provide the critics of free trade with more ammunition. As Barry Bosworth of the Brookings Institution notes, it is unlikely that either Europe or Japan would have allowed a trade relationship as unbalanced as that which now characterizes the United States and China.⁴ In a somewhat more positive vein, an increased imbalance would probably add momentum to the attempts that every recent American administration has made to open China's markets. However, if trade talks heat up just when the Chinese economy is weakening, Chinese leaders would be unlikely to respond in a positive manner.

Nevertheless, serious institutional barriers inhibit a more balanced flow of U.S.-China commerce and ought to command the attention of both governments. In contrast to the relatively open U.S. market, numerous obstacles face American exporters to China, notably, onerous licensing procedures such as quality certification and "automatic" registration requirements. China does not accept U.S. quality certification on most products, but instead requires separate inspections. Automatic and compulsory registration applies to about four hundred products, typically electronics and machinery. Moreover, U.S. producers of computer software, video tapes, compact discs, books, and motion pictures suffer because their products are frequently copied illegally in China. This intellectual piracy costs U.S. companies some \$2 billion per year in lost foreign sales.⁵ This "piracy," it should be noted, is a Western concept and not an Asian one.

A slowdown in China's growth is also likely to cloud the expectations of U.S. and other Western investors. Most can be expected to soft-pedal the current cliché—"China is the most rapidly growing major market in the world, and so we can't afford to be left out." Surely there would be less support for the unrestrained enthusiasm of the late Ron Brown, then secretary of commerce: "China . . . is the pot at the end of the rainbow."⁶ Many corporate investors would reevaluate their China commitments, especially those whose rosy profit expectations have not been achieved—an experience that thus far is hardly unusual. An early 1998 survey of ninety-six multinationals operating in China reported that 62 percent had overestimated the market potential and an almost equal number (61 percent) had experienced worse profit performance than they had expected.⁷ Of course, those percentages still leave room for some outstanding successes. The Gallup Organization reports that considerable majorities of the Chinese population recognize such American brand names as Coca-Cola (which far outsells Hainan coconut juice), Jeep, Head and Shoulders, Marlboro, Mickey Mouse, and Kodak. Motorola cellular phones are ubiquitous. Thirty-seven McDonald's are open in Beijing, and Ken-de-ji is also very well known in the largest cities (and in the West as Kentucky Fried Chicken).

A reduced inflow of new foreign capital would not only worsen the slowdown in the overall Chinese economy, but also exacerbate the effects of the short-term overbuilding reported in Shanghai and other major coastal cities. China, however, is unlikely to accept passively a major reduction in its economic growth. Officially, the government says it needs 8 percent expansion per year to maintain social stability and to continue its ambitious reforms—such as the notable aim of forcing state-owned enterprises to meet market forces. In mid-1998, protests by laid-off workers were rising and at times even violent. Northeastern China has been particularly affected because of the concentration there of money-losing state-owned enterprises.⁸

One option to sustain economic growth is to increase government spending, if only temporarily. Beijing has already announced an infrastructure construction program amounting to \$750 billion or more. Such a response to the economic slowdown will consume more than 40 percent of China's gross investable resources, according to RAND economist Charles Wolf, Jr. That action could be counterproductive if it crowds out the private local investment that has been the main engine of China's recent growth.⁹ To be sure, governmental investment aimed at eliminating transport bottlenecks might be a constructive contribution, and China can also rely to some extent on expansionary monetary policy to boost domestic demand. But if pushed too far, stimulus packages and monetary ease could renew inflationary pressures and damage China's already tenuous competitive position in East Asia.

Another option for Beijing is to devalue its currency in the face of regional competition resulting in part from the massive currency devaluations in Korea and Southeast Asia. But many Western economists believe that China need not react in this manner thanks to its large foreign exchange reserves (approximately \$140 billion), ability to control capital outflows, and still large trade surplus. Moreover, China, if it desired, could encourage capital inflows by easing some of the existing barriers to domestic joint ventures with foreign firms.¹⁰ Be that as it may, China may well opt for a large devaluation of the renminbi, a destabilizing event that would reverberate across East Asia. Once again, the United States would likely be drawn in, either as a direct source of financing or via the IMF.

Overall, then, the evidence points to a somber conclusion: a slowdown of the Chinese economy will aggravate existing imbalances in U.S.-China trade, strengthen the critics of free trade, discourage the inflow of new capital, and reduce profits of U.S. companies and investors. Beijing's options to avoid a slowdown could lead to even greater turmoil and involve the IMF. In an increasingly global economy, the fates of China and the United States have become intertwined. A sharp and sustained decline in China's growth rate would, on balance, not be good news for Americans.

POLITICAL RELATIONS.

The political relationships between China and the United States may be even more difficult to fathom than the economic. Considerable disagreement exists about the starting point. For example, President Clinton likes to describe the current state of Sino-American ties as "a strategic partnership." Yet few of the basic aspects of a true partnership are present—a situation parallel to the so-called economic partnership. A comparison with Japan makes the point. That country cooperates with the United States in a variety of important foreign policy activities, for example, when Japan contributed a considerable portion of the cost of the Gulf War. Japan and the United States also share a common outlook toward democracy, private enterprise, and personal freedom. By contrast, China's help to Pakistan's nuclear program and its sales of weapons to some of the most irresponsible regimes in the Middle East do not exactly promote the basic interests of this nation.

On the other hand, there is no direct basis for confrontation between China and the United States. The two do not share a common border or assert competing claims for territory. Any serious political problems that arise between them are likely to involve third parties. However, significant differences in fundamental values are clearly visible in the treatment of citizens by the Chinese government, especially in regard to political, economic, and religious freedom. Such strictures on the exercise of individual liberty gail many Americans, e.g., the persecution of Christian groups and jailing of political dissidents. It is extremely difficult for American citizens to accept the idea of "partnership" with a nation that engages in such offensive practices, not least because they believe that a nation that respects the freedoms of its own people is more likely to live at peace with its neighbors.

On the positive side, many close observers of living conditions in China have in recent years reported a considerable relaxation in the rules governing everyday life for the typical citizen. Power is now substantially decentralized, and private enterprise enjoys far greater latitude. The impact of Western culture and commerce has been pervasive, especially in the larger cities, while multinational corporations, contrary to the negative image many people have of them, do serve to advance human rights goals. They create safer workplaces, follow more progressive personnel practices, raise living standards, and introduce new ideas, attitudes, and ways of thinking. A number of American companies, such as Mattel and Nike, have adopted codes of conduct requiring local subcontractors and suppliers to eschew child labor and other practices common in China but inconsistent with U.S. standards.¹¹

More indirectly, but of fundamental effect, foreign companies' widely recognized commercial products and advertising carry a powerful implicit message of personal choice, and technology has made the array of choices much wider. Chinese rock groups mimic the moves of the American entertainers they watch on official Chinese television. Young women wear miniskirts and don Western-style makeup. Internet connections are growing rapidly (albeit subject to governmental choke points which can block access to "undesirable" web sites).¹² Privately owned satellite dishes receive Western programming, including uncensored international news broadcasts.

According to Li-Lu, a Tiananmen Square student leader now in the United States, "... business is the ultimate force for democratic change in China."¹³ Apparently, this is a compelling truth whose power frightens much of the traditional communist leadership in China. It also eludes the understanding of so many political activists in the United States who still cling to archaic views of capitalism that have long since been discredited in China—and Russia too. In any event, a major slowdown in the Chinese economy could interrupt the limited trend toward liberalization, and perhaps even reverse it. A weaker economy would strengthen the position of old-line communists—who have reluctantly gone along with Deng's reforms only because they appear to

work. To the extent that Western investment has been accompanied by Western culture and attitudes, a diminished presence by American business would reduce the prospects for an eventual move by China to a more open political system and a more modern legal regime.

It is ironic that the major victims of poorer economic performance in China and reduced U.S. economic involvement would not be Beijing's centralized leadership. Surely the impact of trade restrictions on state-run monopolies and on the more repressive rural provinces would be minor. Rather, the greatest injury would be felt in Hong Kong, Guangdong, and Fujian—precisely the regions that have made the greatest strides toward economic and personal freedoms.

Recent military initiatives on the part of China have generated great uncertainty for American leaders in the public and private sectors alike. Objectively, it is clear that the Middle Kingdom is in the midst of a major effort to upgrade its military capability. The acquisition from Russia of destroyers with supersonic missiles is a cogent example. Subjectively, however, the intent of this buildup is not so clear. Is Beijing motivated by the desire for regional hegemony, as its high-handed behavior toward Taiwan and its rival claimants to the islands in the South China Sea might suggest? Or is China's current weapon procurement effort essentially defensive in nature? After all, its military capability is still rudimentary compared to that of the United States and would continue to be so even after the current buildup. China's main military asset would appear to be its huge number of troops (about 3 million) coupled with large inventories of tanks (9,400) and fighter aircraft (5,200). But those troops are poorly equipped by Western standards and their weapons, in the main, obsolete. The Gulf War demonstrated that large stockpiles of outdated equipment, such as China possesses, are of little use in a conflict against a more advanced opponent. Moreover, China has lacked the ability to project its power into blue water in any substantial way. It possesses a total of fifty-seven surface ships and just seven modern submarines.¹⁴ In sum, although China now presents little direct military threat to the United States, it could still emerge as a substantial destabilizing force in the East Asian strategic theater.¹⁵

Economic growth has allowed the People's Liberation Army (PLA) to procure some sophisticated aircraft, ships, and missiles, expanding its power radius to include India, Japan, and portions of southern Russia. Over the past decade, the PLA has acquired considerable amounts of high-tech equipment, in particular from the cash-strapped countries of the former Soviet Union. These include purchases of Su-27 attack aircraft, MiG-31 fighters, T-72 tanks, and Mi-17 helicopters. And ranked by explosive power, China's nuclear arsenal is reported to be the world's third largest, trailing only the United States and Russia. Chinese strategists may be working toward the day when their nuclear and missile forces suffice to deter great power intervention in the Asia/Pacific theater and their conventional forces to cow regional rivals. Such a combination would allow, indeed define, local hegemony.

Would an economic slowdown frustrate the PLA's designs, whatever they be? After all, it is economic growth that enables Beijing to invest in technological modernization and increase its "power projection" capability.¹⁶ Such financing might be curtailed in a weaker economy, both directly from the national treasury and from the earnings of the PLA's numerous civilian business ventures.¹⁷ Yet, rising unemployment might generate such severe social and political pressures on the Beijing regime that it would mobilize the armed forces to maintain internal order or, what is worse, attempt to divert public attention from internal problems through military adventures abroad.

A final influence on Chinese security policy is access to energy sources. At present, China is extremely dependent on its domestic coal supply for energy, and increasingly thirsty for the vast untapped oil and gas reserves of the South China Sea. However, overlapping portions of that strategic area are claimed by Vietnam, Malaysia, Brunei, Taiwan, and the Philippines. Some military skirmishes involving Chinese armed forces have already occurred. Furthermore, all ocean

shipping among those six countries, as well as the transport of oil from the Persian Gulf to Japan, passes through the South China Sea. Ironically, in this case a slowdown in China's economic development might *reduce* the potential for a military confrontation by reducing China's projected energy requirements, even as it slowed the PLA's acquisition of advanced technology.

ENVIRONMENTAL ISSUES A NEW SOURCE OF TENSION

The global environment represents a relatively new subject of international relations and one in which American and Chinese interests could readily collide. The U.N.-sponsored meeting on global climate change, held in Kyoto in December 1997, drafted a treaty that would commit the United States to a major reduction in emissions of the greenhouse gases that many scientists believe cause global warming (particularly carbon dioxide, or CO₂). The treaty would, however, effectively exempt China and other developing nations from its tough restrictions.⁸ Such a double standard would inevitably generate serious political difficulties in the United States. In a resolution overwhelmingly adopted last fall, the Senate pledged to defeat any treaty on climatic change that did not include the developing nations, and any attempt to revise the Kyoto agreement along these lines will target China above all. China relies on coal—the prime emitter of CO₂ and key concern of ecologists—for 75 percent of its energy. Projections show that, during the time period covered by the Kyoto proposals, China is likely to become the world's largest emitter of CO₂, thanks to its inordinate dependence on bituminous coal and vigorous economic growth rate.

Poor countries tend to believe that they cannot afford to sacrifice current income to avoid the uncertain costs of environmental damage fifty or one hundred years from now. Even though air pollution is a visibly serious problem in developing countries such as China, they consider ecological restriction to be a rich country's luxury. Moreover, some Chinese leaders see the concern of Western nations with international environmental matters as an indirect way of limiting China's rise to global power. Exempting China and other developing countries (such as India) from the force of the Kyoto caps on CO₂ may well mean that their rising CO₂ emissions will totally offset the economically painful reductions in the United States and other Western nations. Clearly, real progress in dealing with the global warming issue is not likely to be achieved in this manner. However, trying to convince China to limit its energy consumption while the major Western countries use five to ten times as much energy per capita will probably prove futile unless wealthier countries such as the United States pay poorer ones not to burn fossil fuel.¹⁹ The one bright side of a slowdown in China's economy, therefore, is that it would dampen the now sharply upward trend in its generation of CO₂ and other emissions, and perhaps reduce the Senate's objections to the terms of the Kyoto agreement.

Another international environmental issue involving China (but not, directly, the United States) concerns the use of chlorofluorocarbons (CFCs) in aerosols that deplete the ozone layer. The United States and other industrialized nations adhere to a U.N.-sponsored treaty on ozone layer protection. China's consumption of CFCs, however, has soared since 1986 from 3 percent to 18 percent of the world total.²⁰ Internally, the Chinese authorities recognize the need to deal with the tremendous amount of pollution being generated, especially in its major cities. However, enforcement of China's formal antipollution laws is often undermined by corruption and special treatment. For example, many offending factories are owned by senior members of the Communist Party, who have the necessary *guanxi* (connections, or "pull") to avoid shutdowns or fines.²¹

In the longer term, there is an important negative side to any extended slowdown in China's development. When countries reach per capita income of about \$10,000 a year, they begin to take a more active role in environmental improvement—because they believe they can afford to do so. A curtailment of China's growth rate would delay the achievement of that happy condition. (Its per capita income now is less than \$5,000.)

RECONCILING DIVERGENT INTERESTS

When asked the meaning of the French Revolution, Zhou Enlai was supposed to have replied, "It is too soon to tell."²² In this vein, it is with some reluctance that I will try to pull together the various strands in Sino-American relations. Policymakers in Washington and Beijing alike face difficult, if not fundamental challenges in attempting to deal simultaneously with the host of contentious economic, political, social, religious, military, and environmental issues that face them. It is unreasonable to expect that all of these serious matters can be solved in a short period of time. However, given the importance of each country to the other, it would be sensible, while taking account of these intricate interactions, to focus on the highest priorities. Asian expert Nancy Bernkopf Tucker has properly described the U.S. task in dealing with China as showing "consistency, purpose, and imagination."²³ That is a tall order, but surely desirable.

A useful starting point is to note that, throughout the twentieth century, China has remained outside the circle of traditional major powers—but that isolation is ending. Today China is more open to the influences of Western culture and business practices than ever before. Its senior officials state that they want their country to be a full and successful participant in the world economy. They acknowledge that this requires China to move to a market economy and in general to modernize its society. Yet China is not a member of key international organizations such as the World Trade Organization or the annual economic summits. As would be expected on the basis of the earlier experiences of other powerful nations, it is difficult for a prospective member of these important "clubs" to take a more active and responsible role in the international community while promoting national interests it developed in relative isolation. A substantial amount of lingering suspicion of the motives of other countries is to be anticipated.

Viewed in a long-term context, the United States is in a special position to aid China in its entry into the club of advanced nations. From a historical perspective, the United States itself is a relative newcomer on the world stage, and from a geopolitical perspective, the United States has a major stake—far greater than Europe's—in China's emergence as a peaceful and prosperous member of the Asia/Pacific community of nations. China and the United States also complement each other in terms of their economic needs and resources. The temporary problems of East Asia notwithstanding, the United States is China's leading export market as well as the most logical partner to help upgrade its technology through investment, joint ventures, and provision of advanced software and financial services. China, in turn, is the most promising new market for American business and agriculture.

China's huge development and infrastructure needs can provide enormous export and investment opportunities for U.S. companies seeking geographic diversification. This would hold true even given a slower pace of Chinese development. In the important area of higher education, U.S. colleges and universities are a popular place for wealthier Chinese to send their youngsters, especially for graduate school. Such interaction has the added potential of generating long-term personal and intellectual bridges between the two nations.

Nevertheless, we should acknowledge that a far less sanguine attitude toward these matters is held by some distinguished scholars. Samuel P. Huntington of Harvard, for example, sees a "clash of civilizations" taking place between the advanced industrialized nations of the West and areas dominated by Confucian thought and culture, notably China.²⁴ Concerns such as Huntington's should not be quickly dismissed. China's distance from the West is even greater than a glance at the globe suggests. Fundamental differences exist in historical experience, cultural orientation, and political and social institutions. The rule of law, for example, is still essentially a foreign concept in China. How, then, should U.S. policy address some of the main issues that will either separate these two powerful nations or bring them closer?

It may be surprising for an economist to start with military rather than economic concerns, but matters of war and peace are still central to any discussion of national policies and interests. Thus, the continued expansion of China's military power should be acknowledged as potentially destabilizing. However, the sensible response is not to try to talk Beijing out of what it believes is a reasonable aspiration to great power status. Instead, the United States should simply but clearly get across the idea that, in terms of its vital interests, the expansion of the PLA's strength provides a compelling justification for the maintenance of a substantial U.S. military presence in East Asia. At present the United States has security alliances with Japan, South Korea, the Philippines, Thailand, and Australia. Consistent with such a position, the United States should make it clear that a China that is secure from foreign threat and can protect its legitimate sovereignty is desirable for both Asian and American vital interests. On the other hand, coercive pressure by China against its neighbors in the South China Sea or against Taiwan only serves to escalate tensions in East Asia, an area of continuing concern to the United States.

Anyone who follows domestic political trends in the United States knows that strong pressure exists for devoting an increasing share of the federal budget to domestic matters. There is no shortage of expensive internal priorities, ranging from health care to the social security system. Therefore, an American willingness to assign a significant amount of military resources to East Asia only reflects the high priority the United States places on stable relations in that region. At the same time, better relations with China may allow the United States eventually to resume limited sales of defensive weapons to China. No action would do more to alleviate Beijing's fear of a policy of containment on our part.

Simultaneously, the United States remains a bulwark—likely the main bulwark—of free flows of commerce and capital across the globe. Nevertheless, being a democracy, the American government must respond to the concerns of its citizens as expressed in the political process. Thus, when PRC officials dismiss these concerns as "just domestic politics," they demonstrate that they do not yet fully understand how a democracy works.

A slowdown in China's economic growth is likely to bring to a head the very uneven nature of U.S. trade under circumstances that make political life difficult for both governments. The United States must make it clear that China's expectation of a fully open American market becomes exceedingly unrealistic in the face of: (1) a host of formal and informal barriers to U.S. exports to China, (2) severe restraints on the operations of U.S. firms in China, (3) lack of a functioning legal system that provides local citizens as well as foreigners with essential protection of individual liberty and property, and (4) overt discrimination against and persecution of people with whom many Americans identify. Such barriers to fair trade, as Americans define it, only give ammunition to the Pat Buchanans and Richard Gephardts who oppose more open economic relationships with China because of that litany of genuine concerns. One might object that it is presumptuous and counterproductive to try to tell China what to do under those circumstances. As Henry Kissinger insists, "Public hectoring is usually the least effective diplomacy."²⁵ But clearly explaining the American position, motivation, and actions is mandatory if the Chinese are to acquire a more sophisticated awareness of "the facts of life."

Ultimately then, a new economic scenario of slower growth can give birth to a new political scenario. The precise nature of that scenario will depend on whether both governments endeavor to reconcile their divergent interests or simply recoil from making hard decisions. For China, that means taking a more enlightened position or postponing the time when it gains full membership in the global marketplace and in the ranks of fully modern societies. For the United States, that means taking a longer view that balances concern for human rights against other important interests that also have moral components including peace, national security, and the prosperity of its citizens. The decisions will not be easy, but true statesmanship is not about choosing the easier option. If anything, the new economic scenario will narrow the margins for political error.

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Foreign Policy Research Institute
1528 Walnut Street, Suite 610
Philadelphia, PA 19102
Phone: (215) 732-3774