U.S.-CHINA RELATIONS

EIGHTH CONFERENCE
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DICK CLARK
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On the eve of President Hu Jintao’s first visit to the United States as president of the People’s Republic of China (PRC), the eighth Aspen Institute Congressional Conference on U.S.-China Relations was convened in Honolulu, Hawaii, from April 9-15, 2006. Participants from both parties and both chambers of the United States Congress discussed a variety of topics central to the current Sino-American relationship and its future, including: China and the global competition for energy resources (Hal Harvey, The Hewlett Foundation, discussion leader); China’s military modernization and foreign policy posture (David Shambaugh, George Washington University, discussion leader); China’s internal stability (Susan Lawrence, former correspondent, Far Eastern Economic Review, discussion leader); and the PRC and global trade and finance issues (Albert Keidel, Carnegie Endowment for International Peace, discussion leader). Their papers follow this introductory summary.

The domestic and international settings in which the conference took place shaped the discussions. In March 2006, China concluded its National People’s Congress (NPC) session at which its Eleventh Five-Year Plan (2006-2010) was approved. Key themes to emerge from the NPC session and the Five-Year Plan were the need to place emphasis on rebalancing the distribution of development benefits between the countryside and cities and between coastal and inland areas—“harmonious development” was the catchphrase. Another key objective was to have energy use grow at half the rate of economy-wide economic expansion, a key initiative to try to reduce the rate at which China’s dependence on imported energy is expanding. In terms of foreign policy, emphasis was placed on continuity with past policy and China’s “going global” strategy. With respect to U.S.-China relations, in the preceding twelve months President Bush visited Beijing, Secretary Rumsfeld made his first trip during the Bush Administration, and visits by Vice President Cheney, Secretary Condoleezza Rice, and other cabinet secretaries took place. For their part, the Chinese have sent numerous officials to the United States during the preceding twelve months, including Vice Premier Wu Yi (in overall charge of trade issues) who was in the United States as the Aspen Institute conference was underway. The Vice Premier was laying the foundation for a successful visit by her president by announcing meaningful policy changes on intellectual property protection in China and purchases of aircraft, agricultural, and other products.

The first conference session was led by Hal Harvey who is an engineer trained at Stanford University, on “China Energy Issues.” Among the central points to emerge was that the energy-related fates of China and America are intertwined in key areas—oil dependence, global warming, and air pollution.

Because the United States and China are big
petroleum consumers, with a relatively small share of global petroleum reserves, both are “price takers” with respect to petroleum, meaning that they control few oil reserves and have to take the prices given by the international market no matter how painful. Both nations are contributing to ever-larger demand, in China’s case because of increased automobile ownership and a rapidly expanding, energy-intensive middle class. The United States and China need to jointly manage demand by cooperating in the development and utilization of new transportation, industrial, and construction technologies.

Moreover, because coal provides about 65 percent of China’s total energy consumption, addressing clean coal combustion and carbon sequestration are gigantic issues. Overall, energy efficiency provides enormous opportunities for Sino-American cooperation and environmental and energy efficiency technology sales—not least because China uses four times the energy to produce a dollar of output as does the United States—and eleven times that used by Japan. Harvey put the bottom line as follows: “Just do the math. Autos, the 1,000 biggest industrial enterprises, and buildings are the big issues in China. There is no supply-side solution.” While increasing supplies can help in the short run, the only long-term way to deal with shortages is through more efficient use of the petroleum and other energy we already have. Moreover, even if supplies of carbon-based energy increased, this would only compound global warming and other environmental problems, assuming current technologies.

China’s air pollution—sulfur dioxide, nitrogen oxides, particulates, ozone, and heavy metals—directly affects America. Up to one-third of the air pollution on the U.S. West Coast comes from China, as does one-fifth of the mercury in the Great Lakes. Parenthetically, both Japan and South Korea complain about acid rain and other air pollution that has its origins in North China. Emission of greenhouse gases spreads globally, and has global impacts. The United States leads in the emission of CO₂ and China is a rapidly growing second. The United States and China have great opportunities for cooperation in areas relevant to clean coal technology, coal being a huge source of CO₂ emissions, particulates, heavy metals, and sulfur products.

Cooperation in energy and environmental policy is essential. Because China’s State Environmental Protection Agency (with only 240 employees) is relatively weak and could learn greatly through a well-funded cooperative arrangement with the U.S. Environmental Protection Agency, there is an opportunity for meaningful U.S.-China cooperation. At the present time, however, in almost all areas of environmental relevance, the U.S. private and nongovernmental sectors are playing bigger roles than the federal government. The bottom line is that if the United States and China don’t each separately, and together through cooperation, get their energy demand and emissions under control, actions by the rest of the world will have little impact.

In the course of the discussion Members of Congress and the invited Chinese and American scholars raised questions, made observations, and discussed possible policy implications:

- Isn’t the United States trying to “drill” its way out of shortages and dependency, and isn’t China trying to “lock up” foreign energy supplies in rogue states? Aren’t these both defective strategies?

- Forty percent of China’s oil is imported (this percentage is growing rapidly) and about 90 percent of that comes on foreign flagged tankers. China, in effect, is highly dependent on the U.S. Navy for its energy security, something about which Beijing gets nervous when some in Washington talk about China as a “competitor” and potential future threat. It is this uncertainty about Sino-American relations that, in part, accounts for China’s determination to strengthen its Navy and for Beijing’s
attempts to diversify the modes of petroleum delivery to China and the sources of that petroleum. Perhaps China and America could cooperate to secure international energy pathways because both countries are dependent upon them.

- Some of these oil and natural gas suppliers (e.g., Sudan and Iran) are severe human rights and/or security problems from the American perspective.

- Because China desperately needs energy, and is investing heavily in Iran for both oil and natural gas, what are the odds that Beijing is going to be helpful on proliferation issues now under consideration by the International Atomic Energy Agency and the United Nations Security Council as they pertain to Tehran?

- Chinese scholars pointed out that Congressional opposition to UNOCAL’s acquisition by China’s National Offshore Oil Corporation sent the message to Beijing that the U.S. doesn’t rely on market principles, so why should China? One interesting suggestion for a future U.S. policy was that the United States might say to China, “If you would permit American oil companies to own majority shares in Chinese oil companies, then the United States would reciprocate that policy.”

- One participant opined that, “Till we change what we do, we have no moral high ground; we are reduced to military action.” As it pushes for more sensible energy policies in China, the U.S. has enormous areas where it needs to improve its energy and environmental performance. Enhanced performance by the United States would help reduce critical problems and make Washington more credible in its dealings with others. Among the suggestions were: push for a much more technologically dynamic U.S. auto industry; promote agriculturally based liquid fuels; and make buildings more energy efficient.

The discussion of energy and transnational environmental impacts provided a fitting segue to the second conference session on Chinese foreign and security policy led by David Shambaugh, Professor of Political Science and International Affairs and Director of the China Policy Program at George Washington University. Shambaugh put China’s military modernization into the broader context of the PRC’s foreign and security policy.

With respect to China’s military modernization narrowly construed, among the key points are: China is putting a steady stream of resources into military modernization, but these investments are not yet so large as to compete with resources necessary for economic development; China has made significant improvements in slimming down its land army, upgrading remaining units, improving the air force, and most of all improving naval capabilities, in particular submarines. Beyond its modest, improving intercontinental missile force, however, the People’s Liberation Army’s capacity to project power at great distances is very limited and will remain so for a considerable period. China’s power projection as it relates to Taiwan, however, is becoming increasingly potent.

One does not want to be complacent, however, with the Chinese having made significant improvements in the last few years in the areas of electronic and cyber warfare, cruise missiles, joint training and doctrine, jet fighters, and submarines. “Thus,” Shambaugh concludes, “China’s military has transitioned from being a third-rate to a second-tier military power, but still has a very long way to go before it can be described as a military of first-class global standard.”

Moving beyond the strictly military to broader Chinese foreign policy, Shambaugh emphasized the central features of the U.S.-led Asian security system, how that system is adapting to China’s rise, and how Beijing is responding. Looking first at U.S. policy, it is most aptly described as “hedged engagement,” meaning that Washington cannot be certain about future PRC behavior so it protects itself from downside
risks by taking a number of actions, including a meaningful buildup of the Pacific Command; forging new relations with India, Pakistan, and Indonesia; developing deeper security relations with Singapore and others; and strengthening alliances where possible. At the same time that “hedged engagement” has the elements enumerated above, engagement is primary, based on both sides’ recognition of deep interdependence, not the least financial, economic, and environmental. Most importantly, stability in East Asia is inconceivable if there is a high degree of conflict between China, Japan, and the United States.

China sees the hedges in U.S. policy (China also hedges its own policy) and desires to minimize countervailing behavior by its neighbors who might fear increasing Chinese power. Beijing has changed its policies as a consequence, becoming much more proactive in its own neighborhood. This is seen in more involvement in regional multilateral institutions, regimes, and negotiations, most notably the ASEAN (Association of South East Asian Nations) structure, the Shanghai Cooperation Organization, and the Six-Party Talks involving North Korea. Moreover, China’s military increasingly is involved in exchanges and exercises with militaries in the region and beyond to build confidence and introduce more transparency into PLA operations.

Shambaugh emphasized a point that came up throughout the conference—that the deterioration of Sino-Japanese relations is contrary to American interests and the interests of regional stability. The United States, through a combination of Track II dialogue and government encouragement, should seek to tamp down this friction and, to the degree possible, urge Japan to come to terms with its history that has created disquiet throughout much of Asia.

Among the points raised in the discussion were:

- A Chinese scholar pointed out that: “It needs to be understood that we [China] don’t want to create a security dilemma [for others], drive the security modernization of others—this would hurt us. We have to explain our modernization in a reasonable way.”
- China’s attention is mostly directed to its periphery, but the Middle East has become an extension of that periphery because of energy resources.
- Democracy in Taiwan is a principal consideration that keeps Taiwan salient to American interests, despite the increasing strategic importance of the PRC.
- If Washington goes to the United Nations Security Council to seek to halt the presumed Iranian nuclear weapons program, “What will China do?”
- China is very wary of the U.S. Anti-Ballistic Missile system and would like to have dialogue on this because it threatens China’s capacity to retaliate if it is attacked. As one participant put it, China will maintain its capacity to retaliate no matter what the cost and, in fact, could do so at bearable cost. It would be better to avoid an arms race in this area.
- The 2006 DOD Quadrennial Defense Review report mentions China as a potential security concern and has two pictures in the China section that are threatening from
a Chinese perspective, leading some to wonder about DOD’s intentions. The need for congressional hearings on this topic and on Sino-Japanese relations was suggested.

• Chinese activity in Latin America was a concern raised by some who wondered whether or not Beijing is filling a void left by U.S. inattention.

• Concern was expressed about whether or not General Zhu Chenghu’s recent remarks about nuclear weapons being used in a Taiwan contingency reflected Beijing’s actual policy.

• Beijing is sharing intelligence germane to the Global War on Terror with Washington, but some in the PRC’s intelligence community are nervous because when you tell another nation what you know, you inadvertently tell them what you do not know.

Underlying conference discussions was a central issue: “Is China stable, and what are U.S. interests in PRC stability?” Susan Lawrence, formerly a journalist with the Far Eastern Economic Review, kicked off the third session by making a central point—“Beware of fragility in China.” At the same time that Lawrence saw fragility, she also emphasized that current policy directions and overall stability in China are likely to be maintained unless there is a confluence of more popular dissatisfaction, greater coordination among protesters, a looser media environment, and a split in the elite itself.

Among the social and political forces creating fragility are: increasing rights consciousness of the populace; mounting socioeconomic inequality (particularly urban-rural inequality); corruption; increasing numbers of violent clashes in rural areas about environmental problems and land expropriations; and indications at the recent session of the NPC that there is serious disagreement within elite circles about the future direction of reform, the most notable piece of evidence being the NPC’s failure to adopt a law on private property.

Beijing’s leaders, however, are aware of this fragility and have taken measures to defuse tensions, including: abolishing agricultural taxes; promising to abolish school fees for all rural residents; boosting oversight of government in villages and urban districts; expanding the scope of elections within the Communist Party; and relaxing laws pertaining to migrants who come into the cities. Nonetheless, when all else fails, there is repression, which the Party has used with considerable skill. In the end, the Party is worried because its control capacities are in a twin race with new means of communication and popular dissatisfactions.

It was suggested that the U.S. should understand its stakes in Chinese stability and make clear that it values stability in the PRC, at the same time that it also expresses concern about how stability in China is maintained. It also is important that the United States contribute to positive institutional reform, particularly in the areas of judicial reform, grassroots democratic development, and technical assistance.

The following points were raised:

• There are three schools of thought on China’s stability: China will muddle through; China’s current regime will collapse; and China is trapped in an era of stagnation—“trapped transition.”

• Several scholars pointed out that many of today’s problems are a result of past successes. China is on a treadmill in which “solutions” to past problems create new challenges to which the regime must respond. It is impressive that China’s leaders have been adaptable to date; this creates some confidence about their ability to do so in the future.

• The Communist Party is broadening out in terms of composition, becoming “an all-people party.”

• Environmental issues are an increasing source of instability—water-related concerns may be the single biggest problem.
• The European Union is doing a lot more than the United States in terms of constructive technical assistance to help the PRC overcome these challenges.

• The United States could help by not making its visa system an impediment to U.S.-China exchanges and business and academic contacts.

• Concern was expressed that China “gets a pass” on human rights issues because of business interests and strategic concerns. A Chinese scholar responded by noting that the United States fails to extradite Chinese criminals seeking asylum in the U.S.—“they are human rights abusers” in some cases.

• One American noted that in terms of U.S. policy, spending more on “public diplomacy” and “keeping the U.S. competitive” are top priorities.

• Given the impact of China’s environmental pollution on the U.S. and its allies and friends and our mutual concerns as the world’s largest energy-consuming nations, it was strongly suggested that it would be productive for congressional committees to hold hearings on these issues.

• Reacting to discussion of protests over power plant construction and forced relocations, a Chinese scholar summed up the Chinese leadership’s challenge as “how to be responsive to the people but also meet the needs of development.” The scholar also expressed concern about recent efforts by retired officials and other elites in China “to repudiate reform.”

• The question was posed as to whether it is realistic to try to bring rule of law and impartial justice to a one-party state.

• Do constraints on religious observance in China have an impact on Chinese citizens’ sense of “empowerment, destiny, or efficacy?”

• A Member asked if Falun Gong is a legitimate oppressed minority. Another asked about Falun Gong’s roots in Chinese culture. [When President Hu Jintao visited the White House a week later, a Falun Gong adherent disrupted the welcoming ceremony on the South Lawn, making the issue of Falun Gong relevant and worthy of exploration beyond the interest it already has.]

• Over time there has been a change in the reason we engage China—initially we did so to “change China;” now we do so because its power has increased and it has become central to U.S. interests.

The final conference session concerned economic issues in U.S.-China relations. The discussion was kicked off by Albert Keidel, senior associate at the Carnegie Endowment for International Peace, previously at the U.S. Department of Treasury and the World Bank. Among Keidel’s key points were that China’s continued reform would benefit greatly from informed U.S. engagement and that change in China requires change in America as well. He addressed several of what he described as “myths” about China’s economy and its implications for the United States.

Among the important misconceptions that he feels people often have are: an exaggerated sense that Beijing’s central leaders can fully control the behavior of recalcitrant local leaders; a mistaken belief that China’s overall economic growth is fueled by exports (important as they are), rather than high internal savings and growing consumer demand; a mistaken belief that China has worse corruption than many other nations; an exaggerated sense of the precariousness of the Chinese financial system; unrealistic expectations that revaluation of the Chinese currency would solve American trade deficit problems with the PRC; and, a failure to recognize the many dimensions along which China’s economy is comparatively open.

China’s pursuit of a relatively successful economic development strategy is creating pressures for the United States to invest in itself to maintain competitiveness. Beyond this policy
suggestion, Keidel argued that China would be better off importing more agricultural goods from abroad, including from the United States, and that this would both help American farmers and free up Chinese labor and land to engage in higher value-added pursuits, suitable in light of China’s resource endowments and scarce useable land. To do so, however, China needs to be assured that food would not be used as a weapon in crises.

Among the points made in the ensuing discussion were:

- “The U.S. and China are important stakeholders in the international order. China no longer is a revolutionary. It is part of the order. So both [the U.S. and China] have shared interests and stakes to improve the international order.”

- “It is great to be a statesman when you don’t have a problem. We need both free trade and fair trade. There is a tendency to think we are not competitive. But we faced the dumping of steel and we rationalized with relief. The same in autos. Our productivity has increased dramatically. The worst is IPR [protection in China]. This is important.”

- “I don’t have confidence the U.S. will invest in herself—this year’s budget is going backwards. I don’t think we’ll solve the visa problems. So, China becomes a target of what we have failed to do. We react to China through the prism of our own missed opportunities. We say that everything is important to solve, we have no priorities and we are not tough enough on things that matter.”

The conference concluded with a discussion of what some of the policy implications of the preceding four days had been. Among the points raised were: The United States needs to spend more on foreign relations, not foreign aid; that doing away with a specialized agency, the United States Information Agency, that had been devoted to America’s soft power, was probably an error, even though the Agency had had problems; the United States needs an annual report on U.S. national competitiveness, commissioned by the Congress but a product of an outside agency; Congress needs to build a cadre of internal leadership that understands U.S.-China relations; the U.S. Congress should strengthen dramatically its exchanges with the Chinese NPC; both houses of Congress need to hold a broad range of hearings on China and U.S.-China relations; and finally, Washington should regularly sit down with the Europeans to discuss China policy.
China Energy Issues

Hal Harvey, M.S.
Environment Program Director
The William and Flora Hewlett Foundation

Introduction

The U.S. economy is highly dependent on oil—even “addicted,” as President Bush put it in his State of the Union address. Understanding the consequences of this dependence and the possible ways to alleviate it requires an understanding of the global oil market. And that, in turn, takes us to China, which is, behind the United States, the second largest consumer of oil, and has the fastest growing demand.

A parallel energy concern is the growth in greenhouse gas emissions, and the attendant climate change this portends. Recent real-world observations show impacts on the high end of what the models predicted, especially with regard to glacial melt, polar ice melt, and storm severity. Here, too, while the United States is the largest emitter of greenhouse gases, China has the highest growth, and is poised to get to current U.S. levels in the next 25 years.

Finally, the air pollution from inefficiently burned energy in China now constitutes a significant fraction of the total pollution (such as mercury and aerosols) on the West Coast of the United States, and this will grow over time.

In the largest realms of concern over energy—oil dependence, global warming, and air pollution—the fate of the United States is directly tied to China’s policy choices.

This paper begins with a brief overview of the global oil situation and key trends, then examines the China situation, and then considers some policy options for the United States. The second section of the paper is devoted to how China’s energy policy can affect the emissions of greenhouse gases, and what constructive role the United States might take. Finally, the paper considers conventional pollutants, and again makes some policy suggestions.

Oil

The beginning of wisdom in understanding oil is that oil is irrevocably part of a global market. The price U.S. consumers pay for their gasoline will depend on the global supply/demand balance. This fact has embedded in it both good and bad news. The bad news is that, as holder of only three percent of global oil reserves, and consumer of more than a quarter of the world’s oil, the U.S. has set itself up as a “price-taker.” With our current policies, the U.S. will simply have to pay whatever the global oil market demands. Today’s U.S. government policies—whether on the supply side or the demand side—do not materially affect this dynamic.

The related bad news is that demand growth is far outstripping supply growth, so oil will increasingly be a seller’s market.

The good news is that there are two giant consumers of oil in the world, the United States and China, and intelligent policy in these two countries can significantly affect the supply-demand balance.
The Global Oil Market

Supply Side

Some two-thirds of the world’s conventional oil reserves are in the Middle East, which makes these nations, especially Saudi Arabia and Iran, the swing producers—meaning they can adjust output to manipulate oil prices. There are really no other oil suppliers who can play this role, and there will not be in the coming two decades.

After the tumult of the two oil crises in 1973 and 1979, the Organization of Petroleum Exporting Countries decided to build long-term price stability and avoid price shocks. This strategy worked for two decades. Oil prices remained low, and growth in oil demand was enormous. Keeping with President Bush’s addiction analogy: for the last two decades, lured by low oil prices, the United States and the rest of the world got ever-more dependent on the Mideast.¹

Any serious assessment of geology tells us this situation will not change. There is no conventional oil source in North America that can materially affect the global supply.

Today, as growth in oil demand has vastly exceeded new production or oil discovery, oil prices are higher—and are likely to remain so. It is hard to find an oil price projection that shows prices dropping below $40 per barrel, and many suggest we will reach $100 per barrel oil in the near future.

This demand growth and supply constraint leaves the United States vulnerable in four important ways:

1. Higher absolute prices take a toll on the economy. The U.S. is far richer than it was during the previous oil crises, and energy is a smaller percentage of our GDP, but there are still sectors and regions of the country that are extremely vulnerable to higher oil prices.

2. Besides higher average prices, when petroleum product demand approaches maximum physical supply without any supply safety margin, price shocks happen. This was evident in 2004, as the capacity of U.S. refineries neared 100 percent, and then Hurricane Katrina took a good fraction of capacity off-line.

3. The U.S. sends enormous sums of money to nations that are not especially friendly and not at all democratic. National security experts have railed against this cash transfer, wondering why “we are funding both sides of the war on terror.”

4. Our national security policies are often constrained by oil dependency—as recent interactions with Iran and Saudi Arabia suggest.
China is acutely aware of the distribution of petroleum across the globe, and has moved to secure resources where they are available. The two large Chinese petroleum companies, Sinopec and the China National Petroleum Corporation (CNPC), are making very substantial investments in petroleum reserves. (Recall the attempted purchase of UNOCAL by CNPC last year). China has substantially structured its diplomacy to ensure long-term access to oil, and this will affect U.S. interests. Chinese foreign policies are increasingly constrained by its thirst for imported oil—as indeed is the United States. News agencies report Chinese commitments to Iranian energy development of between $50 and $100 billion, for example, which gives Iran a great deal of operational freedom vis-à-vis other nations.

**Demand**

The United States is the largest user of petroleum in the world, with consumption of about 20 million barrels per day, or about one-quarter of the world’s total. China is second, at about 6 million barrels per day, or six percent of the world’s total. China has the fastest growth, however, and is expected to grow to some 15 million barrels of oil per day in the next twenty years. This will severely stress the global oil market, as this incremental demand nearly equals the total Saudi production today.

Chinese demand growth is directly due to the increase in automobiles sold. As China’s economy booms, more and more people purchase automobiles. The amount of oil consumed by China’s auto fleet will depend on three factors: (1) the number of cars sold; (2) the number of miles they each drive; and (3) their fuel efficiency. The Chinese government is developing policies that address each of the latter two factors. The number of cars sold will grow as China gets richer and as trade barriers fall. This trend will not be affected by policy, except in cities such as Shanghai, where parking permits are a constraint.

But the next two elements are susceptible to good policy intervention. The Chinese government is looking at mass transit options that will be faster than private automobiles. In particular, “Bus Rapid Transit” (BRT) has caught the government’s eye, and the first BRT system in China is now successfully running in Beijing.

BRT is a system that can achieve subway speeds and capacities at only five to ten percent of the cost. A BRT system is a super-fast, super-efficient bus network. To achieve this extraordinary performance, BRT systems have:

- Exclusive lanes for buses (typically the center lanes);
- Stations, not stops, for buses, so that passengers have already paid before they board.
- Rapid boarding and exiting, through a wall of doors at the same level as the station, much like a subway.
- Long buses—double or triple length.
- Green light transponders, to speed buses along key streets.
- Electronic ticketing, to speed station access and egress.
- A host of other security, convenience, and cleanliness improvements.

The Chinese government is also working to reduce energy burned in each auto by raising

![Figure 3: Total Autos in China](image-url)
mileage standards and through innovative fiscal policy. China has passed fuel efficiency standards for automobiles that are second only to Europe and Japan in their strictness. These standards, based on the Japanese model, will save some two billion barrels of oil in total by 2020.

But this progress is not enough to prevent enormous growth in Chinese oil consumption and the attendant pressures on international markets. Further required steps include:

- A second phase of the fuel economy standards cutting fuel use in passenger cars, and setting standards for trucks.
- Establishing fiscal policies that reduce driving, and steer consumers to advanced, efficient cars.
- Speeding the introduction of advanced technology vehicles, such as hybrids.
- Spreading BRT systems across all major cities in China.
- Developing alternative and renewable fuels for autos.

The Chinese government is interested in all of these steps, and has made at least preliminary commitments to each.

**U.S. Policy Options**

The steps described above all live in an international context. The United States is the single largest producer and consumer of automobiles, and U.S. fuel use is the single most dominant element of global demand. The United States can help China, and help itself, by:

- Developing domestic policies to increase the fuel efficiency of trucks and cars. The U.S. is lagging the world in fuel efficiency, and we will increasingly pay for it—with higher fuel costs and with lower market share for our domestic cars. Indeed, there is no more significant step the U.S. could do in taking pressure off of global oil markets than to develop a serious, long-term strategy to increase auto fuel efficiency.
- Considering strategies to accelerate the wide production of hybrid cars, trucks, and buses. The future of the world oil market depends on the technology deployed on the next generation of cars and trucks. Good technology will affect the whole market, including China. Today’s public Research & Development budgets for auto technology are near-zero, and U.S. auto R&D lags far behind our Japanese and European competitors. As long as our technology storehouse is empty, we will be condemned with high fuel consumption and declining U.S. manufacturer market share.
Greenhouse Gas Emissions

Background and Trends

The second principal U.S. concern with respect to China’s energy future is the future of a global warming strategy. The United States and China are the two largest emitters of greenhouse gases (GHG), with China fast approaching U.S. levels. It is hard to imagine an effective strategy for controlling global warming emissions that does not include the U.S. and China. Furthermore, the fact that the U.S. population is less than one-fourth of the Chinese total population, but its GHG emissions are almost double the Chinese level, gives China a rationale for its inaction.

Fortunately, while the Chinese government has not yet staked out a position on future climate talks, China’s official energy policy provides a terrific starting point for considering new options. Over the two decades ending in 2003, China had the largest improvement in energy efficiency of any nation in history. In those two decades, China quadrupled its economy, while only doubling energy consumption. Thus, the overall economy became twice as energy efficient. China’s policy in the coming decades is similar, with a goal of doubling energy productivity over the next twenty years.

Unfortunately, the last three years have seen a reversal of this energy efficiency improvement. Because of a recent shortage in electricity in China, China undertook an enormous coal power plant construction boom, adding a 1,000 megawatt power plant every week. In 2005, China burned twice as much coal as the United States. As a consequence of this boom, and insufficient investments in energy efficiency, over the last three years, China has actually had energy consumption outgrow GDP. Thus, great challenges are imminent in the Chinese energy sector. On the other hand, today, China uses four times as much energy to produce a dollar of goods as the United States, and 11 times as much as Japan. From a positive point of view, this unsustainable energy situation implies that there is a great potential to further decrease Chinese energy intensity.

For China to get back on track to reach its energy efficiency potential, it will have to increase its investments in energy efficiency, especially in the industrial, buildings, and transportation sectors. There is a political statement that China will reinvigorate energy efficiency investments, but it remains to be seen in the next Chinese 5-year plan if increased R&D efforts and investment commitments will be made in China to improve energy efficiency.

Figure 6: Source: General Accounting Office (2003)

Figure 7: Source Lawrence Berkeley National Lab.
efficiency; early indication of government planning shows that China may do so. If China can get back on track with energy efficiency improvements, it will be in an excellent negotiating position for a future round of climate talks, as discussed below.

**U.S. Policy Options**

The United States has two kinds of options with respect to China’s energy growth. We can much more actively encourage modern energy efficiency and renewable energy technologies, and we can help set in place a strategy to roll China (and the United States) into a future climate regime.

Today, the United States government does close to nothing to encourage clean energy and energy efficiency in China, despite the fact that some other countries have made serious commitments in this realm in China. U.S. aid programs do not operate in China. The U.S. Environmental Protection Agency has made important inroads with pollution control in China (discussed below), and the Department of Energy has some modest programs, but in general, the U.S. has decided not to be a player. In fact, it appears that U.S.-based non-governmental organizations play larger roles than the U.S. government in promoting best practices of energy conservation and renewable energy.

This is a missed opportunity. China is eager for new technology and new policy, and the United States, especially in the states, has terrific experience in both realms. California, for example, has 30 years of history in clean energy policy. California emits only half as much carbon per capita as the United States average—and saves $1,000 per family per year in the doing. The policies that led to this remarkable achievement include appliance and equipment standards, building codes, and utility efficiency programs. The cost of the programs range from 1/2 to three percent of the average consumer’s energy bill in any given year—but the payback has always been higher than 12 percent per year, and often approaches 50 percent. It would be terrific if the United States would offer program design assistance to China, and establish cooperation programs to learn from the Chinese where they have led. Cooperation between the U.S. and China can certainly help reduce costs and market risks of clean, efficient technologies such as the integrated gasification combined cycle (IGCC), which make it possible to sequester carbon dioxide, the principal greenhouse gas, underground—making climate-friendly coal a real-world possibility.

China and the United States will also be the two most important nations in building a serious future climate policy. Finding cost-effective ways for these two nations—and India, Brazil, and Mexico—to participate is perhaps the most important climate challenge in the world today. There is good news on this front: It turns out that abating greenhouse gas emissions is far cheaper than most expected. As the California numbers above demonstrate, the first big steps (fifty percent reduction for California and New York) made serious money for consumers. The two dozen large corporations that have made climate commitments have all made money—in the hundreds of millions of dollars for some.

The further good news is that China is determined to follow an energy efficiency path, has the technical and economic potential to do so, and has shown the will to do so in previous years. It still needs programmatic assistance and political encouragement.
Air Pollution

Background and Trends

The world’s atmosphere does not recognize national boundaries. Today’s air pollution emissions are so large they routinely cross the Pacific Ocean, so pollution has become a global issue.

In fact, up to a third of the air pollution on the West Coast of the United States is Chinese in origin. This includes particle pollution, toxic dust, and a third of all mercury deposited in the U.S.A.

There are three principal sources of this pollution. The first, by far, is the industrial boilers and coal-fired power plants of China. These are generally operated without pollution controls, and many lack even basic combustion control technology. There are some 500,000 industrial boilers in China that use obsolete technology, and China now burns two billion tons of coal per year, twice as much as the U.S.

There are staggering health costs to this pollution. Premature deaths in China from air pollution are estimated at 400,000 per year, with a further 75 million acute asthma attacks.

China has taken some steps to control air pollution. Most notably, with vehicles, China is moving toward European standards for both fuels and tailpipe emissions. It is not difficult to reduce conventional air pollution from autos. Sulfur has to be removed from gasoline and diesel fuels, engines need to be modern, fuel injected, and computer controlled, and cars need durable, advanced catalytic converters and, for diesels, diesel particulate filters. This costs about 3 cents per gallon of fuel, and about $300 per automobile—for a 97 percent reduction in emissions of carbon monoxide, nitrogen oxide, volatile organic compounds, and particulates. The U.S. success of reducing vehicle tailpipe emissions in the past 35 years by more than 95% shows that this can be accomplished. The health benefits have typically outweighed costs by between factors of 10:1 and 40:1 in nations including the U.S.

Still, China’s Environmental Protection Agency (SEPA) is not nearly as strong, nor as well-staffed, as its counterpart in other nations. China needs a new Clean Air Act, with serious enforcement provisions, and a much stronger SEPA, if it is to seriously tackle its air pollution problems.

U.S. Policy Options

The United States is well-positioned to help China reduce air pollution. Our EPA is among the most capable in the world, and has led the world in reducing both stationary and mobile pollution sources. Recently, the EPA has begun work with SEPA to help it develop better pollution monitoring and modeling. This work is only marginally funded, and does not cover the
large stationary sources. The opportunities to expand this work are terrific. U.S. National Labs, especially Lawrence Berkeley, Argonne, and Pacific Northwest National Lab, have terrific resources on energy and pollution issues and strong relations with Chinese officials, but these are marginally funded.

It would also be helpful for senior U.S. policymakers to provide the political support senior Chinese officials will need if they are to raise the status of SEPA. In the long run, SEPA must be a much more powerful agency if Chinese air pollution is to be controlled.

**Conclusion**

The economies of the world depend on secure, affordable energy sources. Our environmental future depends on how we deal with global warming and air pollution. Increasingly international security is driven or conditioned by nations’ appetites for energy. The economy, the environment, international security—all will be profoundly affected by the intelligence and foresight of national energy policy.

The two largest actors in these realms, by far, are the United States and China. If these two nations take global warming seriously, a global strategy is possible; if not, we will face drastic environmental changes. Similarly, if these two nations take seriously the challenges of stabilizing the global oil market, it can be done; otherwise they, and the world as a whole, will be susceptible to oil price shocks and unsavory alliances.

China’s government has showed that it is willing to tackle these challenges. China’s work could be substantially speeded with technical assistance from the United States, and with clear political signals that the U.S. would like to enter a substantive, not symbolic, partnership on oil, greenhouse gas emissions, and air pollution.

China’s Military Modernization: What It Means for the United States

David Shambaugh, Ph.D.
Professor of Political Science and International Affairs
Director, China Policy Program
The George Washington University

Keeping China’s Military Modernization in Perspective: A Net Assessment

Like virtually everything else in China today, China’s military modernization is a mixed picture and moving target. Yet estimating the capabilities of the Chinese military—more than most aspects of contemporary China—is often prone to exaggeration and hyperbole. An objective evaluation of China’s military modernization program, capabilities, and contingency planning must strive to be balanced.

Glass of Water Half Full?

With fifteen years of sustained double-digit growth in its defense budget, continual downsizing and streamlining, doctrinal evolution, improved logistics, intensified training, and a variety of new weapons systems, China’s People’s Liberation Army (PLA) in 2006 is demonstrating new competencies and capabilities. Today, the PLA can certainly capably defend China’s continental territory from invasion, and now possesses a substantially enhanced (compared with 5-10 years ago) range of coercive capabilities against Taiwan—including electronic and information warfare capacities, naval blockade competence, air interdiction and dominance capabilities, improved sea and air denial assets, and increased ballistic and cruise missile deployments. Steady improvements in Chinese submarine capability and modernization of its intercontinental ballistic missile forces have also been notable in recent years.

While the ground forces have received lesser priority—as the naval, air, and missile forces have received more—commensurate with new peripheral war-fighting doctrine, they remain the backbone of the PLA. The ground forces field a full range of equipment, including tanks, armored personnel carriers, artillery, surface-to-surface and surface-to-air missiles, helicopters and unmanned aerial vehicles. While the numbers of inventory are large, the quality remains very uneven and much of the hardware remains antiquated. For example, of the 7,580 main battle tanks (MBTs), 6,300 are of 1950s-1980s vintage. The ground forces also possess a huge number of towed artillery (14,000), anti-tank weapons (7,200), air defense guns (7,700), and other conventional land systems.

Like the rest of the PLA, the Air Force is in transition from dated to more modern equipment. Yet, more than other services, the PLAAF has been severely handicapped by the problems afflicting China’s indigenous defense industries. What the PLAAF lacks in quality, it tries to make up in quantity (despite mothballing large numbers of aircraft in recent years). But unless and until it can sort out its production handicaps, the PLAAF will remain dependent on foreign sources of supply for its most advanced aircraft. The PLAAF’s most advanced fighters are the 78 Su-27s and the 76 Su-30 fighter-bombers bought from Russia. Since 2003, production of
the indigenously built J-10 has also begun to come on stream, after two decades of manufacturing difficulties. Another new fighter, dubbed the J-11, is the domestically-assembled version of the Russian Su-27SK. The FB-7, an all-weather medium-range fighter-bomber, is also under development. The PLA air force also flies approximately 100 helicopters (in addition to those in the ground forces), 513 transports, 10 tankers, 180 bombers (all of old Soviet design but many with upgraded capabilities), 290 reconnaissance aircraft, and 200 trainers. The Air Force has also acquired and adapted airborne warning and control (AWAC) aircraft from Russia, and is also building its own indigenous version.

If military aircraft production has been a long-standing story of problems and failures, China’s missile forces (dubbed the Second Artillery) have been a success story. It is also the story of what sustained resources and political protection over five decades will do for the development of a high-priority military objective.

Today, the Second Artillery possesses the full spectrum of offensive missile forces as well as a bona fide second-strike nuclear deterrent. This includes approximately 30 intercontinental ballistic missiles (ICBMs) with a range of 13,500 kilometers, 110+ intermediate range ballistic missiles (IRBMs) with ranges of 6500-9000 kilometers, and approximately 800 short-range ballistic missiles (SRBMs) with ranges up to 1000 kilometers. Deployment of the intercontinental and intermediate-range missiles are dispersed around the country, while the bulk of SRBMs are deployed on the eastern seaboard within range of Taiwan. The U.S. Defense Intelligence Agency estimates that China’s SRBMs are increasing at a rate of 75-120 per year. The PLA Navy (PLAN) also has deployed one Xia class nuclear submarine with approximately 12 JL-1 intercontinental-range missiles, and has successfully flight-tested a new longer-range and more accurate JL-2 version. A priority has also been placed on making the missile forces more road-mobile (and therefore harder to detect and thus more survivable), solid-fueled (and therefore much quicker to launch), and possessing smaller, more accurate, and more potent nuclear and conventional warheads.

The PLA has recently supplemented its strengths in ballistic missiles by adding a cruise missile capability to its inventory. While air and sea-launched cruise missiles have been in the PLAs arsenal for a number of years, and more advanced versions have been transferred from Russia in recent years, China is now building its own land attack cruise missiles (LACMs). These have been undergoing tests, and can be expected to be deployed soon (if not already) within range of Taiwan. This would significantly complicate the island’s defenses even further, giving the PLA a new accurate strike capability.

The PLA Navy (PLAN) has probably been the highest priority service for modernization in recent years. This has been the case for three principal reasons: (1) the military demands of containing with a Taiwan contingency; (2) the desire to eventually establish a blue water presence throughout the western Pacific and Indian Ocean; and (3) the attributes of China’s shipbuilding industry. Additionally, Russia has helped with supply of key destroyers and submarines and the best supersonic anti-ship cruise missiles available in the world. Thus, broad military doctrine has combined with specific war-fighting scenarios and industrial capacity to make the PLAN a favored service.

Today the PLAN deploys 64 principal surface combatants, approximately 331 coastal patrol craft, 34 mine warfare vessels, 50 amphibious landing ships, 160+ support ships, and 69 submarines. Like the Chinese Air Force, most of the surface warships (destroyers and frigates) are 20-30 year-old ships that have been retrofitted and upgraded over time. A limited number of these vessels can be considered open ocean capable—the vast majority constitute a coastal force. The most advanced destroyers are clearly the two Russian Sovremenny class guided missile destroyers deployed in 2000-01. Each carries eight SS-N-22 (“Sunburn”) sea-skimming anti-ship missiles, which are among the most advanced in the world. The Sunburns were designed specifically to penetrate the defenses
of U.S. Navy Aegis destroyers and aircraft carrier battle group defenses. China has ordered two more Sovremennys from Russia, due for delivery in early 2006.

Last, but not least, the PLAN has a substantial and diverse submarine force. While many of the known subs in the fleet are old Romeo and Ming class—which are slow, noisy, and easy targets for modern anti-submarine warfare (ASW)—the PLAN has embarked on a substantial buying and building program in recent years. It bought four Kilo class diesel attack submarines (SSKs) from Russia during the mid-1990s and has eight more on order (with one delivered and others due for delivery by 2007). While the PLAN has experienced some maintenance problems with these, the Kilos are quiet, relatively fast, well-armed, and can stay submerged for significant periods. Perhaps as important has been the very capable and adequately quiet domestically developed Song, Yuan, and Jin (Types 093 and 094) class submarines.

As a result of these new weapons and upgrading of old systems, there is no doubt that China’s military today is significantly improved over a decade ago. The PLA’s training regimen has improved significantly, and the fighting capacity of all services has been increased. Perhaps above all, the command, control, and “jointness” of PLA forces have been improved. PLA forces are now undertaking certain types of exercises and are displaying certain capabilities that many foreign analysts and intelligence agencies did not think was likely just a few years ago.

**Glass of Water Half Empty?**

At the same time that one recognizes these enhancements, it is important to keep the PLA’s broader capabilities in perspective. While the military modernization program has been steadily developing, with defense budget increases continually rising at an average rate of 14.5 percent per annum over the past sixteen years, China still spends less than 2 percent of its GDP and less than 10 percent of total government expenditure (CGE) on its [official] defense budget. At the height of the Cold War the Soviet Union allocated between 50-60 percent of its CGE on the military. Even its weapons purchases from Russia, averaging approximately $2.2 billion per year over the past five years, remain very modest in both financial terms (Saudi Arabia bought approximately five times this amount in 2003), and total numbers of platforms imported. Its total official announced defense expenditure for 2005-2006 will be $35.3 billion, although if one includes hidden off-budget expenditures, the total is likely closer to $60 billion—more than the United Kingdom, France, and Germany, but close to that of Japan and Russia.

Moreover, when one examines the PLA’s inventory of ground, naval, and air assets, it must be said that the vast majority still remain a decade or more behind the international state of the art—and in many areas, the gap is actually widening (due to advances in U.S. and NATO systems). China’s naval surface fleet is still a “green water” rather than “blue water” one, i.e., it is only capable of patrolling China’s coastline rather than the open ocean. The PLAAF is similarly dated—only 15 percent of its total fighter force is fourth-generation interceptors. While the newest in the PLA’s conventional forces are approaching world standards (e.g., the T-98A and T-99 main battle tank), the bulk of the ground forces’ firepower still lags behind NATO, Russian, or even Japanese systems.

When one compares the quality of China’s weapons systems regionally, however, the gap is not as great (although there still is one). The best of the PLA Navy’s (PLAN) surface combatants compare well with those in any regional navy, as the newer destroyers are comparable to those of even Japan, and the best of the PLAAF’s fighters are about equal in quality to those of Australia, Japan, Singapore, South Korea, Taiwan, and Thailand. Of course, what the PLA has that these other militaries do not is numbers. The Chinese air, ground, and naval weapons platforms dwarf those of any regional military. This is not an unimportant factor in any potential regional conflict scenario involving China. Despite large numbers of retired sys-
tems in recent years, the PLA can still bring to bear a substantial force and wave-upon-wave of attacks against any adversary. Indeed, mothballed weapons can be refurbished and mobilized if necessary.

When viewed in a broader regional or global context, the PLA still has very limited or no capabilities. Specifically, the PLA evinces little evidence of attempting to acquire a power projection or force multiplier capability—it has built no aircraft carriers; has no intercontinental bombers; possesses only a very small fleet of in-flight refueling tankers (and has not mastered that skill) and airborne command and control aircraft; has a small number of truly blue-water capable surface combatants; possesses no military bases abroad; has no global network of command and control; or other elements that one would expect to see from a nation trying to seriously develop a power projection capability or become a global military power. Even a close reading of Chinese military doctrinal manuals gives little, if any, evidence that power projection beyond China’s immediate periphery is a priority.

Glass Half-Full and Rising

Thus, any net assessment of PLA capabilities and progress in China’s military modernization program must conclude that the proverbial glass of water is simultaneously half-full and half-empty—but the volume is rising. Only three or five years ago, such an assessment would have likely concluded that the glass was only one-quarter or one-third full. With the recent developments noted above, the PLA has made a “mini-leap” forward over the last three or so years. This is particularly the case with respect to information and electronic warfare, land attack cruise missiles, joint training, more fourth generation fighters, a few new surface combatants and submarines.

Yet, any balanced assessment should also be cognizant of the various bureaucratic, financial, industrial, and technological impediments confronting China’s military-industrial complex, as well as the important fact that China remains essentially cut off from importing weapons or defense technologies from the West. China remains under a total embargo on arms sales and defense technology transfers from the United States, and there is no prospect of this being relaxed or lifted. The European Union maintains a similar embargo, although it is not as air-tight as the U.S. one. Even with limited access to European military-related technologies, China’s only real foreign option for advanced weapons and defense technologies remains Russia and, to a much lesser extent, Israel and Brazil. In the Israeli case, the United States has stepped up its pressure on Tel Aviv to restrict such sales to the PLA.

Without such access to Western sources of supply, the pace and scope of PLA modernization has been negatively affected and slowed. The PLA is modernizing without much access to advanced Western systems, but the lack of such access does substantially affect both the speed and scale of modernization. Recognizing this, Russia has nonetheless been a major supplier of entire end-use weapons platforms to the Chinese military. In purchasing these systems from Russia, the PLA has sought to simultaneously address its most pressing needs and deficiencies. That is, these are weapons systems that China’s own defense industries have proven unable to produce indigenously (see discussion above), but are also systems most urgently needed for a potential war over Taiwan that would involve conflict with the United States. By filling these “niche needs” from Russia, China’s own defense industries have been able to concentrate their resources on a wide range of other less sophisticated systems. More and better imported weapons systems from Russia can be anticipated in the future, perhaps including Su-35 fighters, multi-role destroyers, and non-nuclear Amur class attack submarines.

Thus, the PLA is steadily modernizing and making surprising progress in select areas. Compounded over time this modernization process will transform the PLA into a fairly modern military within 10-15 years, yet one that
is still limited to a regional reach (notwithstanding ICBMs and SLBMs). Thus, China’s military has transitioned from being a third-rate to a second-tier military power, but still has a very long way to go before it can be described as a military of first-class global standard.

Overall Perspectives and Policy Implications

So what should the U.S. Congress and Government think and do about China’s military modernization? What follows is, first, a brief discussion of metrics and prisms to view these developments, and then several specific policy recommendations.

All Asian nations and the United States must wrestle with the reality of a more modern Chinese military. This trend will only continue unabated, and may even accelerate in certain categories of military power. China _will_ possess a modern military—the only real questions are _when_ and _to what ends_ it will be put? In some areas we are already witnessing “modern” near state-of-the-art capabilities (new generations of guided and ballistic missiles, fighters, destroyers, submarines, tanks, electronic warfare). In many other categories, China’s military-industrial complex is making incremental advances that, over time, will close the technological gaps. Yet, in other areas, the PLA continues to lag considerably behind modern capabilities, i.e., power projection and command and control technologies. Thus, the answer one gets to the _when_ question very much depends on the category of capability one examines. The PLA does not all of a sudden one day arrive at the stage of “modernization” _in toto_—rather, as is already evident, certain sectors “arrive” before others, while some lag perennially behind.

The answer to the “to what ends” question is more complicated. This very much depends on perceptions.

Some may view the PLA’s acquisition of _any_ power projection capability as threatening and destabilizing—simply because it is a new capability that China has not previously possessed. An alternative view takes a more sanguine view of PLA modernization and the development of power projection capability, i.e., that it is natural for a continental nation with China’s size, level of development, and national interests to build and possess the full range of such military capabilities. Thus, the answer to the question of whether China’s military modernization is natural or not very much depends on the metric applied.

While the scope and pace of China’s military modernization process can be slowed from the outside, via arms embargoes for example, it cannot be stopped. It is a fact of life that Asia, the United States, and the global community will simply need to adjust and get used to. This will not be easy to accept for many accustomed to a weak China and a weak Chinese military, but it will only become an increasing reality with which they must come to terms.

Ten Policy Recommendations for the Executive Branch

1. Devote priority attention and resources to intelligence collection, monitoring, and analysis of Chinese military modernization and capabilities.

2. Do not be taken in by hyperbolic and exaggerated depictions and estimates of China’s military; be hard-headed and balanced in intelligence assessments.

3. Beware of how American actions—including the U.S. military buildup in the western Pacific, deployments in Central and Southwest Asia, and growing U.S.-India military ties—shape Chinese strategic perceptions, and hence military resource allocations.

4. Consult regularly and intensively with U.S. allies and other nations in Asia about _their_ perceptions of China’s military modernization, China’s regional posture, and policy, and U.S.-China relations.

5. Maintain a robust deterrent, but not aggressive, U.S. military presence in East Asia and the western Pacific.
6. Be sensitive to China’s concerns about Taiwan independence.
7. Be sensitive to China’s concerns about U.S. containment.
8. Maintain a strict embargo on all military systems and defense-related technologies to China—so as not to augment China’s military modernization in any tangible way.
9. Increase dialogue with the EU concerning China and maintain pressure on the European Union not to lift or relax its arms embargo on China—to the contrary, work with the EU to tighten it.
10. Engage in expanded U.S.-China military-military exchanges so as to improve understanding, improve confidence, and reduce misperceptions.

Ten Policy Recommendations for Congress

1. Require regular reporting by the executive branch on intelligence assessments of the Chinese military—and query the basis for judgments contained in the Pentagon’s annual report to Congress: The Military Power of the People’s Republic of China.


3. Provide adequate funding for sufficient intelligence collection, monitoring, and analysis of China’s military, security, foreign policy, and domestic politics—and require regular reporting on the expenditure of such funds.

4. Increase funding to dramatically improve “open source” collection and analysis on China’s military, security, foreign relations, and domestic politics—including for the Library of Congress and the Congressional Research Service.

5. Hold occasional hearings by the House and Senate Armed Services and Intelligence Committees of nongovernmental experts on China’s military/security.

6. Hold periodic Foreign Relations (Senate) and International Relations (House) hearings on China’s global foreign relations and their implications for the United States.

7. Build expertise in Congress on Chinese affairs and hire committee staff fluent in Chinese language, possessing advanced degrees in Chinese studies, having lived in China, and knowledgeable about China (today there are none possessing these attributes on any Congressional committee!).

8. Draft legislation and fund a major national educational initiative in Chinese studies at the secondary and university levels across the United States.

9. Engage in dialogue with legislators and parliamentarians in Europe and Asia about their views of China, the “rise” of China, and cooperatively managing China.

10. Stay engaged on China, see the “Big Picture” and “Long Term” of the U.S.-China relationship, educate yourselves and be mindful of the history of the relationship.

Stability since 1989

In the aftermath of the 1989 military crackdown on peaceful protesters in central Beijing, China’s leaders pleaded with foreign visitors for understanding. China could not afford instability within its borders, they said, and nor could the world. They raised the specter of an unstable China, unable to feed and clothe its then 1.2 billion people and deluging neighboring countries with wave upon wave of refugees. China’s leaders said they had ambitious plans for economic development, but insisted those plans required a stable environment at home and abroad.

Over the 17 years since, with the stick of repression and the carrot of improving living standards, China’s ruling Communist party has been remarkably successful at heading off widespread unrest even as Communist regimes elsewhere collapsed. That record is even more striking given that China has been feeling its way through an inherently destabilizing transition from a socialist to a market economy. That transition, which is ongoing, has lifted 200 million people out of poverty and rapidly moved China up the rankings of the world’s largest economies, but also exposed China’s population to wrenching changes. In the early 1990s, price reforms sent the cost of basic necessities in the cities soaring. In the late 1990s and early years of this century, restructuring of the state sector cost some 40 million workers their jobs. Urban citizens have lost their homes to development projects and farmers their fields. Environmental degradation has accelerated. Protests have been common, yet overall social order has never broken down.

Stability now

Can the Chinese Communist Party continue defying the odds? China watchers are asking that question with some urgency now partly because of dramatic reports that have filtered out since late 2004 of violent clashes between farmers and police in far flung parts of the country. Chinese activists and foreign journalists have chronicled half a dozen major cases, but because the Communist Party routinely throws up roadblocks around restive villages and bans all media coverage, other equally serious incidents have almost certainly gone unrecorded. The largest known incident was in November 2004, when the government called in paramilitary police to quell protests by an estimated 100,000 farmers in western China’s Sichuan Province.

Also feeding concerns about stability in China are the Chinese government’s own statistics suggesting protests are on the rise, though the broad categories the government uses make the numbers only modestly useful. The Ministry of Public Security reported 87,000 crimes of “disturbing public-order” in 2005, an increase of 6.6 percent over 2004. Included in that category were cases of citizens hindering government functions (up 18.9 percent over the year before), “gathering mobs to disturb public order” (up 13 percent), “brawling” (up 5.8 percent) and “creating distur-
bances” (up 11.8 percent). In July 2005, Minister of Public Security Zhou Yongkang referred to a different, more useful category of “mass incidents,” including riots, demonstrations and collective petitions. The total of such incidents in 2004 was 74,000, involving 3.76 million people, he said, a sharp increase from 2003’s figure of 58,000 incidents, and 8,700 in 1993.

Comments from government and party officials occasionally hint at high-level concern about social stability. In a December 29, 2005 speech, Premier Wen Jiabao, for example, chastised local officials for mishandling the seizure of land from farmers for development projects and setting off “mass incidents” that posed a “significant problem for social order.” At a time when unrest in China has become a hot button issue in Western policy circles, however, it is worth noting that many Beijing elites are far from convinced that China has a particularly urgent problem on its hands. In an internationally-televised press conference on rural policy in February, a Chinese vice-minister went so far as to declare China the most stable country in the world.

Media censorship and incomplete official statistics make the true scale of unrest in China difficult to gauge. In the near term, widespread unrest may be unlikely. Nonetheless, scattered protest on a significant scale is clearly already happening and, as this paper will detail, many groups in China have genuine grievances that the Communist Party has so far shown itself ill equipped to address. To manage those grievances, the Party needs, at a minimum, to pursue serious reform of the courts, which are currently heavily biased in favor of local governments and thus unable to mediate disputes fairly. To tackle the root causes of many popular grievances, the party needs to embrace political reform. Without such reforms, long-term stability will be hard to guarantee.

What stake does the United States have in China’s stability?

China’s stability matters to the United States most of all because of the growth of the Chinese economy in recent decades and its integration into the world economy. China recently became the world’s fourth largest economy, after the US, Japan, and Germany. It is the world’s third largest trader, the third largest trading partner of the U.S., and the sixth largest market for U.S. exports. Even moderate instability in China would cause huge disruption to global manufacturing, devastate the increasingly China-tied economies of China’s neighbors in Asia (including U.S. allies), and risk shutting down a key engine of growth for the world economy. It would drive up household bills for millions of Americans who currently rely on cheap imports from China to sustain their standard of living. It would also deliver a serious blow to American businesses, which have collectively invested more than $50 billion in China to date.

Serious instability in China would affect the global political order, too. With its permanent seat on the United Nations Security Council, its nuclear weapons, and its sway with North Korea, China is an important player on a wide array of global issues. Instability in China would also worsen world poverty, fuel transnational crime, undercut efforts to control the spread of disease, and fuel illegal immigration from China to the rest of the world.

Sources of instability: the Communist Party’s view

The Communist Party sees some level of unrest as an inevitable byproduct of the transition from an agricultural to an industrial society. The root of social instability in this transitional period, the party has decided, is the uneven distribution of wealth across the country. The economic development of the last 28 years has disproportionately benefited China’s 350 million urban residents and the booming eastern part of the country. Each year, China’s 950 million citizens from rural families, along with the poorer western part of the country, fall further behind. Highlighting the gap, the United Nations-commissioned Human Development Report 2005 for China calculated the human development index, a measure of life expectancy, level of edu-
cation, and level of economic development, at 0.81 for China’s urban areas and just 0.67 for its rural areas. For the country as a whole, China admits now that its Gini coefficient, a measure of income inequality, has risen to a dangerous 0.4. (Zero is completely equal wealth distribution and 1 is completely unequal wealth distribution.)

With social stability firmly in mind, helping the rural population catch up has become a national priority. In 2003, the government scrapped regulations that had allowed for the arbitrary detention and deportation of rural citizens from cities. This year, it abolished agricultural tax. Also this year, it ordered rural schools in western regions to stop charging tuition for the first nine years of compulsory education. Rural schools in the rest of the nation are to eliminate tuition fees by 2015. Critics note, however, that the effect of some of Beijing’s grand gestures has simply been to make local governments more cash-strapped than ever, and thus more inclined to pursue fund-raising schemes that alienate the rural population, spurring more unrest.

A common way for local governments to raise funds is to sell off farmland to developers for industrial parks, factories, villa complexes and golf courses. Farmers, who are permitted to contract land but not own it, frequently complain that the compensation they are given for their seized fields is far less than the developers paid for them, and that local officials have pocketed the difference. No surprise, then, that land seizures have become a leading trigger for rural unrest.

Among other issues sparking rural unrest are local government-imposed fees, environmental pollution, unpaid wages, and official corruption. In urban areas, major unrest stems from resettlement orders commanding residents to leave their city center homes to make way for new high-rise apartment and office blocks. Other issues include disputes over layoffs, pensions, and again corruption, particularly in the medical and education systems and the land development process.

Sources of instability: other views

Analysts outside the Communist Party tend to see the root cause of unrest not so much in income disparities as in the Leninist state. The lack of accountability inherent in a one-party state breeds the official corruption and high-handedness that so enrage ordinary citizens. Every year, the party announces new initiatives designed to weed out corruption in its own ranks, but each year, the scale of the problem only seems to grow.

As fundamental a problem is that without an independent judiciary, free media, or opposition political parties, citizens with grievances against local officials or politically-connected businesspeople lack legitimate outlets for redress. Because of the government’s great fear of all organizing it does not control, aggrieved citizens even run into trouble with the party if they try to select representatives to take up their complaints with the authorities.

The inadequacies of China’s legal system are a particularly glaring problem. The role of courts anywhere should be to mediate disputes in society. In China, however, local governments control court personnel and court budgets, and party committees and people’s congresses routinely weigh in on court verdicts. Courts therefore have a built-in bias toward supporting the government. Ordinary citizens have little hope of winning cases brought against officials and courts routinely decline to hear such cases, anyway.

In a recent interview with the *Peking Review*, (an authoritative English-language weekly aimed at foreign audiences) Peking University Professor He Weifang cited the example of land resettlement cases. When the courts were ruling on cases challenging government resettlement orders, Professor He charged, they simply acted as “a proxy of local governments” in upholding the resettlements. Then, he noted, the Supreme People’s Court issued a judicial interpretation, forcing the lower courts to stop accepting litigation involving resettlement issues altogether.

The single legal outlet that the government recommends for disgruntled citizens is the peti-
tion system, which allows them to deliver complaints to designated government petition offices. Under new rules designed to defuse popular discontent, governments must issue responses to those complaints within a set time frame, but the sheer number of petitions filed makes responses to all petitions, let alone meaningful responses, next to impossible. (Last year, the Public Security system launched a campaign to respond to petitions filed with its offices in a four-month period. It got through 180,000 petitions, but still had 20,000 left by the time the campaign ended. Chinese citizens lodged a total of 30 million petitions with various government and party offices in 2005.) A more fundamental problem is that, like the court system but worse, government petition offices naturally side with accused officials. That leaves the desperate to turn instead to illegitimate outlets, such as sit-ins, attacks on government or company buildings, blockading of roads and train lines, and clashes with police.

Potential sources of instability

Potential sources of instability include an outbreak of pandemic disease, such as avian flu, which could trigger widespread unrest if the government handles it badly. Another is the emergence of nationwide charismatic movements such as Falun Gong, which in 1998 came out of nowhere to become the most tenacious challenge to political authority that China has known since 1989. The Communist Party worries obsessively about the potential for instability from restive minority populations in the northwestern region of Xinjiang Province and, to a lesser degree, in Tibet. It even frets that perceived insults by Japan or moves toward independence by Taiwan could cause nationalist passions to spill over into an anti-government protest movement. The Communist Party does not openly consider the implications for stability of a war to recover Taiwan, possibly pitting China against United States forces, but such a scenario would undoubtedly strain China’s social fabric to the breaking point.

How has the party so far managed to prevent unrest from spreading?

The party’s control of the Chinese media has been central to its success in keeping unrest from spreading. The media are under strict injunctions not to report outbreaks of unrest, so citizens in other communities, or with similar grievances, usually do not know they are happening and cannot be tempted to protest in solidarity. In an age of cell phones, text messages, and web logs, the party no longer exercises complete control over information, but through intimidation, including publicizing the arrests of citizens who send sensitive text messages or post sensitive material on the Internet, it remains surprisingly effective at keeping most incidents of unrest under wraps.

Also important are the party’s tactics in dealing with unrest when it does break out. Police are ordered to avoid anything that might escalate the protests, and to use force only with great caution. Local authorities routinely give in to at least some of the protesters’ demands, especially for monetary compensation. Police arrest protest leaders, but often after the fact, and generally do not round up rank and file protesters. To be sure, those tactics, while helping to defuse individual outbreaks of unrest, also encourage new outbreaks. Police literature refers to a principle among protesters: “Small fuss, small pay off; big fuss, big pay off.”

Beijing is on constant alert for the possible emergence of national protest leaders, swiftly arresting any local protest leaders with proven charisma and leadership abilities and sentencing them to long prison terms. The so-called “color revolutions” of Central Asia have even revived the party’s suspicions toward nongovernmental organizations, particularly those with foreign funding. Chinese leaders hold NGOs responsible for the street protests that swept authoritarian leaders from power in Georgia in 2003 (the Rose Revolution), Ukraine in 2004 (the Orange Revolution), and Kyrgyzstan in 2005 (the Tulip Revolution). All such NGO’s are now on a short leash, with their activities closely monitored.
The Communist Party’s defenders say it does recognize the need for political reform, too, and that it is working to increase opportunities for legitimate political participation. But the examples they cite are modest. The government is holding more public hearings on new laws and regulations, they say. It is working to strengthen the role of party-controlled labor unions and agricultural unions, as well as people’s congresses, which play a nominal role in supervising government. It is supporting elections at the lowest level of government. Among the party’s newest initiatives is allowing grassroots party members to participate in direct elections for party chiefs of townships, the political unit above the village. Township party secretaries have until now been appointed by higher-up party bodies. The new approach is meant to bolster popular support for local party leaders by giving local party members a stake in their election.

In the face of the tensions thrown up by a rapidly changing society, however, such limited reforms seem hardly adequate. The danger for the party is that the sheer number of aggrieved citizens attempting to deliver petitions and resorting to protest will eventually overwhelm the party’s ability to keep all outbreaks of unrest isolated and unpublicized. The party must fear that anger at any number of issues, from corruption to land seizures, combined with new communications technologies, a news media willing to push back against party injunctions, and a disunited leadership, could spur the rapid formation of a protest movement on a national scale.

**Recommendations for American policy**

In considering what American policy toward China should be, a key first question must be whether stability in China is in the U.S. interest. In 1989, at the height of the Tiananmen demonstrations, many Americans may well have said no. Although China’s leader at the time, Deng Xiaoping, enjoyed a popularity in the United States that no Chinese leader since has matched, those demonstrations dangled the possibility of an end to Communist Party rule in China, an outcome that many Americans would have welcomed on human rights grounds alone. The United States had limited economic stakes in China then. Americans’ biggest concern about a period of instability in China would have centered on the not trivial question of who would secure China’s nuclear arsenal.

Today, most Americans would likely give a different answer, mostly because of the substantial economic stakes the U.S. and the world now have in China. If one does indeed conclude that the U.S. has an interest in stability in China, what then? A useful first step would be to declare as much to the Chinese leadership, which continues to suspect that U.S. officials, and particularly U.S. lawmakers, secretly wish nothing more than to see China in turmoil. With some level of goodwill generated with that declaration, the U.S. might next want to encourage the Communist Party to undertake the kind of systemic political reforms that are China’s best bet for heading off widespread unrest.

Reform of the judicial system, to enable it to play its proper role in mediating societal disputes, is an urgent imperative. That means explicitly moving the courts out from under the influence of Communist Party committees, switching to a system of national and provincial funding of court operations, and authorizing the Supreme People’s Court, rather than local governments, to appoint judges. The U.S. could offer technical support for the reform. It could also increase funding for training of Chinese judges, who must be taught to rule according to the law, rather than according to the interests of local governments.
Economic issues highlight the most important U.S.-China dynamic, to wit, how much China’s evolution as a world power and its relations with the United States depends on U.S. policy. Could efforts to limit China economically, to exclude it from its normal place in the world, succeed? Or would they damage U.S. interests in the process? Do policy initiatives maximizing China’s stake in a collaborative and democratic world order have the best chance of guaranteeing American prosperity and security? If so, America needs dramatic domestic reform, raising productivity in modern and emerging products, to prepare for a world where protectionism and U.S. isolation risk long-term secondary economic status.

China’s economic record by now has made it clear that its growth performance is no flash in the pan. It conforms to growth patterns in other earlier East Asian industrializing economies, with the exception that it successfully relies more heavily on its own domestic demand than did Japan, South Korea, Taiwan, Hong Kong or Singapore. China’s economy will not be twice the size of America’s economy until after the middle of this century, so there is still time. But the policy challenges are unmistakable. The best policy is to engage China and reform at home.

A. Is China already a superpower? No. Will it be? Yes.

The volume of China’s trade, its number-one status in foreign direct investment (FDI), and its sustained high growth rates make it look like a global “engine of growth.” But it is not really there yet. Measured correctly for commerce and military power (i.e., with exchange rates), China’s GDP is 17 percent of America’s. It won’t reach America’s 2005 level until around 2025, by which time America will still be much bigger.

Roughly half of China’s export value was imported from somewhere else. When China’s growth slumped seriously in the latter 1990s, it didn’t make a dent in the U.S. dot-com expansion, and China’s own rapid domestic demand-led growth in 2002 could not counter the impact of the U.S. recession that year on the rest of Asia and Europe. What looked like China’s 2003 contribution to economic recovery in Japan and the rest of Asia was heavily a recovery in Asian exports to the United States and Europe through China, with other countries’ products assembled and finished in China for the last leg of their processing journey to OECD markets.

Thus, China is not a superpower yet—but it will be. The character of China’s current growth success indicates continued high-single-digit GDP growth through the first half of this century. Even if America grows robustly, China will have an overall economy roughly double America’s by 2060. That day is little more than two generations away. We need to get ready.
1. Non-democratic polity and China’s national character

Does China’s non-democratic nature mean it will be a bad actor when its economy eventually gives it the heft to throw its weight around? This has not been the record for similar economies successfully engaged into the world’s commercial and legal systems. South Korea and Taiwan both had repressive non-democratic regimes well past the time when their domestic economic status was similar to China’s today. I lived for several years in each place during those bad times. Bad actors emerged in earlier twentieth-century history when new industrial powers were prevented—by a draconian peace or by global depression and colonial boundaries—from assuming the international stature to which their economic productivity entitled them.

Domestic changes in China over the past 25 years have dramatically expanded individual freedom of choice over lifestyle and occupation, with nothing approaching the crippling and unconscionable restrictions by caste and gender found, for example, throughout South Asia. As China’s domestic pie expands and as current policies promoting broad-based education, orderly migration to cities and social safety nets continue, citizen participation in a whole range of public decisions will likely continue to improve apace.

China’s 3,000 year economic and political history is one of commercial competition and continual evolution of orderly national governance systems based on written law. The era of one-man rule in China’s current dynastic cycle is already long past—it ended with Mao’s death in 1976. China’s re-creation of a stable law-abiding commercial and political system along modern international lines still has a long way to go, however, in large part because of China’s poverty. The major U.S. policy implication argues for resources on a large scale to assist China in making just those improvements to its judicial, legislative, corporate governance and economic regulatory systems that China itself is seeking to improve. This is not our stance now.

2. China’s poverty and its place in the world

The World Bank says 200 million Chinese live on less than a dollar a day and more than a half-billion on less than two dollars a day. With better PPP (purchasing power parity) accuracy these rates would almost certainly be higher. China is not desperately poor like much of sub-Saharan Africa or huge segments of South Asia, but it is poor nevertheless. China’s per-capita GDP in commercial terms is only 4 percent of the U.S. average. This means that despite its size, China’s economic attention for a long time must be turned to domestic development and management of fierce wrangling at home over such a small per-capita economic pie.

A development gap represented by labor productivity at only 4 percent of the American level also indicates that China’s potential for enjoying rapid catch-up growth is strong. This level of relative development matches South Korea’s position somewhere in the 1960s. Hence, even more than today, we should expect Chinese penetration of increasingly sophisticated markets to follow at least a South Korean pattern in coming decades, but on a much larger scale. This is a competitive challenge calling for enhanced skills development and labor mobility—through much improved health-care and pension systems, for example. America’s private sector is going to need the infrastructure and public resource base necessary to stay ahead of the game.

3. Secrets of China’s growth success—its own policy paradigm

China’s rapid growth is proving sustainable because it has evolved an economic policy paradigm that solves many of the problems that confound other poor countries. In my analysis, five major policy dimensions explain China’s current and likely ongoing growth success.

Mobilization of financial resources for large-scale infrastructure and other basic investments, including educational investments, is first. Second is gradual strengthening of market-based incentive systems rewarding knowledge, effort
and risk-taking. Third is measured opening to global commerce, both trade and investment, without succumbing to excessive liberalization. Fourth is successful attention to building a middle class through land-reform, decently funded poverty-reduction programs and a measure of compensation for losers in the country’s wrenching restructuring. Finally, fifth is enforcement—albeit imperfect—of a relatively crime-free and stable society where corruption—albeit prevalent—is prosecuted and punished on a regular basis. All of these policy dimensions are targets of continuing if not accelerating reform and Chinese legislative action.

The crux of this paradigm is strong national and local economic leadership. Political promotions increasingly reward not just growth but a growing list of complementary policy accomplishments, including technology progress, poverty reduction, environmental progress, improved education indicators, peaceful resolution of local unrest and avoidance of serious corruption. Transparency International puts China’s corruption levels just below Poland’s and ahead of Argentina, India, Bangladesh, the Philippines and Indonesia. This system of political incentives enjoys the robust support of the military, internal security agencies and—polls show—large segments of the population.

This policy paradigm also relies on powerful systems of repression targeting any person or institution threatening CCP (Chinese Communist Party) authority and legitimacy. A major U.S. policy objective must be to help persuade Chinese authorities—with minimal condemnatory invective—that, as China succeeds in gaining economic stature, such repressive systems become unnecessary and counterproductive, given the effectiveness and constructive utility of other mechanisms for channeling opposition opinion. Helping strengthen such alternative mechanisms is an obvious high priority.

4. Risks and likelihood of crisis or growth failure

Risks to continued success are of two kinds—policy blunders and policy inertia in two critical dimensions. Blunders would involve excessively rapid liberalization of China’s domestic financial system and its management of international capital flows. Such rapid liberalization would invite financial failures highly disruptive to rapid orderly growth.

Inertia threatens long-term success if China fails to strengthen central and provincial government oversight in the affairs of local governments. China’s current corporate political system worsens local abuses contributing to social unrest because higher governmental levels must work through the very local governments subject to investigation.

Inertia also encourages China to limit grain importation and hence limit lucrative farm product diversification. This outdated political posture risks keeping large swaths of rural China growing low-profit staple crops, limiting their potential for shifting to the modern non-farm world and increasing chances for rural dissatisfaction and unrest.

Besides blunders and policy inertia, neither of which has been in much evidence, there seems little downside to China’s growth prospects. China has shown it can weather international crises like the Asian financial crisis and domestic crises like SARS. Policy adaptability seems to be one of this government’s many strengths.

5. Implications for the developing world—lessons to learn

An intriguing potential outcome of China’s success with this growth paradigm is its attractiveness to other large poor countries. Take China’s two-pronged financial system. It continues to use and perfect a system for directing private and corporate deposits into public investment projects—arguably the single most important underpinning of sustained rapid growth, given a poor country’s weak tax base. At the same time China is encouraging the rapid improvement of its nascent market-based financial system, a system unlikely to reach maturity
for several decades. Many other countries have tried directed credit and failed. China’s successful approach—following earlier successes in South Korea and Japan—could pique interest from other countries. If they succeed in emulating China’s growth success, the U.S. domestic policy implications mentioned here with regard to China will only become amplified.

6. Long-term strategic implications of China’s growth for America

Policy implications of China’s successful growth paradigm are of two sorts. The first is: Do not waste time wishing for or intriguing in the direction of a “color revolution” in China like Ukraine’s “Orange Revolution,” when mass demonstrations by a popular citizens’ movement forced a more representative election outcome. China’s economic system is too robust, too successful and too well buttressed by interlocking structures of financial, military, and social support for any such citizens’ movement to succeed. Instead, put resources into encouraging understanding and implementation of institutional developments in China that can both serve its long-term success while encouraging government solutions leading to maximum choice for its people, including over the nature of government.

Second: Get ready at home. Insufficient domestic U.S. investments in human productivity could eventually trigger U.S. populism and protectionist measures irresistible in a democracy as sophisticated as America’s. At its extremes, the policy choice is stark. America could ride the crest of China’s own productivity wave by staying on top in terms of new products and the labor force able to provide them without leaving anybody behind. Or, America could find its purchasing strength and its currency rapidly losing stature as the century proceeds.

B. China’s balance of payments and holdings of U.S. currency

It is important to note at the outset that U.S.-China bilateral trade balances say nothing about China’s policy behavior or its currency. Bilateral balances exaggerate China’s contribution to the American deficit. What look like China’s exports include exports from other countries channeled through China. The key is global patterns of trade and payments.

1. China’s global trade and payments

America’s overall trade deficit is a deficit with the global supply chain. The only way to know which countries are responsible for the American deficit is to ask, “Which countries have large trade surpluses with the global supply chain?” In other words, if the American trade deficit is pumping dollars into the global economy, which countries are sucking the most dollars back out? The answer is the Euro currency countries and petroleum exporters. Germany’s trade surplus alone has been bigger than China’s for many years. Until last year, China’s global trade surplus was smaller than the combination of surpluses from Singapore and Malaysia.

The growth of China’s trade surplus in 2005 reflected an import slump from domestic policies cooling off investment that had been pumped up to fight SARS. It was not caused by Chinese exchange-rate movements, for example. The important policy lesson is to refrain from drastic and irreversible anti-China policy steps based on appearances from bilateral trade deficits with China. One should look at global balances and know that China is not the bad actor that bilateral balances say it is. Pressure on Germany and Japan to run their own deficits is key.

2. China’s U.S. Treasury bill holdings

China’s accumulation of foreign exchange reserves is similarly easy to misinterpret. Reserves build up because of three factors: trade surplus, FDI net inflows, and speculative capital inflows anticipating a Chinese currency revaluation. Over the recent years of China’s exchange-rate controversy, speculative inflows have been the largest part. These could reverse flow quickly, so they are considered “hot” and not really part of China’s long-term holdings.

What level of long-term reserve holdings is
appropriate? The Asian financial crisis of 1997-98 showed that countries hoping to keep their exchange rates stable in the face of speculative investment surges need both very large reserves and the ability to suffer significant deflation and drops in property values if they are going to permit investment funds to come and go freely. This is one reason why China has not completely liberalized investment flows and why its reserve build-up could come in handy once it does decide to do so.

China holds most of its reserves in the form of U.S. Treasury bills and close substitutes, like other U.S.-government-backed bonds. This is because they are the highest-quality, most liquid bonds in the world. Two reasons explain why this concentration of holdings, second only to Japan’s, is not a threat to the U.S. economy or its security. First, bond markets for U.S. Treasuries and all their substitutes are deep and liquid. If China suddenly tried to sell off any significant share of its holdings, it would only hurt itself by having to take a lower price. Second, China’s whole global economic strategy for decades to come is to be a reliable commercial and financial partner in world affairs. Any politically motivated sell-off of U.S. paper would run completely counter to that long-term strategy for global economic success.

3. China’s exchange rate

China’s nominal exchange rate has remained relatively stable for over ten years. But accounting for high inflation in China in the middle 1990s, it appreciated strongly before stabilizing in real terms in the late 1990s. Interestingly, the very recent ten-year revision in official Chinese growth rates revealed that the currency had appreciated an additional ten percentage points in real, inflation-corrected, terms beyond what we had originally thought.

China’s exchange rate is a secondary factor for explaining U.S. trade balances and China’s global surplus, for several reasons. First, the bulk of China’s exports that are composed of lightly processed imported parts and kits would hardly be affected by a Chinese revaluation. The impact on inbound parts would be reversed on export. The key issue here would be exchange rate movements in South Korea, Japan, Taiwan, Thailand and the Euro-country zone.

Second, China’s tariffs and non-tariff barriers with the rest of the world are changing rapidly in ways that have much stronger influence on trade patterns than exchange-rate adjustments. It is better to wait for the WTO and Multi-Fiber-Agreement dust to settle before considering the exchange rate.

Third, China has strict controls on short-term capital movements. Short-term capital outflows caused the sharp devaluations in Asian exchange rates during the Asian crisis. If China relaxed controls on capital flows, many domestic investors would diversify into U.S. dollar, Euro, Yen and Hong Kong dollar-denominated assets. The effect would be devaluation, not revaluation. A truly market-based result thus would mean a weaker, not a stronger, Chinese Yuan.

For U.S. policy, this analysis points to reduced policy emphasis on China’s exchange rate, to the degree made possible by partisanship and political vulnerabilities.

C. Domestic Social Instability and its Economic Foundations

Recent international media reports describe violent protests against official corruption, uncompensated land seizure, and unpaid wages and pensions. Official Chinese data releases indicate that China had to manage 87,000 incidents of disturbance to the peace in 2005, up from 10,000 in the early 1990s. I don’t know of a useful breakdown of this statistic, which includes barroom fights as well as mass demonstrations. We really do not know what is what. International media describe peaceful demonstrations, sit-ins and office-occupation protests broken up by goon squads supported by police, with the arrest of ringleader demonstration organizers. In one South-China incident this winter, police fired on peasants, killing an uncertain number. The officer in charge of
police was, however, subsequently arrested.

One view interprets these trends as a failure of governance and a descent into destabilizing chaos. But analyzing the economic foundations of this unrest indicates that many such incidents are unavoidable side-effects of economic reforms that reward initiative and hard work at the expense of inherited privilege. Those losing privileges often opt to protest publicly. There are four basic dimensions to the economic causes behind this unrest.

1. Four ways that economic reforms promote social unrest

First, price reforms reflecting relative scarcity have raised rural prices and undermined financing for formerly subsidized urban food and services. The roughly one-quarter of China’s families eligible for urban subsidies have found their incomes, and even employment, hurt. Such price reforms caused cash wage costs to grow rapidly in the 1990s, forcing the layoff of roughly 50 million urban workers from 1995 to 2005. Dissatisfaction with urban job prospects and with China’s three-level safety net is intense, triggering untold demonstrations, many of them violent.

Second, major portions of China’s pre-reform industrial capacity were located either in Manchuria (at the terminus of the trans-Siberian rail line) or deep in interior provinces (relocated there in the 1960s for fear of foreign attack after the Sino-Soviet split and during the U.S. war in Vietnam). China’s global commercial reforms have made these locations unprofitable compared to coastal cities. “Rust-belt” layoffs of manufacturing workers in locations with little opportunity for reemployment have triggered urban labor unrest throughout these interior regions.

Third, reforms that relax restrictions on rural migrants seeking jobs in urban areas have put pressure on subsidized urban labor to work harder for reduced pay and benefits, feeding widespread discontent. The discontent is worse if the migrants come from ethnic minority areas.

Fourth, suburban land is so scarce—and use rights so diffusely managed by the village as legal owner—that disputes over land seizure and fair compensation are potentially explosive for virtually every county in the country. Seizure and compensation are both necessary for growth and productivity gain, but they inevitably trigger popular dissatisfaction.

2. Corruption and government policy

Corruption in some local jurisdictions only makes matters worse. It may not by itself be the underlying cause of so much unrest, but it contributes to much of the injustice and amplifies the anger. Claims of corruption also serve to hide the hard facts of the situation. Many pre-reform subsidized families feel entitled to a standard of living that their own productivity (or lack thereof) cannot in fact justify, especially under market-price conditions. Rather than acknowledge this, it is easier for workers to blame one’s problems on corruption.

China’s governmental response as it maintains reform momentum has been predictable and fairly effective—however messy and at times distasteful. Central and provincial leaders struggle to find a balance between protecting citizens’ legal rights for public support on the one hand and the need to maintain the authority of local governments and their officials on the other. Media blackout of protest stories complements a policy combination of enhanced compensation to resolve underlying issues and arrest and prosecution of protest leaders, especially if protests turn violent or disrupt public order. Punishment of official criminality is well publicized.

For U.S. policy, the question is how to discourage excessive use of force and repression while encouraging more practical techniques for resolving such conflicts, all the while avoiding draconian U.S. steps that might isolate China from the benefits of international exchange on ways to manage such problems. A complete breakdown in Chinese social order would destabilize East Asia.
U.S.-China Relations

CONFERENCE PARTICIPANTS

Honolulu, Hawaii
April 9 - 15, 2006

Members of Congress

Representative Howard Berman
and Janis Berman
Representative Lacy Clay
and Ivie Lewellen Clay
Senator John Cornyn
and Sandy Cornyn
Representative Sam Farr
and Shary Farr
Representative James McDermott
Representative George Miller
and Cynthia Miller
Representative Donald Payne
and William Payne
Representative Bobby Rush
and Carolyn Rush
Representative Loretta Sanchez
Senator George Voinovich
and Janet Voinovich

Scholars

Hal Harvey
The William and Flora Hewlett Foundation

Albert Keidel
Carnegie Endowment for International Peace

Susan Lawrence
Former Correspondent
Far Eastern Economic Review

David Shambaugh
George Washington University

Foundation Representatives

Doug Bereuter
The Asia Foundation

Pablo Farias
The Ford Foundation

Consultant and Rapporteur

David M. (Mike) Lampton
Johns Hopkins University

Moderator

Dick Clark
Director, Congressional Program
The Aspen Institute

Aspen Institute Staff

Diane Anello
Sara Kuhn
Bill Nell
Pat Walton

Chinese Participants

Hsiao Bi-khim
Member, Taiwan’s Legislative Yuan

Jia Qingguo
School of International Studies
Peking University

Shen Dingli
Center for American Studies
Fudan University

Yang Jiemian
Shanghai Institute for International Studies
China, the U.S. and the Global Competition for Energy Resources
Hal Harvey, The William and Flora Hewlett Foundation

China’s demand for energy, particularly oil and natural gas, is growing rapidly to fuel economic expansion and the rising demands of a middle class that is buying cars, homes, and appliances. Between 1995-2003 China accounted for 68 percent of global demand growth in oil (50% in the last three years) and its need to clean up urban air is driving a hunt for natural gas. Available energy resources often are in areas with severe human rights and governance problems (e.g., Sudan and Iran), so Beijing’s dealings with these regimes raises humanitarian, proliferation, and other issues. To avoid total external resource dependence, Beijing simultaneously is undertaking a nuclear power construction program aimed at building nearly forty plants in the next two decades—thereby creating both safety concerns and economic opportunities for foreign firms. The growing use of fossil fuels means China’s greenhouse gas emissions will continue rising, probably passing the United States in total emissions in the next twenty years, even as China has made considerable efforts to restrain growth in demand by adopting incentives, developing renewable resources, and conservation efforts including ambitious vehicle standards. What are the implications of these developments for: Energy availability in the United States? Global and national climate policy? Broader U.S. foreign policy? And, for U.S. energy policy domestically?

China’s Military Modernization: What It Means for the U.S.
David Shambaugh, George Washington University

China is surrounded by neighbors of great consequence, including nuclear, or presumed nuclear, neighbors: India and Pakistan to the south, Russia to the north and west, North Korea to the north-east, not to mention other neighbors that could become nuclear in a short period of time. China is important in hotspots from Kashmir in the south, to the tumultuous Central Asian region, to the Korean Peninsula in the northeast, to offshore issues with several states in the seas to the south and east. Its decline in relations with Japan causes concerns for security in the Pacific. China is modernizing and professionalizing its military services and has an ambitious space program. Its military budget has grown by double digits every year since 1990, but remains only a fraction of U.S. spending. Much of China’s modernization effort is focused on a Taiwan conflict scenario, which means that Beijing is planning for the contingency of a U.S. intervention. While both Beijing and Washington are trying to improve bilateral relations, they each must take into account the possibility of conflict with the other. At the same time China’s military is growing, so are Beijing’s commitments to UN peacekeeping operations all over the world—including Haiti. What is known about
China’s military development both in terms of hardware and doctrine, not to mention actual capabilities? What are the intentions and thinking of China’s military and civilian leadership? What do American allies in the region think about these developments? Are U.S. alliances strengthening or weakening in the face of China’s rise? Is China’s military modernization a threat to the U.S.? Will China be a responsible nuclear power? What are appropriate congressional responses?

**China’s Internal Stability: Implications for U.S. Policy**

Susan Lawrence, Former Correspondent, *Far Eastern Economic Review*

It is becoming increasingly important for the world that China remain stable and moving forward. The entire discussion of China’s “peaceful rise” presumes forward momentum and progress will be maintained. But, what are the considerations that could derail or set back continued progress? How likely are these negative scenarios to develop? What would be the consequences if they did? Among the problems China faces internally are risks related to: the domestic financial system; rising inequality among regions, between urban and rural areas, and among various social strata in every corner of China; and, by some estimates, the problem of corruption consumes as much as 15% of GNP, breeding not only economic inefficiencies but a sense of social injustice that can be explosive. Last year China had an estimated 74,000 demonstrations and social incidents, not overwhelming in a system of China’s size, but of concern to China’s leadership. What are the mechanisms by which all of this discontent and angst at social change could coalesce into regime destabilization? What capabilities does the regime have to counter these sources of instability, and is political reform anywhere on the horizon? Is new technology (like the Internet and personal telecom devices) empowering discontented people to organize or is the regime using the technology to suppress discontent? In light of these developments, do U.S. policies play any role? If so, what are the options? What are the prospects for political reform gaining speed?

**Global Trade and Finance Issues and Their Role in U.S.-China Relations**

Albert Keidel, Carnegie Endowment for International Peace

There now are three locomotives for the world economy—the United States, the European Union, and China. For the first time we have an economic superpower that is neither a democracy, a fully market economy, or a nation with high per capita income. This, combined with China’s blistering economic growth of about 9% for two decades, creates policy challenges. China is the second largest foreign holder of U.S. debt instruments, has about $700 billion in foreign exchange holdings, runs an enormous current account surplus with the United States, in 2005 ran a very large trade surplus with the world, attracts more foreign investment than any other nation, and has a currency that many economists believe is undervalued, throwing the global economy into some disequilibrium. Internally, China faces economic challenges in absorbing huge numbers of people into the modern economy, and doing so without creating intolerable social disorder at home and antagonism abroad. In light of these developments and challenges, what kinds of policy options does the United States have in its trade and financial policies toward China? What will China’s growth mean for the rest of the Developing World? What domestic policy and other changes does China’s growth and development imply for the United States itself?