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“U.S.-China Relations: Status of Reforms in China”

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A Note About Taiwan:

In light of Assistant Secretary of State James Kelly's remarks yesterday to the House International Relations Committee, I would to preface my testimony with a few words that are not found in the printed handout, but are on the disk.

First, it is important to realize that the United States has *never* recognized Chinese sovereignty over *Taiwan*, whether that sovereignty was claimed by Chiang Kai-shek's Republic of China government, which we nevertheless recognized until 1979 as the legitimate government of China, or by the People's Republic of China, whose claims to Taiwan we only "acknowledge" but do not accept, as is clear in the transcripts of Mr. Kissinger's discussions, and was reiterated by the Clinton administration, when Press Secretary Mike McCurry was forced to correct remarks to the contrary. Our consistent position is that the status of Taiwan under international law "remains to be determined"

Therefore the phrase "one China policy" does not mean that we recognize Taiwan as part of China: we do not. Rather, it means that while we did recognize both East and West Germany, and could well recognize both North and South Korea, in the case of China we have decided that we can recognize only one government. That was a problem only when Taipei presented itself as the government of all of China. This is no longer does.

Yesterday Mr. Kelly, one of our finest diplomats, revealed the growing confusion about our China and Taiwan policies, when he stated flatly that efforts by Taiwan to assert its own independent national identity "must be stopped"—strong words—while saying of China's threats to use force against the island only that "we strongly disagree with the approach." He did not say that it "must be stopped."

Clearly we are in a bind here. On the one hand we have never recognized that Taiwan is part of China. Yet we are deeply concerned lest it declare "independence." Independence from what? Unless it is a part of China, which we do not accept, it is already independent.

Briefly we have three problems here:

First, by responding as it has to democratic developments in Taiwan, Washington risks bringing its commitment to democracy into question.

Second, I have no doubt that the current concern in the administration arises from China's increasing military strength and growing talk about using it against Taiwan. To be frank, we are appearing to be intimidated, something no great power should ever allow. Of course we want cooperation from Taiwan on avoiding conflict, but whom should we insist "be stopped"? Not so much Taiwan, as China—for it is China that has

the immense military, and China that is making the threats of war. It is not enough to “strongly disagree” with China’s menacing approach. We must make clear that we reject it, period.

Third, I think we have a lesson here in diplomatic plans gone awry. When President Carter severed all relations with Taiwan in 1979, his assumption, I think, was that the island, then ruled autocratically, would become part of China through an agreement over the heads of the people of Taiwan, between Taipei’s unelected leaders, and the unelected leaders in Beijing.

We did not consider the possibility that Taiwan would reform and liberalize and democratize. So not only did we fail to plan for such a possibility, we gave away all sorts of things that would have helped us to deal with that situation, for instance by failing to insist that Taipei remain in the UN General Assembly.

Thinking we were stabilizing the situation, we unwittingly created deep instability in the Taiwan Strait under the Carter administration. Historical development took off in a direction we had scarcely considered and for which we were unprepared. The answer today is not to try to put things back the way they were—like King Canute, proverbially lashing the incoming tide to force it to retreat—but rather to begin to rethink our whole approach, dealing with the current reality, and not the failed expectations of thirty years ago.

Introduction:

The situation in China today is more volatile than most observers understand. “Reform” is not quite the word to apply to what is happening there; something like “unplanned but major change in several dimensions” would be more appropriate. For although economic, political, and social forces have been released over the past quarter century that will certainly take China somewhere, no one in China can specify exactly to where that will be. No plan or roadmap exists. So when change does come, as it most certainly will, most likely it will be unexpected and discontinuous, which means that it will have the potential to affect not only China, but also her neighbors, the world economy, and direct interests of the United States and its friends and allies.

No Progress on Political Reform:

Politically, the Communist Party seems intent on maintaining its slipping hold on power. No signs of progress are visible in areas such as establishment of real law and impartial courts, the freeing of speech and political and religious activity, or the constitution of legitimate government by voting at local and national levels. Quite the opposite: political repression is, if anything, increasing. With the help of American companies, China has created a highly sophisticated system for monitoring the internet, tracking individual users, blocking access to web sites. Thanks to powerful new computers and technology, China’s secret police even has the ability to monitor cell phone conversations and text

messaging, and to store and screen messages in detail. This monitoring ability extends to an increasingly well developed Chinese secret police network in the United States, operated out of the Chinese embassy and consulates, and now so deeply rooted on our university campuses that a Chinese dissident can be monitored by Beijing almost as easily here as in China.

More conventionally, the freedom even of the Party run press has, if anything, been curtailed in the past year, with a number of editors being fired, and some publications closed. Even respected academic specialists in such areas as economics often find it impossible to publish their opinions in the Chinese press, while nothing remotely resembling dissent—or even the *USA Today* style of editorials, one pro and one con, is to be found.

This situation cannot last, for as Chinese sages taught thousands of years ago, imposing dictatorship depends upon keeping the people ignorant and tied to the land—as they were in the Qin dynasty (221-206 B.C.E.) and again under Mao Zedong (1949-1976). Since Mao's death new forces have been unleashed, not least intellectual and political. China's educational institutions have begun to regain some of their pre-Communist distinction. The number of highly educated people has grown, and so has the number of those who have traveled or lived abroad. In addition, Chinese people are beginning to own their own dwellings, have a bit of money, and feel a stake in society. Put simply, the system has begun to turn out citizens, or rather potential citizens—for at the moment these educated and thoughtful people (like the farmers, who also have a certain wisdom) are denied any meaningful influence on how they are governed. Officials are appointed, not elected: even mayors. At the top, no transition of rule has ever occurred in the PRC that actually followed the Constitution or even the rules of the Communist Party. The current ruler, Hu Jintao, was simply designated by the late strong-man Deng Xiaoping, at the time of the Tiananmen massacre, to succeed Jiang Zemin, who was installed in power immediately—and quite illegally—while Premier Zhao Ziyang was placed under house arrest (which continues). This lack of even a defined system for choosing a leader is a powerful contrast to India (where even a series of assassinations never disrupted constitutional rule), Japan, South Korea, Taiwan, and numerous other countries. Politically the Chinese system remains rather primitive, and lacking in legitimacy.

It also quite evidently lacks any feeling of the urgency of reform. One reason for this is that the leadership is deeply divided, and things work best in the short term if everyone is allowed to do more or less as they want. But that approach will work only in the short term. As economic development makes China more complex, the need for objective mechanisms, for choosing leaders responsive to popular needs and wishes, and for resolving disputes objectively, will become inescapable. Doing those things will require that the Communist Party give up power.

If the Party does not move on its own, it will probably face increasing internal division and popular turbulence, which may effect the sort of change it is unwilling to carry out itself. That sort of chaotic shift is worrying enough. But even more worrying is the

possibility that the Party will somehow retain control, and develop China into a state having a dictatorial government having unfilled territorial aspirations (see below), a sizeable treasury and military, and no internal checks and balances.

The unwillingness of the Party to consider change is clear in its approach to Hong Kong, to which it promised democracy in 1984. In the past year or so, as the people of Hong Kong began to call for real progress towards actually electing their government, Beijing seems to have panicked and, in effect, torn up all its promises in favor of rule from the center, intermediated by carefully selected pro-Beijing locals. To some extent Beijing must be bluffing, for she lacks the capacity to coerce Hong Kong (as she did her own capital in 1989) without destroying the hub of her most advanced economic region. Yet so strong is the instinct for control that the central government has adopted quite astonishingly hard line talk and methods.

The same unwillingness is demonstrated in Beijing's policy toward Taiwan, now a democracy, and a state having a national character and identity quite different to that of the People's Republic. Taiwan would like to coexist with China, and enjoy the benefits such coexistence would bring to both sides. For more than a dozen years the government in Taipei has been offering to negotiate with China, but after a brief start in 1993 in Singapore, Beijing has refused all offers to meet. Instead, she has adopted a strategy of pressuring Washington somehow to force Taiwan to do what she says—which is of course both impossible, and dangerous.

So much as we may all hope for political reform leading to freedom and democracy in China, and however much we may be heartened by the occasional liberal straw in the wind, it is essential that we recognize clearly the complete lack of progress in this area at least since 1989. We should talk to the Chinese about this; we should never be bashful about listing prisoners or condemning abuses—but we must not comfort ourselves with the illusion that the present leaders are “reformers.” They are not. They are dictators, having aspirations to a sort of totalitarianism they cannot achieve (this is evident in their approach to religion) improvising expedients to stay in power, whatever it takes—arrests, propaganda, whipping up xenophobia, even perhaps a Splendid Little War. These leaders are to be treated with great care and caution, even as we are mindful of the precariousness of their power.

A Precarious Economy:

Economically, China is in the midst of an unsustainable boom and headed for a hard or a soft landing, depending upon policy. China's astronomical growth rates are not entirely credible and to the extent they are real they do not represent healthy growth. By and large they are the product of three factors: (1) exports, which as we know, are soaring; (2) foreign investment, which is fine so long as it does not substitute for the development of Chinese entrepreneurship. Sadly, a good half of China's exports are accounted for by firms having foreign participation, and in some key sectors foreign ownership is greater than Chinese (in Information Technology, for example, Taiwanese investors own roughly

70% of China's capacity), and (3) massive state investment, based on government-directed borrowing from the state-owned banks (the only place Chinese can put their savings)—which borrowing goes heavily to support loss-making state enterprises, rather than to genuinely profitable uses. Chinese growth, in other words, is not being created by increased productivity and efficiency, the proverbial “assignment of goods to their highest paid uses,” but rather by a torrent of capital investment, both foreign and state, much of which is misallocated and thus wasted.

To be more specific, last year in 2003 non-farm investment increased at three times the rate of GDP. So far this year that rate has doubled again. Year on year it is up 53% in the first two months of 2004. Investment by state enterprises is up 55% with investment in industry up an astonishing 79%. Purchases of building materials in the first two months of this year grew at an annualized rate of 137%. Chinese demand for oil—a commodity of which the globe has only a limited supply—has now passed that of Japan, to stand second to our own country, which consumes roughly four times as much. Not surprisingly world commodity prices are beginning to rise in response.

But this is artificial demand, driven above all by state directed loans to state enterprises. It is not the product, as some would have us believe, of dynamic “free enterprise” or “entrepreneurship” in China. If anything, the entrepreneurial class, is being squeezed out and denied capital of which it could make good use, by extravagant state lending (only 1% of which goes to the private sector) and by foreign investment, which often receives preferential treatment.

The result of all this is of course insolvency in the banking system (experts disagree about the exact percentage of bad loans, but an estimate of one third would be conservative) and growing government debt. Local currency loans through February of this year alone rose by 20.7% year to year, to \$1.98 trillion. New loans in the past year alone amount to one quarter of GDP. Total government debt, including unfunded liabilities for unemployment, for medical care, and retirement for state workers, is of course far larger.

Although plans are regularly announced to reduce the rate of growth of debt, purge the banks of non-performing loans, rein in over-investment, and so forth, so far these have little to show. China is of course not the only country where fiscal irresponsibility may be politically expedient. But in today's world she is nearly unique in the all-important role that governments, central and local, play in deciding, not always very rationally, what will be invested and where. So even though countries such as the United States and Japan also face massive fiscal and debt problems, in both of them the economy as a whole is sound and productive. Both are host to dozens and dozens of world-class global companies, and have been for many years. If we count twenty-eight years from the creation of the Ministry of International Trade and Industry in Japan in 1949, we reach 1977, by which time Japan already boasted such players as Honda, Fujitsu, Kyocera, NEC, and others. By contrast, count the same number of years from Mao's death in 1976, when so-called “reform” began, and you reach the present—and the worrying realization

that even after all that time, China has yet to produce a genuinely world-class competitive company, whether private or state owned.

Most worrying, perhaps, is the rapid growth in regional and personal inequalities of income owed to state misallocation of resources, and to massive corruption. In September of last year rural incomes in China averaged \$217 U.S., while urban incomes were at \$766 U.S. Hundreds of millions of farmers remain dirt poor and deprived of all political rights as well. Tens of millions of unemployed rural workers roam the urban areas, sleeping on streets, working at construction and other hard labor, or trading, without any provision for health, education, or even wages. (Official estimates of unemployment are now touching 14%). Nor is the typical Chinese urbanite the fashionable young woman one reads of so often, stopping in at a fashionable Shanghai boutique to spend \$400 on a pair of the latest shoes. Urban life has a much more uniformly early industrial revolution shade of gray about it than we often realize.

So we have a vicious circle. Population and unemployment are rising, which pose an obvious threat to order in China. Unwilling to unleash the private sector, which already accounts for half to two thirds of new jobs in some areas, the state insists on taking the precious savings of the impoverished Chinese people and pouring them into make-work projects that may absorb some labor for a while, but are unlikely ever to be profitable, which is to say, provide real long-term jobs. The money thus wasted cannot be recovered: it is a vast, wasted, opportunity cost. Nor does China have the resources to continue to waste money at such a rate.

As one economist at the Chinese State Development Bank recently put it, “All the characteristics of China’s financial industry today are similar to those found in Thailand before the Asian financial crisis [of 1997]. The probability of a crisis erupting in China is rising.” This comment, by a well qualified Chinese economist, deserves careful note.

Sooner or later a crunch will come, with the ordinary people being the chief victims—as the perpetrators will mostly have expatriated first their money and then themselves ahead of time. We can only guess about the consequences for the rest of the world, and for the Chinese regime.

Military Buildup:

Finally, and perhaps most importantly, China is engaged in a massive military buildup, to which both Washington and China’s neighbors unaccountably pay far from adequate attention.

Ever since the sack of Beijing by the People’s Liberation Army in June of 1989, that army has been dissatisfied and ashamed of what it did. I have been told as much personally by a very senior Chinese military commander. Chinese join the army to protect their country, not to kill their fellow citizens. Furthermore, ever since Mao died in 1976, and his chosen successors were swept away by a *coup d’etat* of the 8341 unit, or

capital bodyguard division, the military has been the ultimate kingmaker in China. Put these two facts together, and it becomes clear why over the past dozen years or so members of the Chinese Communist ruling elite who lack military ties have been so eager to create them.

Since the Tiananmen massacre, the PLA has been given immense budget increases, difficult to estimate but obvious when one considers new military hardware, the space program (which has strong military dimension) and huge increases in research and development and military production capability. Jiang Zemin, China's former president who retains a great deal of power today as Chairman of the Military Commission, created numerous field and flag level officers in a bid to win loyalty. Now, evidently, Jiang's ostensible successor, Hu Jintao has *also* established his own military headquarters, in the Western Hills, in an attempt to counterbalance Jiang's continuing influence over the military and security apparatus.

At the same time the military has been given a new mission: not so much national defense (as no country seems to have any desire to attack China) but rather national expansion, or as it would be put in China, "recovery" of lost national territories—to most of which Beijing holds only the most tenuous of claims. Hence we have seen repeated Chinese probes into the Japanese Senkaku Island chain (Diaoyutai in Chinese) which have deeply irritated Tokyo and, along with the acquisition of nuclear weapons by North Korea, evidently set Japan on a course toward military self-sufficiency: very bad news for Beijing. We have seen "archaeological" research carried out that reassigns the ancient Korean kingdom of Koguryo to the "Chinese" world, which would mean that Korea almost to the 38th parallel would be Chinese. This is a difficult move to judge, but it is hard to resist the conclusion that it prepares the way for possible intervention to prevent Korean unification. On the Indian border, China has proved most unforthcoming about territories occupied in the 1962 war—and some territory given to China by Pakistan. As with Japan, Beijing's condescending and ham-fisted approach to India has led to terrible strategic consequences, in the form of a nuclear armed India alert to its national interests. Without Chinese assistance, the Pakistani nuclear program would have been little more than blackboards and some smart physicists. In the South China Sea, China is asserting sovereignty over various reefs and islands, some seized from Vietnam, another from the Philippines, probably with a view to declaring the entire area territorial waters. And of course there is Taiwan, against which China is carrying out an unprecedented military buildup. She will soon possess more advanced fighter aircraft than Taiwan does; her submarine and surface fleets are growing, and she has roughly 500 missiles—one for every 45,000 Taiwanese—aimed at the island. Russia seems not yet to have grasped fully the potential threat to her interests that this newly well-armed China poses (Moscow, after all, is a major source of weapons and technology) but that realization may come soon. Added together, all of this portends increasing tension and danger in Asia, as China attempts to shift the military balance decisively in her favor—an action, how ever, more likely to elicit a balancing coalition than lead to success.

Most importantly, however, Americans should understand that the new Chinese military is the only one being developed anywhere in the world today that is *specifically configured to fight the United States of America*. Thus China has gone to great lengths to acquire supersonic missiles from Russia that were originally designed by the USSR to destroy American aircraft carriers. Her researchers are deeply involved in identifying potential weaknesses in the American military. She is working hard on counter-stealth technologies, lasers, cruise missiles, space surveillance, and weapons that target our vulnerable communications and other links. Many argue that China seeks only minimal deterrence and a certain degree of influence in Asia, But that does not account for the vast scale of, for instance, her ICBM and space programs, nor for her development of specific systems to target American forces. *My own view is that no objective reason exists why China, if she stays on her present course, should not eventually pose an even greater threat to the United States and its friends and allies than did the Soviet Union.*

Conclusion:

Received opinion in Washington appears to be, overwhelmingly, that in spite of the worrying indicators I have mentioned, China is in a process of change and democratization that will make her eventually into our close friend, rather than competitor or adversary. Most people remain highly bullish about the Chinese economy, despite the warning lights I have mentioned. American business has made itself increasingly dependent upon China, regularly provides technologies it should not (e.g. for internet surveillance) and increasingly lobbies for Chinese wishes in Washington. Many also believe that U.S. policy mistakes (support for Taiwan, for example) rather than Chinese political competition and strategic debates, explain whatever difficulties or menaces may seem to appear. The result is an extraordinary degree of complacency in the face of potentially real threats.

Those threats may never become real, but if they do not, the reason is likely to be more than just good luck. It will be the result of serious American and allied action to cut off Chinese access to advanced military technology, enhance the defensive and deterrent abilities of the free countries in Asia that are our real friends, and straight talk with the Chinese government.

In the longer run, the only assurance of our interests and those of our Asian friends and allies will be for China to abandon Communist dictatorship, as the USSR and its former satellite states did, introduce freedom and democracy, and redirect spending away from prestige projects (such as the Olympics and extravagant new buildings in Beijing and Shanghai) and toward the still-pressing needs of her people.

This may occur. The US can do much to help it to occur, and should. But we must not count on its occurring. Things could go very well, or they could go very wrong. We need a China policy that can deal with either outcome.