



**T.C. YEDİTEPE UNIVERSITY
GRADUATE INSTITUTE OF SOCIAL SCIENCES**

ESSENTIALS OF CHINESE FOREIGN POLICY AND ECONOMY

By

CAN KIROĞLU

**Submitted to the Graduate Institute of Social Sciences In partial fulfillment
of the requirements for the degree of
Master of
Business Administration**

İSTANBUL, 2007



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LIST OF ABBREVIATIONS

AAPSO	Afro-Asian People's Solidarity Organization
AML	Anti Money Laundering
APCs	Armored Personnel Carriers
APEC	Asia Pacific Economic Cooperation
ARF	ASEAN Regional Forum
ASEAN	Association of Southeast Asian Nations
CBM	Coalbed Methane
CCP	Chinese Communist Party
CNDCA	China National Democratic Construction Association
COCOM	Coordinating Committee for Multilateral Export Controls
CPM	Communist Party of Malaysia
CRO	Contract Research Organization
CSRC	Chinese Securities Regulatory Commission
CUCBM	China United Coalbed Methane Corporation
DPP	Democratic Progressive Party
EAI	Enterprise for ASEAN Initiative
EU	European Union
FDI	Foreign Direct Investment
FECs	Foreign Exchange Certificates
FTA	Free Trade Area
GDP	Gross domestic product
GEB	Growth Enterprise Board
GEM	Growth Enterprise Market
GMP	Good Manufacturing Practice
GMS	Greater Mekong Sub Region
GPCR	The Great Proletarian Cultural Revolution
HKSAR	Hong Kong Special Administrative Region
IAEA	International Atomic Energy Agency
ICBM	Intercontinental Ballistic Missile
IFC	International Finance Corporation
IMET	International Military Education Training
IMF	International Monetary Fund
IPO	Initial Public Offering
IPR	Intellectual Property Right
ISG	Inter-Sessional Support Group
KMT	Kuomintang
Kwhr	Kilowatthours
LNG	Liquefied natural Gas
MFN	Most Favored Nation
MoF	Ministry of Finance
MOU	Memorandum of Understanding
MPI	Ministry of Petroleum Industry
MPLA	Movimento Popular de Libertacao de Angola
MPVs	Multi-purpose Vehicles
Mtoc	Million Tons of Coal Equivalents
MTOPS	Million Theoretical Operations per Second

MWp	Megawatts-Peak
NBS	National Bureau of Statistics
NDRC	National Development and Reform Commission
NNSA	National Nuclear Safety Administration
NSC	New Security Concept
OCTS	One Country, Two Systems”
PBC	The People’s Bank of China
PCA	Partnership and Cooperation Agreement
PLA	People’s Liberation Army’s
PNTR	Permanent Normal Trade Relations
PRC	People’s Republic of China’s
PWR	Pressurized Water Reactor
R&D	Research and Development
SAT	State Administration of Taxation
SETC	State and Economic Trade Commission
SFDA	State Food and Drug Administration
SFIC	State Foreign Investment Corp
SLBM	Submarine-Launched Ballistic Missile
SLOCs	Straddles Critical Sea Lanes of Communication
SLORC	State Law and Order Restoration Council
SOEs	State-Owned Enterprises
STCF	Strait Textile and Clothing Fair
SUVs	Sport Utility Vehicles
T&D	Transmission and Distribution
TVEs	Township and Village enterprises
UMCT	Urban Maintenance and Construction Tax
UNITA	Uniao Nacional Para a Independencia Total de Angola
URD	Utility Requirement Document
VAT	Value-added Tax
WANO	World Association of Nuclear Operators
WMD	Weapons of Mass Destruction
WTO	World Trade Organization
YoY	Year over Year
ZANU	Zimbabwe African National Union
ZAPU	The Zimbabwe African People’s Union

ABSTRACT

China is one of the most leading countries in the world and a very important actor of a international organizations which influences the world history and foreign policies. One of the prominent reasons of choosing this subject is that under the platform of changing world conjecture after Cold War and, China contains very powerful dynamics in its structure which impacts regional and global power balances in the world. Recognizing China from the perspective of academics, and analyzing its tendencies in region and in the world are supposed to affect power balances now and in the future. In order to understand better the probable position of Chinese Economy and Foreign Policy now and in the future, to make some predictions, first of all Political Structure of Chinese Foreign Policy and Organs of Foreign Policy Decision-Making Structure must be known. For better understanding the actual and future position of China in the world, first of all, we have to learn its political structure and foreign political structure and foreing policy decision-making mechanisme.

In this thesis, I intended to examine historical background of China, physical setting and economic structure, foreign policy actors and all decision-making ranks from the nationalism, pragmatism, liberalism and realism.

Finnally, I examined Chinese foreign and economic relations toward other countries and its foreign policy toward the major powers in Asia- Pasific Region. (Russia, European Union and U.S.A.)

ÖZET

Çin dünya tarihi ve dış politikalarına yön veren başlıca devletler arasında yer alan, uluslararası ortamın önemli bir aktörüdür. Bu araştırma konusu seçiminde temel nedenlerden birisi de Soğuk Savaş sonucunda değişen uluslararası konjüktür zemininde, Çin'in değişen dış politika önceliklerinin bölge ve küresel ölçekli güç dengelerini yakından ilgilendirebilecek sonuçlara bakıp güçlü dinamikleri bünyesinde barındırmasıdır. Akademik açıdan bakıldığında, Çin'i tanımak, eğilimlerini analiz edebilmemiz, günümüz ve geleceğin güç dengelerini etkileyebileceği varsayılmaktadır. Çin Dış Politikasının mevcut ve gelecekteki muhtemel durumunu daha iyi anlayabilmek ve bazı tahminlerde bulunabilmek için, öncelikle bu ülkenin politik yapılanması ve dış politika karar alma organlarının çalışma dinamiklerini bilmek gerekmektedir.

Bu çalışmada Çin'in günümüze kadar tarihsel gelişimi, inişleri ve çıkışları, fiziksel yerleşim özellikleri, ekonomik yapısı, dış politika aktörleri ve tüm karar verme derecelerinde rol oynayan milliyetçilik, pragmatizm, liberalism ve realism ele alınmıştır.

Son olarak da Çin'in diğer ülkeler ile yürüttüğü ekonomik ilişkiler ve Asya- Pasifik'teki büyük güçle (Rusya, Avrupa Birliği ve Amerika) olan dış politikası incelenmiştir.

INTRODUCTION

In this academic research I have analyzed the characteristics of Chinese foreign policy according to the universal ideas and such as pragmatism, realism, liberalism and nationalism. We have discussed the patterns of Chinese foreign ideology by explaining the fundamental points of these ideologies and practices of the real policy.

Pragmatism has a long history in China and has exerted great influence since 1919. The experience of pragmatism to great dimensions reflects the tortuous course of western philosophy in China. This paper explores the fate of Pragmatism in China against the broader social and cultural background. It will lay out the different stages of the spread of and research on Pragmatism in China. The relationship between pragmatism and Chinese Communism is a question important in its consequences but ambiguous in its content. By careful reading of the intellectual history of China during past half-century, certain implications on the intertwined relationships between them can be easily detected. Although the precise relationship between pragmatism and Chinese Communism remains undefined to this day, the pragmatic element in Chinese Communism is a popular theme which has gained wide currency among some recent interpretations.

Chinese nationalism has been characterized by its instrumentality to the communist government in compensating for or, to a certain extent, replacing the all-too-evident weaknesses of communist ideology since the 1980s. Pragmatic leaders have fashioned nationalism because it has the effect of removing differences within the country and replacing it with a common, hegemonic order of political values. Nationalism has been used to rally popular support behind a less popular communist regime and its policies by creating a sense of communality among citizens. Pragmatic nationalism thus does not have a fixed, objectified, and eternally defined content. Instead, it has been continually remade to fit the needs of its creators and consumers.

Chinese defensive nationalism is calculated and often has a strong moral appeal. In case of border conflicts with neighboring countries, the PLA has not always taken territorial occupation as an ultimate objective. Several times, the PLA enacted the drama of unilateral withdrawal after gaining ground in the first series of skirmishes. The bloody sacrifice aimed at telling the

opponent of the moral superiority of the PRC and the secularity of its state sovereignty. The best known example of unilateral withdrawal appeared in the Sino-India war of 1962 when the PLA demonstrated its ability to defend the territory and withdrew 40 kilometers after forcing the Indian troops back 40 kilometers. Another example is the Sino-Vietnam war of 1979 when the PLA suggested a truce and general cessation of hostilities after reaching the city of Liangshan, before suffering further casualties and totally losing the aura of invincibility it had gained in the otherwise analogous Indian border conflict seventeen years earlier. Similarly the military exercises in 1995 and 1996 in the Taiwan Strait suggest no intention of the PLA to occupy Taiwan. The objective was to demonstrate determination to halt the tendency of Taiwan separatism and foreign intrusion.

After the end of the Cold War, while Chinese leaders found themselves facing a less favorable international environment, there were no immediate military threats to China's security. Thus, pragmatic leaders in Beijing could afford to avoid a confrontational policy against the United States and other Western countries. In November 1990, Beijing abstained during the UN Security Council's vote on the use of military force against Iraq, thus freeing the way for Operation Desert Storm led by the United States. According to a Chinese scholar, when America's power and influence were amplified by its victory in the Gulf War and the formal demise of the Soviet Union in 1991, there were great pressures on the Beijing leadership to launch an ideological campaign against Western political ideas and the Soviet leaders' betrayal of socialist principles. However, pragmatic leaders, particularly Deng Xiaoping, argued that "China's power and interests did not allow confrontational relationship with Western countries." As Deng was quoted on his twenty-four-character principle for handling world affairs after the Tiananmen incident in 1989: Observe developments soberly, maintain our position, meet challenges calmly, hide our capacities and bide our time, remain free of ambition, never claim leadership." This principle later evolved into an official sixteen-character principle for dealing with Sino-U.S. relations: "enhancing confidence, reducing troubles, expanding cooperation, and avoiding confrontation," which was delivered by President Jiang Zemin at his meeting with U.S. President Clinton in Seattle in 1993. This defense strategy may sound deceptive, but it is in line with the essence of pragmatic nationalism and serves China's national interests. Using nationalism as a defensive weapon, pragmatic leaders encouraged the surge of nationalism in response to the rising voice of containment against China in the Western media after the Taiwan Strait crisis of 1995-1996. They also let nationalist sentiment decline when they saw an

improvement of the Sino-U.S. relationship marked by the state visit of Jiang Zemin to Washington in October 1997.

Liberalism also played a serious role in the structure of Chinese foreign policy. Liberalism was to suffer in the wake of the immense challenges China faced from Japanese militarism and the impact of the Communist movement. By the 1930s many of the younger generation felt that only radical, authoritarian doctrines could save the country. The Guomindang or Nationalist party absorbed a good deal of Fascist doctrine and practice. Liberalism increasingly seemed to serve as a forlorn “third force”, able only to admonish authoritarian regimes of the Left and Right.

The ascendancy of Mao Zedong and the establishment of the People's Republic of China in 1949 brought the liberal impulse to its lowest level. Ideological witchhunts were organized against the (real or imaginary) followers of Hu Shi, and their values were ceaselessly derided as bourgeois delusions which could only weaken the nation.

With the collapse of Mao's ideology on his death, seeds of regeneration which had lain dormant gradually came to life. Liberal ideals like intellectual freedom, the separation of powers, civil society and the rule of law were reexamined in the light of the destruction wrought by the Communist party which had been so vociferous in denigrating them. Starting in the Cultural Revolution, many younger people experienced virtual conversions to liberalism. This process was given further impetus by the Tiananmen Square protests leading up to the massacre of June 4, 1989. The democracy movement espoused (however imperfectly) many liberal doctrines.

In Chapter II, we have analysed the historical background of People's Republic of China after the Communist Revolution. The economy policies applied in the time of Cultural Revolution and implications of the Cultural Revolution for China's Future. Also my research goes on with Deng Xiaoping era by explaining the changes in China's Economic Interface. Also i had focused on the development of defense industry and the role of science and technology in this process. In this Chapter, my aim was, to find a parallel line with the past and the coming future of China in the following years. By the way, foreign affairs of China were evaluated by its retrospects and prospects.

In Chapter III, my research was firstly focused on the fundamental economical importances playing the major role in Chinese economy. The future challenges in the energy sector indicating the role of coal industry, natural gas, petroleum & oil, nuclear reactors and

prospects of usage of power in the future. The role of electricity and renewable energy was also considered in this chapter.

The role of small and medium enterprises in China was so important that, the mentality of the Chinese economy had been shaped by the help of SMEs during economical development of China in 90's and i tried to show the importance of SMEs and current taxation and fiscal policies that have been applied by Chinese government. Also it is so important for SMEs to be continued by the help of financing alternatives such as; bank loans, venture capital and private equity Funds and stock markets were considered in this Chapter.

The sectoral analysis of industries in China, such as auto industry, steel industry, chemicals industry, pharma industry, textile industry, banking industry, defense industry and economy industry are also considered in this chapter. A rapidly growing China will be "a very positive force for Asia as a region, ASEAN countries' exports to China have been growing rapidly and "it's going to become even more rapid" with China's WTO accession. So China will be a very positive force for all the economies in the region.

Denying that the foreign direct investment flowing to China has increased dramatically after the Southeast Asian financial crisis, in my view, "we haven't seen any marked increase in the amount of foreign direct investment that is flowing to China as a result of after the crisis." "The amount of foreign direct investment that is now going to China is more or less proportional to China's share to total economy of this region. We don't see it being an unusually high amount. We don't see it as being an unusually low amount." Asian countries to improve their competitiveness in the globalizing world instead of worrying how much impact China's WTO accession will have on their economies.

Competitiveness refers to the use of new technology, need for skilled development both in terms of labor force and higher education, various kinds of logistics, the way in which industries and corporates develop global strategies rather than national strategies and position their products in a global value-added chain and in a competitive way.

In this research i have noticed quite a lot of foreign direct investment to China was from ASEAN countries. "It is actually helping to strengthen the position of these companies, and it is part and parcel of the kind of more global strategies that these corporate are taking."

Since healthy domestic corporates are obviously good things for ASEAN countries, the fact that the foreign direct investment going to China does not necessarily mean that this is a bad thing for ASEAN countries. In 2006, the Chinese government has taken series of measures,

including changing economic growth mode, adjusting economic structure, increasing income of residents, promoting social security and speeding up public service reforms. In 2007, efforts will be made to promote economic growth while maintaining a balance between consumption and investment, as well as between domestic consumption and external demands. China will also further enhance macro control. The macro control measures, along with various institutional reforms, are likely to contribute to stable and sustainable economic development. The GDP growth is projected to be 9.5 percent in 2007, 1.0 percentage point lower from this year.

In 2007, China will make the expansion of domestic consumption as the fundamental basis of economic development. Consumer spending will keep at a relatively high growth rate as income rise and higher spending on medical care, education and housing encourages citizens to consume rather than save. But the large base in 2006 and non-lasting high growth of rural incomes will restrain the consumption growth.

I. ESSENTIALS OF THE CHINESE FOREIGN POLICY FRAMEWORK

A. The Role of Pragmatism in Chinese Foreign Policy

After more than a century of struggle with economic weakness and political turmoil, China entered the twenty-first century as a rising power by the help of the progress market-oriented economic reform. The Western businessmen welcomed the massive economic opportunities provided by China's rise, China's long-term great power potential to wonder whether an increasingly strong and assertive China would become a rational, peaceful, and pragmatic power or irrational and expansionist state. This issue has been taken from different positions.¹ Some have been alarmed and argued that the rising economic and military power of China by its own accord makes China a threat to Asian and global security because it may upset the balance of power and remove the realignments in East Asia as well as the world. This is the view of the neoconservatives of the Bush administration of the United States have warned the rise of China as a dominant power as a danger and they are seeking a way to control and manage China by the help of an international community.² In contrast to this view, some other scholars have held that China is a conservative power and "in the future it will seek to maintain the status quo"³.

China's increasing integration into the international system, evident in its growing memberships in international security regimes and economic organizations, such as the World Trade Organization (WTO), has created "adaptation to the prevailing norms in contemporary international relations"⁴. The debate between the realism and liberalism among the international relations scholars is been argued about the rising China. The realist argument claims that the rising China will become assertive and expansionist because, as the People's Republic of China's (PRC) capabilities increase, its intention will become less benign, but the liberal argument believes that China's reform and growing economic interactions with the capitalist world will make it more open and democratic, which will help to promote international stability and

¹ Denny Roy: "The China Threat Issue: Major Arguments," *Asian Survey* 36, no. 8 (August 1996): 767-770; Avery Goldstein, "Great Expectations: Interpreting China's Arrival," *International Security* 23, no. 3 (Winter 1997/98): 62-71; Herbert Yee and Ian Storey, eds., *The China Threat: Perceptions, Myths and Reality* (London: Routledge Curzon, 2002), p.p. 6-10.

² Charles W. Kegley, Jr.: "The Neoliberal Challenge to Realist Theories of World Politics: An Introduction," in Charles W. Kegley, Jr., ed., *Controversies in International Relations Theory: Realism and the Neoliberal Challenge* (New York: St. Martin's Press, 1995), p. 17. See Robert O. Keohane, "**Industrial Theory and Realist Challenge after Cold War**," in David A. Baldwin, ed., *Neorealism and Neoliberalism: The Contemporary Debate* (New York: Columbia University Press, 1993), p. 293.

³ Robert S. Ross: "Beijing as a Conservative Power," *Foreign Affairs* 76, no. 2 (March April 1997): 34.

⁴ Weixing Hu, Gerald Chan, and Daojiong Zha: "**Understanding China's Behavior in World Politics: An Introduction**," in Weixing Hu, Gerald Chan, and Daojiong Zha, eds., *China's International Relations in the 21st Century: Dynamics of Paradigm Shifts* (Lanham, MD: University Press of America, 2000), p. 2.

security. Both views have provided valuable insights, but neither of them is able to be enough to solve this puzzle whether a powerful China will be a major force of stability or threat to international peace.

The sovereign state behavior of China began taking steps to reform and to open up open up to outside world in the late 1970s, many scholars have made fruitful efforts to explore the role of a variety of domestic factors in China's foreign policy-making process. The progress of reform and opening up toward the outside world in recent decades, China has increasingly become a part of a larger international environment that provides opportunities for its policy options. Consistently pursuing the overarching goal of economic modernization, Chinese leaders have to be more sensitive to China's position in the changing international environment, in which Beijing has had only a limited role in shaping. These leaders have developed a pragmatic strategy to work with the major powers and China's Asian neighbors and adopt some established international norms beneficial to its foreign policy objectives by the way China had been successful in making a better foreign policy for years. *Pragmatism* by definition is "behavior disciplined by neither set of values nor established principles."⁵

The pragmatic foreign policy behavior took shape in Mao's final years and has fully developed in the post-Mao era. In the early 1970s, Mao developed a non-Marxist international strategy based on a perceived hierarchical structure of three worlds. Cooperation with the developing countries of the Third World as well as developed Japan and Western Europe, which constituted Mao's Second World, could be a force to counter the alleged hegemonism of the two superpowers that constituted the First World. After The United States extended diplomatic recognition to Beijing in 1979, post-Mao leaders worked very hard to shape a strategic triangle in which China played a crucial role by maneuvering between the two superpowers, the United States and the Soviet Union. After the end of the Cold War, Beijing's foreign policy-makers envisioned and worked hard to promote a world of multipolarization against the speculation of some Western commentators that a unipolar world characterized by United States hegemony had emerged from the ashes of the Cold War. By the way of pragmatist policy making process China emphasized the desirability and likely emergence of a multipolar community of sovereign nations mutually respecting the principle of noninterference. To cooperate toward the perceived trend of multipolarization and to insure a favorable international environment for its modernization, pragmatic Chinese leaders have tried to avoid confrontational relations with the

⁵ Lucian Pye, "After the Collapse of Communism: The Challenge of Chinese Nationalism and Pragmatism," in Eberhard Sandschneider, ed., **The Study of Modern China** (New York St. Martin's Press, 1999), p.38.

United States and other Western powers and, in the meantime, pursued a policy of defusing tensions along its immediate borders. China knows that, the failure of the Soviet Union was largely due to its strategy of confrontation with the United States in a competition for the position of world superpower that exhausted its economic and military capacity. Shen Jiru in his book, *“China Does Not Want to Be Mr. No”*⁶, suggested that, as one of the weaker poles in the multipolar world, China should not become the second “Mr. No” after the former Soviet Union to confront the United States and exhaust itself. Instead, China should defend its national interest by conducting a smart diplomacy, which “requires rationality and calmness.”⁷ Because “both the nation’s problems and most of the possible solutions were perceived from outside.”⁸ Pragmatic strategy has thus gained power both from reacting to and absorbing from the outside world. Pragmatic strategic behavior is flexible in tactics, smart in strategy, and avoid appearing confrontational, but uncompromising with foreign demands that involve China’s vital interest or that trigger historical sensitivities.

The pragmatist foreign policy behaviors of China are resulted from the constraints of international and domestic arrangements among the world. The leaders had been set economic modernization as their top national objective, and they paid a special attention to China’s economic, relations with other countries. This topic was the mainstream of the Chinese foreign policy behavior. The trade issue makes China to behave in neutrally, if the decision makers of China expect high trade rates for the future, they will be less likely take measures, and use force to deal with unresolved issues with neighboring countries. In addition, if China has a negative view of its future trading environment, the policy makers will like to take measures, including military action, to keep the great-power status. By the way, now, it is obvious to see that China is optimistic about the near future, but Chinese suspicion of a Western “conspiracy” to contain China is growing.

China is famous for upholding the flag of principle in the world arena. The real grounds for these principles, reflects the moral and idealistic elements in China’s foreign policy thinking and draw mainly from three sources: The traditional Chinese thinking, which dreams of a world of universal harmony; the humiliating experience in its modern history that causes China to long for fair and reasonable world order: the legacy of Marxism – Leninism and Mao Zedong thought,

⁶ Shen Jiru, *Zhongguo Budang Bu Xiansheng: Dangai Zhongguo de Guoji Zhanlue Wenti (China Does Not Want to Be Mr. No: Problems of International Strategy for Today’s China)* (Beijing: Jinri Zhongguo Chubanshe, 1998), p.62.

⁷ *Ibid*, p. 84.

⁸ Andrew J. Nathan and Robert S. Ross: *The Great Wall and Empty Fortress’s: China’s Search for Security* (New York: W.W. Norton, 1997), p.p. 32-33.

which advocates for a world free of aggression and exploitation of capitalism, imperialism, and colonialism a world free of power politics, bloc politics, and hegemonism. These principles include the following major points:

- Five principles of peaceful coexistence.
- Setting up a fair and reasonable political and economic world order.
- No use of force or threat of the use of force in international relations.
- All nations, big or small, strong or weak, rich or poor, are equal in international affairs.
- China should always side with developing countries. It should never seek hegemony or superpower status.

1. The Pragmatic Calculations and National Interest of Chinese Hong Kong & Korea Policy

Since 1978 and under the direction of Deng Xiaoping, the emphasis on developing the economy and opening the door to foreign investment, technology transfer, trade, and training has propelled China's foreign policy toward pragmatism and realism. The central considerations have become peace and security.⁹ On the other hand; renewed attention has been given to patriotism and nationalism. Anti-hegemonism and fraternity with the Third World continue to be the cornerstones of China's new foreign policy.

Starting from the establishment of the PRC, the way China handled Hong Kong is problematic. By not recovering Hong Kong in 1949 or shortly thereafter, and by allowing it to remain in the hands of Britain China's arch-imperialist foe in modern Chinese history China made a significant exception to its fundamental policy lines. The high degree of rationality and pragmatism displayed in China's approach to Hong Kong, contrasts starkly with the overall thrust of its foreign policy. China's policy toward Hong Kong does not necessarily call for a major revision of the ideological interpretation of Chinese foreign policy since 1949, but it definitely requires us to develop a more nuanced and comprehensive understanding of the way China defined its national goals, pursued its national interests, and handled its relations with nations of strategic importance.

⁹ Thomas W. Robinson: "Chinese Foreign Policy from the 1940s to the 1990s," in Thomas W. Robinson and David Shambaugh, eds., **Chinese Foreign Policy: Theory and Practice** (Oxford, UK: Clarendon Press, 1994), p. 569.

1.1. Leaving Hong Kong in the Hands of Britain

Hong Kong has been part of Chinese territory since ancient times. Before the British occupation, Hong Kong had achieved considerable development in agriculture, fisheries, the salt industry, transportation, cultural undertakings and education¹⁰. It was by no means an empty and unproductive land at that time. British troops occupied Hong Kong Island on 25 January 1841 during the Opium War. In August 1842, the British government formally annexed Hong Kong Island by forcing the Qing government to conclude the Sino-British Treaty of Nanking. In the Second Opium War, British troops forcibly occupied Kowloon in 1860. In October the same year, the British government annexed Kowloon after forcing the Qing government to conclude the Sino-British Convention of Peking. When imperialist powers were locked in their bid to carve up and grab spheres of influence in China, Britain again forced the Qing government into signing the Convention for the Extension of Hong Kong Territory in June 1898 by which it leased a large expanse of Chinese territory south of Shenzhen River and north of Boundary Street and some 235 islands, renamed later as the “New Territories,” thus achieving its occupation and control over the entire Hong Kong region.

In these times, the political system in British Hong Kong was by no means democratic. A scholar wrote: “Hong Kong is not a democracy. Power, both administrative and executive, is in the hands of civil servants who are in law primarily responsible, through the Governor, to the United Kingdom. The people of Hong Kong can neither appoint these public servants to office nor remove them.”¹¹

The reason why the PRC did not recover Hong Kong by force or diplomacy in 1949 and instead allowed the territory to continue as a British colony is still a mystery. No official explanation has been given. Statements by Chinese leaders and officials on this matter are without exception sketchy, cryptic, and tongue-tied. Some Chinese officials hint obliquely at national security as the chief reason why resumption of sovereignty over Hong Kong did not take place in 1949, but they normally fail to elaborate.

It appears that sometime before the establishment of the PRC on October 1, 1949, the intention not to change the status quo of Hong Kong was already quite evident. It also came at a time when the PRC was critically dependent on Soviet support. The intention was against the

¹⁰ Liu Shuyong, “*Hong Kong: A Survey of Its Political and Economic Development over the Past 150 Years*”, **The China Quarterly**, No. 151. (Sep., 1997), p.p. 583-592.

¹¹ Y. C. Jao, “*The Rise of Hong Kong as a Financial Center*”, **Asian Survey**, Vol. 19, No. 7. (Jul., 1979), p.p. 674-694.

wish of Joseph Stalin, the paramount leader of the Soviet Union.¹² According to Michael Yahuda, “Evidence from Soviet Archives suggests that as early as January 1949 (three months before the crossing of the Yangtze River) Mao Zedong had already decided to defer the seizure of the two remaining Western colonies of Hong Kong and Macao.”¹³

Thus far the most revealing explanation of China’s decision was given by Li Hou, former vice-director of the Hong Kong and Macao Office of the State Council, as follows:

“The decision of the Chinese leaders not to recover Hong Kong for a long time to come was based on the following considerations: (1) in an international situation characterized by sharp confrontation between two political camps, it was not possible to resolve the Hong Kong problem through peaceful method. Hong Kong could only be recovered by a resort to force. The British were well aware of the fact that they could not singly deal with China by their own power, so they would definitely bring the U.S. along to jointly defend Hong Kong. This scenario was certainly not what China wanted to see. In the eyes of the Chinese government and its leaders, it was better for Hong Kong to be left in the hands of Britain than to allow Britain to enlist the help of the U.S. to defend Hong Kong. (2) New China was just established; it had no diplomatic relations with many countries. Western countries, led by the U.S., were imposing economic embargo on China. Under these circumstances, maintaining the status quo of Hong Kong would allow it to serve as China’s channel to the outside world, making it possible for China to obtain things which could not be obtained from other channels”.¹⁴

In view of the perception of the international situation by the Communist leadership on the eve of the establishment of the PRC, it would appear that the decision to allow Britain to continue to administer Hong Kong represented a rational attempt of the CCP to avert war with the West over a piece of land that unlike the Korean Peninsula did not pose a military threat to China. By allowing Hong Kong to remain a British colony, China deliberately manipulated the differences between Britain and the United States and ameliorated the pain inflicted on China by the latter’s policy of containment.

In making sense of China’s decision, the first issue that has to be dealt with concerns the possibility of war between China and Britain, and possibly also the United States, if China recovered Hong Kong by military force in 1949. Dick Wilson, for one, thought that “Chinese

¹² Michael Yahuda, Hong Kong: China's Challenge, *The China Quarterly*, No. 160 (Dec., 1999).

¹³ *Ibid.*, p. 45.

¹⁴ Li Hou, “*Refurbishing Hong Kong’s Image: The 1997 Saga and Chinese Nationalism Under Deng Xiaoping*”, *European Journal of East Asian Studies*, Brill Academic Publishers, Volume 3, Number 1, 2004, p.p. 171-205

Communist troops had stopped at the border because China was not ready to absorb Hong Kong, and perhaps feared that such an action would provoke British and American retaliation before the civil war in China was even complete.”¹⁵ The determination of Churchill to remain in Hong Kong was shared by his Labor party successors after the war ended. In fact, in the Pacific war, Britain’s concerns were basically defensive, being fully cognizant of the limited powers at its disposal. The war aims were defined as: hold on to India, “liberate” Singapore and Malaya, keep Hong Kong, and insulate Britain’s Asian empire from any sort of international accountability.¹⁶ Apparently, while Britain could not afford to reassert its prewar position in China, the retention of Hong Kong was important to the empire, to Britain’s role as a major world power, and to the future British economic interest in East Asia.¹⁷

As a result of the perceived importance of Hong Kong, Britain did take steps to militarily fortify the colony and to make preparations to deal with emergencies.¹⁸ As the end of World War II ushered in the Cold War, Roosevelt’s successor, Harry S Truman, took a hard-line approach to Maoist China as part of a global strategy of opposing the spread of communism.¹⁹ Moreover, in contrast with Roosevelt’s sentimental attachment to China, Truman’s attitude toward the Chinese was one of aloofness. In any event, in the extreme anti-Communist atmosphere in the United States and in light of the strident views of the China lobby, it was difficult for Truman to take a conciliatory approach to the PRC.²⁰

The rise of Chinese communism presented a dilemma for British policy-makers: “on the one hand they had to demonstrate solidarity with their US ally who was at the forefront in the Cold War conflict with the Communist bloc; on the other hand, they had to protect British interests in China”²¹. British and Chinese policy-makers were caught in the web of an ideologically divided world and their countries’ practical interests. As London’s imperial ambition transformed into a determination to maintain Britain’s great power status, its China and Hong Kong policies converged with Cold War politics.

¹⁵ Dick Wilson, **Hong Kong! Hong Kong!** (London: Unwin Hyman, 1990), p. 65.

¹⁶ Warren F. Kimball: **Forged in War: Roosevelt, Churchill, and the Second World War** (New York: William Morrow, 1997), p. 287.

¹⁷ Lucian W. Pye: *The International Position of Hong Kong*, Hong Kong Briefing, **The China Quarterly**, No. 95. (Sep., 1983), p.p.. 456-468.

¹⁸ Yu Shengwu and Liu Shuyong: eds, “Ershi Shiji de Xianggang (Hong Kong in the Twentieth Century)” (**Hong Kong**: Qilin Shuye, 1995), p.p. 197-198

¹⁹ Alvin Y. So: “*Hong Kong’s Problematic Democratic Transition: Power Dependency or Business Hegemony?*” **The Journal of Asian Studies**, Vol. 59, No. 2. (May, 2000), p.p.. 359-381.

²⁰ Alvin Y. So: *Ibid.*

²¹ James T. H. Tang: “From Empire Defence to Imperial Retreat: Britain’s Postwar China Policy and the Decolonization of Hong Kong” **Modern Asian Studies**, Vol. 28, No. 2. (May, 1994), p.p.. 317-337.

Britain, while making military preparations for a possible Communist attack on Hong Kong, had also taken steps to mollify the Chinese Communists in order to safeguard Britain's extensive interests in China and to keep Hong Kong. After the PRC was established, against the opposition of the United States, the British government on January 5, 1950, withdrew recognition from the Nationalist government, and the next day it accorded *de jure* recognition to the Communist regime.²² Britain's move prompted a flurry of recognitions of the PRC between January 6 and January 18 by Norway, Ceylon, Denmark, Israel, Afghanistan, Finland, Sweden, and Switzerland.

These goodwill moves by Britain did not fail to impress the Communist leaders. For example, as early as 1949, during the first conference of the Chinese People's Political Consultative Conference, Mao Zedong proposed employing peaceful methods to resolve historical problems, including the Hong Kong problem. For the sake of improving China's diplomatic situation, Zhou Enlai proposed the policy of "advancing Sino-British relationship and promoting peaceful cooperation," exploiting the contradictions between the United States and some Western nations to build a united front in favor of keeping peace and promoting trade.²³ According to these calculations, allowing continued British rule in Hong Kong would drive a wedge between Britain and the United States and hence ease the harshness of the anti-Communist policy of the U.S.A.

Also the mistrust of CCP to Stalin and Soviet Union was a fact that not to recover Hong Kong in 1949. Mao blamed Stalin and the Comintern for the CCP's early disasters. During World War II, Stalin nurtured his vision of a *realpolitik* partnership with the Western allies and sided with the Chinese Nationalists, and, until late in the Chinese civil war, considered the CCP's cause as hopeless.²⁴ Only after the beginning of the Cold War, when all chances for reconciliation with the West were lost and he faced the need to seek new allies, did Stalin begin to develop a strategic relationship with the Chinese Communists.²⁵ Yet despite this, Mao was

²² Ma Ngok: "The Sino-British Dispute over Hong Kong: A Game Theory Interpretation", **Asian Survey**, Vol. 37, No. 8. (Aug., 1997), p.p. 738-751.

²³ Steven M. Goldstein: "Zhou Enlai and China's Revolution: A Selective View," **The China Quarterly**, No. 96. (Dec, 1983), p 724.

²⁴ Peter S. H. Tang: "Stalin's Role in the Communist Victory in China", **American Slavic and East European Review**, Vol. 13, No. 3. (Oct., 1954), p.p. 375-388.

²⁵ John W. Garver: "Battling Western Imperialism: Mao, Stalin, and the United States", **The China Quarterly**, No. 157. (Mar., 1999), p.p. 238-241.

deeply repulsed by Stalin's territorial ambitions in China.²⁶ Privately, Mao even had fonder impressions of the Americans than the Soviets.²⁷

Before 1949, Mao seemed to have wished to develop a normal relationship with the United States when the PRC was established.²⁸ In 1944-1945, he wanted to create the best possible balance of power for China in the international environment, leaning neither toward Moscow nor toward Washington, but using the assistance of both powers to reconstruct a country devastated by the Japanese occupation and the civil war.²⁹

In the end, despite the failure of Mao's efforts to win over the United States and his policy of total dependence on the Soviet Union, his hatred and suspicion of Stalin had never abated. Mistrust of the Soviet Union might have led to the wish to not foreclose all possibilities of an outlet to the West in the future. The Soviet factor influenced on China's policy toward Hong Kong in 1949.



Figure 1: Location map of China

²⁶ James Richter: "Inside the Kremlin's Cold War: From Stalin to Khrushchev", *Russian Review*, Vol. 56, No. 4. (Oct., 1997), p.p. 611-612.

²⁷ David Bachman, "Li Zhisui, Mao Zedong, and Chinese Elite Politics", *The China Journal*, No. 35. (Jan., 1996), p.p. 113-119.

²⁸ James Richter: "Inside the Kremlin's ... *Ibid.* p.p. 142-143.

²⁹ James Richter: "Inside the Kremlin's ... *Ibid.* p. 213.

The sense of insecurity from the CCP rendered the continuation of the status quo of Hong Kong after 1949 inevitable. Gradually, China came up with an explicit and stable policy toward Hong Kong, the thrust of which was instrumentalism and pragmatism. The strategic goals were to avoid international conflicts and to create a peaceful environment for China's socialist construction.³⁰ The evolution of this policy was officially described in the following passage:

In 1959, referring to the impatience of a minority of comrades over Hong Kong, Mao Zedong pointed out that from the perspective of overall global strategy, "it is better not to recover Hong Kong in the meantime. We are not in a hurry. The current [status of Hong Kong] is advantageous to us." In 1960, the Chinese government, after drawing conclusions from experiences in the last decade, put forth the policy of "changqi dasuan, chongfen liyong" "[long-term consideration, full utilization] to guide work on Hong Kong and Macao. This policy means that China would adopt long-term consideration as far as Hong Kong's future was concerned. In the foreseeable future, China would not adopt policies which would drastically change Hong Kong's status quo. At the same time, Hong Kong's special status would be fully utilized to serve China's socialist construction and diplomatic strategy.³¹

The Hong Kong policy of China had several interrelated components. First and foremost, Hong Kong had been part of territory of China since ancient times. It was occupied by Britain because of the unequal treaties forced upon China, but China did not recognize these treaties. When the conditions were ripe, the Hong Kong problem would be resolved in a peaceful manner through negotiations; however, until that happened, the status quo of Hong Kong would be maintained. Second, the resolution of the Hong Kong problem was a matter entirely within the sovereignty of China; it had nothing to do with the commonly understood problem of the colonies. These two principles constituted the foundation of China's Hong Kong policy.

Under the principle of "long-term consideration, full utilization," China's long-term policy toward Hong Kong was eventually established. China's Hong Kong policy was that the territory should remain economically valuable to China. While it is obvious that China's decision not to recover Hong Kong in 1949 was largely due to national security considerations in the political and military sense, the growing economic importance of Hong Kong to China has since loomed

³⁰ Yun-Wing Sung: "The Role of Hong Kong in China's Export Drive", *The Australian Journal of Chinese Affairs*, No. 15. (Jan., 1986), p.p. 83-101.

³¹ Guowuyuan Gangaobangongshi Xianggangshehuiwenhuasi (Bureau of Hong Kong's Society and Culture, Hong Kong and Macao Affairs Office, State Council), *Xianggang Wenti Duben (Reader on the Hong Kong Problem)* (Beijing: Zhongyang Dangxiao Chubanshe, 1997), p. 25.

increasingly large as a factor in China's policy to maintain Hong Kong's status quo as a British colony.³²

1.2. The 1997 Problem, China's Hong Kong Policy and Unresolved Dilemmas

In preparing for the resumption of sovereignty over Hong Kong, the Chinese government had to decide which individuals and groups would occupy the commanding heights of the post-colonial political landscape. During the colonial era, the British had sought to enhance their legitimacy in the absence of democracy through endorsement from representatives of the "business elite" (the families which owned the leading banking, commercial, industrial and real estate enterprises, together with the senior executives of major public companies and leading professionals).³³ In return, these elite and its proxies were granted a privileged role in policy and law-making throughout most of British rule. Chinese officials responsible for managing the transition from British to Chinese rule proved equally eager to have this group's support,³⁴ and well before 1997 China had replaced "the colonial bureaucracy as the political partner of the bourgeoisie and was recruiting a majority of its new political establishment from the business elite.

After the Sino-British Joint Declaration in 1984 the Chinese government, in line with the policy of "one country, two systems" (OCTS) and the spirit of the Joint Declaration, and on the basis of extensive consultations with the people of Hong Kong, promulgated "The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China" and announced a set of political guidelines to achieve the gradual advancement of a democratic system. It is stipulated in the Basic Law that the method for selecting the Chief Executive shall be specified in the light of the actual situation in the Hong Kong Special Administrative Region (HKSAR) and in accordance with the principle of gradual and orderly progress, aiming towards selection by universal suffrage after nomination by a broadly representative committee.³⁵ The Legco of the HKSAR shall be constituted by election in accordance with the same principles. Only when the development of the political structure in Hong Kong during the transitional period converges with the Basic Law can a steady transition and smooth transfer of government be ensured and Hong Kong's long-term stability and prosperity maintained. However, when the

³² Ibid, pp. 52-57.

³³ Alex H. Choi, "State-business relations and industrial restructuring," in Tak-Wing Ngo (ed.). **Hong Kong's History: State and Society Under Colonial Rule** (London: Routledge, 1999), pp. 144, 153-54.

³⁴ Benjamin K. P. Leung, "Political development: prospects and possibilities," in Benjamin K.P. Leung (ed.). **Social Issues in Hong Kong** (Hong Kong: Oxford University Press, 1990), p. 39.

³⁵ Liu Shuyong, Hong Kong: A Survey of Its Political and Economic Development over the Past 150 Years, **The China Quarterly**, No. 151. (Sep., 1997), pp. 583-592.

British government realized that its departure from Hong Kong was a foregone conclusion, it departed from its normal behavior by pushing forward changes and trying to quicken the introduction of direct elections in order to prolong British influence in Hong Kong beyond 1997.

The primary considerations underlying the “one country, two systems” policy were: (1) Hong Kong’s economic value to China should be retained; (2) China’s relations with Britain and other Western countries should not be affected; (3) Hong Kong as an economic bridge between China and the West should be maintained; (4) Hong Kong should not become a security threat to China; and (5) Hong Kong’s return should facilitate the reunification of Taiwan with China.

The essence of the OCTS policy represented the attempt by China to preserve Hong Kong’s prosperity and stability without the British. The key elements in the policy included³⁶:

1. The Hong Kong Special Administrative Region (HKSAR) would be set up on July 1, 1997;
2. The HKSAR would be placed directly under the central government and, aside from foreign and defense affairs, would enjoy a high degree of autonomy;
3. The HKSAR had the powers of administration and legislation. Its judicial power, including that of final adjudication, would be independent;
4. The HKSAR government would be made up of the inhabitants of Hong Kong;
5. The preexisting social and economic institutions as well as the way of life of Hong Kong would remain unchanged;
6. Hong Kong would retain its free port status and remain as a separate customs territory;
7. Hong Kong would continue to be an international financial center;
8. Hong Kong would enjoy independent finances;
9. Hong Kong could establish mutually beneficial economic relations with Britain and other countries;
10. Hong Kong could develop economic and cultural relations with other countries;
11. Hong Kong would be responsible for the maintenance of its public order. The defense of the HKSAR would be the responsibility of the PLA; and

³⁶Lau Siu-kai, *Pragmatic Calculations of National Interest: China's Hong Kong Policy from 1949 – 1997* in **Chinese Foreign Policy: Pragmatism and Strategic Behaviour** (2004), An Eastgate Book, London.

12. The OCTS policy would remain unchanged for fifty years. Eventually, these elements were incorporated into the Basic Law, the miniconstitution of Hong Kong, after its reversion to China.

On the whole, China's policy for post-1997 Hong Kong was a pragmatic and rational policy based on self-interests, yet from the beginning China failed to grasp the momentous ramifications of the policy. China wanted to remove the British but at the same time leave the rest of the status quo in Hong Kong unchanged. That China was so optimistic about achieving the two goals simultaneously in the early 1980s has to do with China's mechanical understanding of Hong Kong as a society, its overestimation of the political passivity of the people of the place, and its overconfidence in Sino-British cooperation and in British capacity to control the situation in Hong Kong in the transitional period. However, it transpired that once it was a known fact that British rule in Hong Kong was going to end in 1997, a Pandora's Box was opened, and China's key premises about Hong Kong were in shambles. In retrospect, China was ill prepared for the fundamental changes in Hong Kong that were inaugurated by the end of colonial rule. Consequently, China's policy in the transitional period was in disarray.

One big premise of China's policy was that since Britain was willing to surrender Hong Kong to China in a peaceful manner, and since Britain had tremendous interests in Hong Kong and in China, Britain should be willing to cooperate with China fully in the transitional period and grant China de facto veto power over major British initiatives before the handover. China insisted that Britain should and could continue to run Hong Kong in the same manner as in the past. Undoubtedly, China was not fully cognizant of the changed political situation of the British rulers who were on the way out. By the same token, China could not sympathize with the need of the British to initiate political reforms in order to stabilize colonial rule in its last days. Nor could China understand the imperative of Britain to depart Hong Kong with honor. In fact, alongside China's optimism about British cooperation was a lingering suspicion of British intentions. The persistence of Britain in introducing political reforms in Hong Kong had greatly exacerbated China's fears of British conspiracies.³⁷ It was indubitably true that Britain did want to groom popular leaders through political reforms to guarantee the realization of Hong Kong people

³⁷ Deng Xiaoping had expressed his suspicions back in the early 1980s to Prime Minister Margaret Thatcher and Foreign Secretary Geoffrey Howe. He was worried that Britain would instigate serious disorders in Hong Kong during the transition. He expressed his hope that the following would not happen: (1) the Hong Kong dollar becoming unstable; (2) the colonial government spending the revenue from land sales irresponsibly; (3) the colonial government creating fiscal burdens for the HKSAR government; (4) the colonial government grooming a separate political leadership and imposing it upon the HKSAR; and (5) British capital taking the lead in fleeing Hong Kong. See Deng Xiaoping, *Lun Xianggang Wenti (On the Hong Kong Problem)* (Hong Kong: Joint Publishing, 1993), pp. 1-3, 9-10.

governing Hong Kong with a high degree of autonomy as understood by it, yet the self-interests of Britain to maintain effective rule before 1997 counseled it against radical moves. The demand of China that Britain take absolute control of Hong Kong before its return to China eventually clashed with the British political agenda to leave with glory. As a result, the two countries moved from uneasy collaboration to intense confrontation when the Tiananmen incident in 1989 proved to be the last straw. The progressive breakdown of Sino-British cooperation in the transitional period created immense instabilities, uncertainties, and disruptions in Hong Kong.³⁸

Another crucial premise was that British cooperation before 1997 was indispensable to a smooth transition. This is somewhat ironic in view of the fact that China repeatedly depreciated the role of Britain in Hong Kong's success and trumpeted instead the contributions of China and the Hong Kong people. This premise was based on the consideration that Britain would still be in full control of Hong Kong before the handover, and that it was risky to work with the preponderantly anti-Communist people there, who were averse to the return of Hong Kong to China. Because of China's ambivalence toward Britain, the reaction of China to the abrupt shift to a confrontation policy by the British in 1992 was a mixture of anger and dismay. The ambiguity displayed by China in the early stage of Sino-British confrontation over Hong Kong and the continued hope on the part of Chinese officials for Britain to reverse its policy underlined the existence of the premise of "indispensability." This premise prompted China to depend on behind-the-scenes negotiations with Britain over Hong Kong issues. Mobilization of mass support in Hong Kong was considered as not only unnecessary but also risky. During the transitional period, China failed to build rapport between itself and the people of Hong Kong. When confrontation with Britain occurred shortly before 1997, China tried to coerce Britain into cooperation, and in the process further alienated public opinion, which largely sided with the departing regime. The gap between the Chinese government and the people of Hong Kong remained wide throughout the transitional period.

Yet another questionable premise was that despite the anxieties and fears generated among the Hong Kong people by the 1997 problem, they would remain politically subservient notwithstanding their mistrust of the CCP and fears of the future. To the people of Hong Kong, however, Britain had served as a shield against the Communist regime since 1949. The departure of the British would expose them to the caprice of the CCP and the thought of it was tormenting. The people were disposed to seek whatever forms of political protection that were available. The

³⁸ Lau Siu-kai, "Decolonization a la Hong Kong: Britain's Search for Governability and Exit with Glory in Hong Kong," *The Journal of Commonwealth and Comparative Politics* 34, no. 2 (July 1997): 28-54

support, though mild and shallow, given by the Hong Kong people to political reform as a means to secure their future alerted China to their anti-Communist intentions. The strong support and intense sympathy by the Hong Kong people to the prodemocratic protesters in Beijing in 1989 alarmed the Chinese leadership to the extent that not only the political motives of the Hong Kong people were reinterpreted, but also that Hong Kong was perceived as a base of subversion. Chinese leaders and officials repeatedly admonished the Hong Kong people not to turn the place into a “political city” (zhengzhi chengshi), and not to allow “the well water to offend the river water” (heshui pufanjingshui).³⁹

The incorporation of antiradicalism clauses into the Basic Law in 1990 and the tightening up of China’s Hong Kong policy widened the chasm between China and Hong Kong and greatly weakened public confidence in the territory.

Reliance on British cooperation coupled with mistrust of British motives made Sino-British relations extremely fragile and unstable during the transition. A major victim of China’s zigzag policy toward Britain emerged during the cultivation of local political leadership. Local leadership was underdeveloped under British colonial rule. The prospect of Hong Kong people ruling Hong Kong theoretically should have provided fertile soil for the rise of popular leaders in the territory. However, Sino-British rivalries were not congenial to the rise of local leaders. On the contrary, by vying with each other for the support of local people in their confrontation, China and Britain inexorably divided the meager pool of local political leaders, widened the gap between leaders and people, discredited leaders in the public eye, and aggravated political apathy among the masses.⁴⁰

The paucity of local political leaders who were simultaneously trusted by China and popular with the people inevitably threatened the implementation of Hong Kong people ruling Hong Kong.

In addition to the dearth of local political leadership in Hong Kong was the problem of legitimacy for the political leaders entrusted by China to run Hong Kong after 1997. China’s mistrust of the political intentions of the people of Hong Kong naturally gave rise to a leadership selection process subject to Chinese influence. This process of leadership formation was bound to meet with public resistance. Moreover, China’s conception of the political needs of Hong

³⁹ Deng Xiaoping, Lun Xianggang, pp. 29,33; and Zhao Rui and Zhang Mingyu, Zhongguo Lingdaoren Tan Xianggang (**Chinese Leaders Talked About Hong Kong**) (Hong Kong: Ming Pao Press, 1997), pp. 16, 29-31, 34, 36, 64, 185-186, 188, 196.

⁴⁰ Lau Siu-kai, “Democratization and Decline of Trust in Public Institutions in Hong Kong,” **Democratization** 3, no. 2 (Summer 1996): 158-180.

Kong had made the problem of legitimacy even more intractable. By defining Hong Kong as a capitalist society, China instinctively determined that after the British were gone, the bourgeoisie should naturally become the ruling class.⁴¹ This logic was also derived from the imperative to maintain the confidence of the bourgeoisie in Hong Kong. China's political reasoning gave the bourgeoisie the political power and status they, as political dependents, did not enjoy under colonial rule. By turning the bourgeoisie into a governing class, the status quo in Hong Kong was fundamentally altered. Signs of class conflict appeared in the transitional period, portending more ominous social conflicts in the post-1997 period.⁴²

As a corollary to the emphasis on the bourgeoisie, China paid insufficient attention to the aspirations and apprehensions of the growing middle class in Hong Kong. In fact, (Tuna was alienated by the Westernized and cosmopolitan values held by the growing middle class. At the same time, China saw the middle class not as an autonomous class, but as a class dependent on the bourgeoisie.⁴³ This disparaging view of the middle class and the lack of sympathy with their aspirations strained relations between the CCP and the middle class in Hong Kong. The alliance between Britain and the middle class to undertake political reform in Hong Kong further weakened the latter's relations with China. The alienation of the middle class greatly hampered China's effort to shape public opinion in its favor during the transition.

Finally, the scheduled end of British rule in Hong Kong changed the international environment of the place. As Hong Kong would soon be part of China and not part of the Western world, the relations between Hong Kong and the West had undergone changes. Western governments had repeatedly expressed interests in the way Hong Kong was treated by China, which aroused Chinese suspicions of Western interference in China's internal affairs. China was also worried about Western governments using Hong Kong as a base of subversion against Chinese socialism, or turning the place into a bargaining chip to their advantage. For the sake of shielding China from the "Hong Kong threat," China adopted institutional and legal safeguards

⁴¹ The equation of capitalism with bourgeois rule was typical of Marxian analysis: A former director of the Hong Kong branch of the New China News Agency, Xu Jiatun, had unmistakably pointed out that the "political regime of the future Special Administrative Region should be composed chiefly of the bourgeois class, but with the participation of the proletariat. While it should be a regime reflecting the unity of different social classes, it however is basically bourgeois in nature." And, "the thinking of the (CPP) center is: (1) the bourgeoisie should have substantial influence on the regime of Hong Kong, (2) there should be political parties (to reflect the interests of) not merely the individual elements of the bourgeois class but the (politically) organized bourgeoisie." See Xu Jiatun, Xu Jiatun Xianggang Huiyi Lu (**Xu Jiatun's Recollections on Hong Kong**) (Taipei: Lianhe Bao, 993), pp. 142, 190.

⁴² Lau Siu-kai, "The Fraying of the Socioeconomic Fabric of Hong Kong," **The Pacific Review** 10, no. 3 (1997): 426-441.

⁴³ Xu Jiatun, *Ibid.*

to forestall external forces from turning Hong Kong against China. And, in doing so, China further undermined the Hong Kong people's confidence in their future.

2. Conclusion

Throughout the period of 1947-1997, China's Hong Kong policy evinced a pragmatic approach to a problem that was intrinsically highly emotional and ideological. A study of China's approach to Hong Kong, particularly in the period of 1949-1978, provides material for a more nuanced understanding of its foreign policy, which is far less irrational or ideologically driven than commonly believed. National security considerations led China to leave Hong Kong in British hands for another half century, and this decision, in retrospect, was highly beneficial to China. It was only when China decided to recover Hong Kong in 1997 that this pragmatic approach met with difficulties.

Admittedly, the policy of "one country, two systems" was an ingenious creation to resolve the Hong Kong problem, which would definitely benefit both China and Hong Kong, and there was tremendous sincerity on the part of China to make that policy a success. Nevertheless, China's understanding of the reverberations unleashed by the end of British rule was minimal. This lack of understanding or even misunderstanding had served China poorly during the transitional period, making the transition unnecessarily rough, particularly in the last five years. The problems that arose in the transitional period are bound to continue to affect the Hong Kong Special Administrative Region (HKSAR). The essence of these problems originated from the simplistic calculation of China that the role played by Britain in Hong Kong could be easily superseded by a set of promises and arrangements while the rest of the status quo remained undisturbed. And, true to its obstinately adhered principle that Hong Kong was a matter between China and Britain, China only permitted Britain to be its interlocutor in Hong Kong affairs. China's simplistic reasoning, in turn, produced overconfidence and, when reality did not match expectations, to frustration and scapegoating. Consequently, China's behavior during the transition was erratic and in many aspects detrimental to Hong Kong.

Having said that, the "one country, two systems" policy was undoubtedly a product of rational imagination. China had to take great risks in pursuing this policy, which included, inter alia, allowing a politically dangerous capitalist enclave to exist in a socialist country, furnishing the West a lever against China, and creating jealousies among the people on the mainland. Obviously, China, by taking these risks, must have come to the conclusion that the gains to national security accrued from the policy warranted the costs incurred.

B. The Role of Realism in the Chinese Foreign Policy

Most of the realists believe that an economically powerful China will become more assertive and expansionist because of structural constraints. As the PRC's capabilities increase, they argue, its intentions will become less benign. Liberals, however, contend that China's reform and growing economic interactions with the capitalist world will make it more open and democratic and a promoter of international stability and security.

For realists, the emergence of China as a potential great power in the international system must be understood within the context of the end of bipolarity and the advent of a "Unipolar world" following the disintegration of the Soviet Union. Soon after the revolutions in Eastern Europe in 1989, Charles Krauthammer argued in *Foreign Affairs* that the bipolar system would be replaced by one of "unipolarity." The center of world power, in his view, "is the unchallenged superpower, the United States, attended by its Western allies."⁴⁴ It would take decades to reach the stage of multipolarity. For the moment, the United States remains "the only country with the military, diplomatic, political and economic assets to be a decisive player in any conflict in whatever part of the world it chooses to involve itself"⁴⁵.

But, realists believe that in a world of unipolarity other powers will rise to challenge the predominant position of the United States, and that the "Unipolar World" may not last a long time. In an article entitled "The Unipolar Illusion," Christopher Layne uses neorealist theory⁴⁶ and historical evidence to explain great power emergence in the international system. The emergence of great powers, according to Layne, is "a structurally driven phenomenon."⁴⁷ The rise and fall of great powers are based on economic power that grows within states at different rates. There are winners and losers in a unipolar system, states with successful economic expansion tend to become more ambitious and more capable of challenging the status quo, defending their increased overseas interests and commitments, and disrupting the dominance of the world's major power.⁴⁸ Any state that wishes to advance its status in an anarchic world must attempt to balance its position against the dominance of the hegemonic power. As states compete with each other, they tend to imitate their rivals' successful policies, moving toward "sameness." States with the capability of becoming major powers naturally seek to challenge the hegemon's

⁴⁴ Charles Krauthammer: "The Unipolar Moment," *Foreign Affairs* 70, no. 1 (1990/91), p. 23.

⁴⁵ *Ibid*, p. 24.

⁴⁶ Kenneth N. Waltz: *Theory of International Politics* (Reading, MA: Addison-Wesley, 1979).

⁴⁷ Christopher Layne: "The Unipolar Illusion: Why New Great Powers Will Rise," *International Security* 17, no. 4 (Spring 1993), p. 9.

⁴⁸ Robert Gilpin: *War and Change in International Politics* (New York: Cambridge University Press, 1981); Paul Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000* (London: Fontana, 1988).

preponderance and to pursue great-power status that in turn produces a shift from unipolarity to multipolarity, thus having a “structural impact” on the international system. Indeed, Layne notes that there was widespread concern in Europe, Asia, and the Third World about America’s “unchallenged dominance in international politics” in the immediate post-Cold War era.⁴⁹

The country that has the greatest suspicion of a unipolar system dominated by the United States is probably China,⁵⁰ which falls within the type of rising powers described by Layne. Over the past two decades, China has achieved remarkable economic success and accelerated its defense modernization. While the Chinese have imitated many of America’s successful policies, it perceives the United States as a major rival in the international arena. Indeed, Chinese officials and analysts argued in the early 1990s that the “new world order” (*shijie xinzhixu*) advocated by George Bush was simply an American vision of a world order based on U.S. values and interests and designed to maintain American “hegemony” (*bachuanzhuyi*) in the post-Cold War world.⁵¹ “In a unipolar world,” says Layne, “others must worry about the hegemon’s capabilities, not its intentions. The preeminent power’s intentions may lie benign today but may not be tomorrow.”⁵² In the eyes of Chinese leaders, however, post-1989 U.S. intentions are not even benign. They suspect that the United States attempts to undermine the legitimacy of their regime through various means following the Tiananmen events and the collapse of the Communist governments in Eastern Europe and the former Soviet Union.⁵³ Thus, China has been determined to challenge the predominant position of the United States in the international system and to defend what it perceives” as its vital economic and security interests. It has been suggested that “China’s primary foreign policy goal today is to weaken American influence relatively and absolutely, while steadfastly protecting its own corner.”⁵⁴ “With certain new equipment and certain strategies,” Thomas Christensen argues, “China can pose major problems for American

⁴⁹ Layne: “The Unipolar Illusion,” p.p. 35-37.

⁵⁰ See the analysis in Rex Li: “Unipolar Aspirations in a Multipolar Reality: China’s perceptions of US Ambitions and Capabilities in the Post-Cold War World,” **Pacifica Review** 11, no. 2 (June 1999/): 115-149.

⁵¹ China’s views of George Bush, Sr.’s vision of a “new world order” were widely expressed in Chinese newspapers, journals, and books in the early 1990s. See, for example, Du Gong and Ni Liyu, Eds, *Zhuanhuanzhong de shijie geju* (**The World Structure in Transition**), (Beijing: Shijie zhishi chubanshe, 1992), p.p. 299-308.

⁵² Layne: “The Unipolar Illusion,” p.p. 13-14.

⁵³ John W. Garver, “China and the New World Order,” in William A. Joseph, ed., **China Briefing**, 1992 (Boulder, CO: Westview Press, 1993), p.p. 55-57; Bonnie S. Glaser, “China’s Security Perceptions: Interests and Ambitions,” **Asian Survey** 33, no. 3 (March 1993): 259-260; Rex Li, “China and Asia-Pacific Security in the Post-Cold War Era,” **Security Dialogue** 26, no. 3 (September 1995): 332, 334

⁵⁴ David Shambaugh: “Containment or Engagement of China? Calculating Beijing’s Responses,” **International Security** 21, no. 2 (Fall 1996): 187.

security interests ... without the slightest pretense of catching up with the United States by an overall measure of national military power or technology.”⁵⁵

Another structural change that encourages China to seek great-power status is the changing balance of power in the Asia-Pacific region since the end of the Cold War. With the breakup of the Soviet Union and a reduced U.S. military commitment to the region, realists predict, a “power vacuum” will emerge that will likely be filled by powerful regional players.⁵⁶ While Japan and India are often referred to as potential candidates who may wish to fill the vacuum in the event of an American withdrawal from the Asia-Pacific region, it is China that many realist analysts believe is the “hegemon on the horizon.”⁵⁷ Why would China want to achieve a predominant position in the region? For realists, “a state’s freedom to choose whether to seek great-power status is in reality tightly constrained by structural factors.” More important, “eligible states that fail to attain great-power status are predictably punished.”⁵⁸ China is seen as such a state that is aiming to become a major power in the Asia-Pacific region. The size, population, and resources of the country, combined with the enormous potential of its economic and military strength, will empower China to achieve great-power status. As Kenneth Waltz argues, “For a country to choose not to become a great power is a structural anomaly.... Countries with great-power economies have become great powers, whether or not reluctantly.”⁵⁹ If eligible states “do not acquire great-power capabilities, they may be exploited by the hegemon.”⁶⁰ Assuming that the existing hegemon (the United States) will decline or pull out from the region, China would have to face the challenge of a potential hegemon, which could be Japan, its historical rival in East Asia. Chinese leaders know perfectly well that China was invaded and exploited by foreign powers during the nineteenth century precisely because it failed to attain great-power status while Japan and the European states did. After all, China suffered

⁵⁵ Thomas J. Christensen: “Posing Problems without Catching Up: China’s Rise and Challenges for U.S. Security Policy,” *International Security* 25, no. 4 (Spring 2001): 7.

⁵⁶ See, for example, William T. Tow: “Post-Cold War Security in East Asia,” *The Pacific Review* 4, no. 2 (1991): 97; Charles McGregor, “Southeast Asia’s New Security Challenges,” *The Pacific Review* 6, no. 3 (1993): 272; J. Mohan Malik, “Conflict Patterns and Security Environment in the Asia Pacific Region—The Post-Cold War Era,” in Kevin Clements, ed., *Peace and Security in the Asia Pacific Region: Post-Cold War Problems and Prospects* (Tokyo: United Nations University Press, 1993), p.p. 33, 38; Barry Buzan and Gerald Segal, “Rethinking East Asian Security,” *Survival* 36, no. 2 (Summer, 1994): 8.

⁵⁷ Denny Roy: “Hegemon on the Horizon? China’s Threat to East Asian Security,” *International Security* 19, no. 1 (Summer 1994): 149-168; Denny Roy, “Assessing the Asia-Pacific ‘Power Vacuum,’” *Survival* 37, no. 3 (Autumn 1995): 50-55.

⁵⁸ Layne: “The Unipolar Illusion,” p. 9.

⁵⁹ Kenneth N. Waltz: “The Emerging Structure of International Politics,” *International Security* 18, no. 2 (Fall 1993): 66.

⁶⁰ Layne: “The Unipolar Illusion,” p. 12

hugely from Japanese imperialism when it was economically and militarily weak.⁶¹ To avoid another “century of shame and humiliation” (*bainian chiru*), China would need to achieve great-power status.

All the available evidence suggests, realists argue that the policy-makers in Beijing have chosen to take advantage of the structural change in the international system. In fact, ever since economic reform and the open-door policy were introduced by Deng Xiaoping in 1978, Chinese leaders have been actively developing China’s “comprehensive national strength” (*zhonghe guoli*) in order to be in a position to compete with other great powers politically, economically, and militarily.⁶² The end of bipolarity has undoubtedly provided China with an excellent opportunity to elevate its status in the hierarchy of the international structure and to fulfill its great-power aspirations. Seen from the realist perspective, the rise of China is primarily a consequence of the fundamental change in the structure of the international system. Certainly, China’s economic expansion since the 1980s has made it easier for its leaders to challenge America’s unipolar position in the post-Soviet world, but the growth of Chinese power is a structurally driven phenomenon that will in turn contribute to the structural transition from unipolarity to multipolarity.

As the emergence of the PRC as a great power in the twenty-first century seems highly probable, realists warn that a rising China will present the international society with an immense challenge that will not be easy to manage. Specifically, an economically and militarily powerful China may pose a long-term threat to the stability and security of the Asia-Pacific region, and the world in general. As the late Gerald Segal puts it, “If, in 2020, the world faces a united, authoritarian China with the world’s largest GDP, perhaps the world’s largest defense budget ... it will be too late to do much about it.”⁶³ Western analysts point to the rapid development of Chinese military capabilities that has been made possible by China’s sustained economic growth in recent years.⁶⁴ “International politics, like all politics,” Hans Morgenthau writes, “is a struggle for power. Whatever the ultimate aims... power is always the immediate aim.”⁶⁵ Realists tend to see power in terms of zero-sum game where one actor’s gain is another’s loss. As John Mearsheimer notes; “States are principally concerned relative power position in the system;

⁶¹ Jonathan D. Spence: **The Search for Modern China** (London: Hutchinson, 1990) chaps. 7-11.

⁶² Gerald Chan: **Chinese Perspectives on International Relations: A Framework for Analysis** (London, UK: Macmillan, 1999), p.p. 28-33.

⁶³ Gerald Segal: “Tying China into the International System,” **Survival** 37, no. 2 (Summer 1995): 70.

⁶⁴ Chong-Pin Lin: “Chinese Military Modernization: Perceptions, Progress, and Prospects,” **Security Studies** 3, no. 4 (Summer 1994): 718-753

⁶⁵ Hans J. Morgenthau: **Politics among Nations: The Struggle for Power and Peace**, rev. 5th ed. (New York: Alfred A. Knopf, 1978), p. 29.

hence they look for opportunities to take advantages of each other. If anything, they prefer to see enemies decline, and thus will do whatever they can do speed up the process and maximize the distance of the fall.”⁶⁶ Therefore, the growth of Chinese power would mean the relative decline of the power of other countries. If and when China achieves its great-power status, realists fear, it will throw its weight around and will not play by the rules of the international community.

From a realist standpoint, a great power’s behavior is determined not so much by its intentions but by its capabilities. As a state’s economy expands, it will use its newfound it’s newfound to extend its spheres of influence and to defend its economic interests whenever these interests are challenged. As an emerging power with a great civilization and a history of being humiliated by foreign countries, China will be likely to behave in the same way as other rising powers did in the past.”⁶⁷ Thus, Denny Roy predicts that “China’s growth from a weak, developing state to a stronger, more prosperous state should result in a more assertive foreign policy” and that “an economically stronger China will begin to act like a major power: bolder, more demanding, and less inclined to cooperate with the other major powers in the region.”⁶⁸

Clearly, realists are pessimistic about the international repercussions of great-power emergence. According to power transition theory, a rising power will seek to challenge the status of the leading power in the international hierarchy, which could result in a war between them.⁶⁹ China is widely known as a dissatisfied and non-status quo power seeking to “right the wrongs” of its humiliating history and alter the existing rules of the international system that are thought to be created and dictated by the West.⁷⁰ Indeed, Beijing’s irredentist claims in East and Southeast Asia have been cited by realists as the most convincing evidence for their argument that a more open and prosperous China will not necessarily be a pacific China. While it is inconceivable that China will attempt to reclaim its historical preeminence in Asia by conquering other countries, the PRC’s neighbors are increasingly worried that it may use or threaten to use force to deal with unresolved territorial disputes.

⁶⁶ John J. Mearsheimer: “Back to the Future: Instability in Europe after the Cold War,” **International Security** 15, no. 1 (Summer 1990): 53.

⁶⁷ For comparisons of Wilhelmine Germany and today’s China, see Nicholas D. Kristof: “The Rise of China,” **Foreign Affairs** 72, no. 5 (November/December 1993): 71-72; Arthur Waldron: “Deterring China,” *Commentary* 100, no. 4 (October 1995): 18.

⁶⁸ Roy: “Hegemon on the Horizon?” p.p. 159-160

⁶⁹ A.F.K. Organski, **World Politics** (New York: Alfred A. Knopf, 1958); A.F.K. Organski and Jacek Kugler: **The War Ledger** (Chicago: University of Chicago Press, 1980).

⁷⁰ Buzan and Segal: “Rethinking East Asian security,” p. 6; Roy, “**Hegemon on the Horizon?**” p. 161; Shambaugh, “Containment or Engagement of China?” p.p. 186-187.

Realists are particularly critical of the liberal assumption that economic interdependence reduces the possibility of military conflict. Both Taiwan and ASEAN states are important trading partners of China, yet their close economic relationships have not prevented the PRC from acting assertively in the South China Sea and across the Taiwan Strait. Gerald Segal argues that “China’s behavior . . . suggests that China does not feel that the fruits of economic interdependence are at risk when it pursues its irredentist agenda or seeks greater international status, or else that these are short-term prices worth paying for a greater good.”⁷¹ Economic interdependence, realists contend, can in fact increase the likelihood of armed confrontation among trading nations as they seek to gain or maintain their access to vital resources and materials that are essential to the pursuit of wealth and power in an anarchic world.⁷² Indeed, China’s activities in the South China Sea are driven in part by the consideration that “the rich natural resources of the Sea are crucial to the survival and prosperity of an overpopulated mainland with ever declining resources.”⁷³ Over the past two decades, China’s demand for energy has increased rapidly as a result of greater energy consumption in the country.⁷⁴ In November 1993, China became a net oil importer for the first time in more than a quarter-century, and it is likely to become more dependent upon oil imports in the future.⁷⁵ According to a recent report, by 2020, China would have to import as much as 60 percent of its oil needs.⁷⁶ Without new reserves and with an 8 percent annual growth rate, China’s current reserves could be exhausted within two decades.⁷⁷ In order to sustain its economic growth and achieve great-power status in the twenty first century, the Chinese government would have to defend existing oil supplies and to find new energy reserves. Given the tremendous importance of the South Sea to China’s national development, realists point out; Beijing will press its claim to the area even though it may involve military confrontation with ASEAN states.

Similarly, Taiwan’s dynamic economic interaction with China does not guarantee permanent peace across the Taiwan Strait because any attempt to separate the island from the mainland will be seen by China as both a threat to its security and an obstacle to the achievement of its great-power status. In the eyes of Chinese leaders, the nationalist cause of building a united,

⁷¹ Gerald Segal: “East Asia and the ‘Constraint of China’” *International Security* 20, no. 4 (Spring 1996): 133.

⁷² Waltz: *Theory of International Politics*, p. 106.

⁷³ Chen Jie: “China’s Spratly Policy,” *Asian Survey* 33, no. 10 (October 1994), p. 896.

⁷⁴ Alan Troner and Sarah J. Miller: *Energy and the New China: Target of Opportunities* (New York: Petroleum & Energy Intelligence Weekly, 1995), p.p. 49-53.

⁷⁵ Ken E. Calder: “Asia’s Empty Tank,” *Foreign Affairs* 75, no. 2 (March/April 1996): 56; Mamdouh G. Salameh, “China, Oil and the Risk of Regional Conflict,” *Survival* 37, no. 4, (Winter 1995-1996): 135.

⁷⁶ “Out of Puff: A Survey of China,” *The Economist*, June 15, 2002, p. 16.

⁷⁷ Salameh: “China, Oil and the Risk of Regional Conflict,” p. 141.

prosperous, and powerful China will not be complete without reclaiming the sovereignty of Taiwan. Thus, economic interests could be forfeited, if necessary for the sake of military security and power maximization.

For realists, the challenge of a more powerful and confident China to international security seems hard, but there is no commonly acceptable strategy to deal with the China challenge. Those who believe that the transition from unipolarity to multipolarity is inevitable and the rise of China is a structurally driven phenomenon tend to advise against attempts to suppress the emergence of new great powers.⁷⁸ Some realist scholars believe that “despite the prevailing global unipolarity, contemporary East Asia is bipolar” and will be dominated by a maritime power and lands power the United States and China.⁷⁹ The “lesser great powers” like Russia and Japan, Robert Ross contends, would not be in a position to challenge the bipolarity in the region due to geographic constraints. The United States and China will be strategic rivals competing for power and influence, but geography and stable bipolarity will contribute to regional peace and order.⁸⁰

Other realists, however, are less certain that it is in the interests of the world to see the reemergence of China as a great power. Specifically, they believe that a stronger China will likely be a regional Hegemon in the Asia-Pacific region⁸¹ and a long-term adversary of the United States.⁸² More seriously, the growth of Chinese power could provoke a remilitarized Japan and further arms buildup in the region that is “ripe for rivalry.”⁸³ Realists maintain that the strength of nationalism as a driving force in international politics has not been weakened by growing economic interdependence. States only pursue cooperation with each other if it helps enhance their national interests or advance their status in the international system.

⁷⁸ Layne: “The Unipolar Illusion,” p.p. 45-46.

⁷⁹ Robert S. Ross: “The Geography of the Peace: East Asia in the Twenty-First Century,” **International Security** 23, no. 4 (Spring 1999): 82.

⁸⁰ Ibid, p.p. 81-118.

⁸¹ Robert Gilpin, **The Political Economy of International Relations** (Princeton, NJ: Princeton University Press, 1987), p.p. 72-80, 85-92.

⁸² Richard Bernstein and Ross H. Munro, “The Coming Conflict with America,” **Foreign Affairs** 76, no. 2 (March/April 1997): 18-32. See also their book, **The Coming Conflict with China** (New York: Alfred A. Knopf, 1997).

⁸³ Aaron L. Friedberg, “Ripe for Rivalry: Prospects for Peace in a Multipolar Asia,” **International Security** 18, no. 3 (Winter 1993/94): 16; Denny Roy, “The China Threat’ Issue,” p.p. 27-32.

C. The Role of Liberalism in the Rising Chinese Foreign Policy: Economic Modernization, Democratization, and Peace

Unlike the realists who tend to stress the importance of structural constraints to state actions, liberals believe that the behavior of a state is determined largely by domestic factors such as culture, ideology, and political structure. In the liberal view, a government that is democratically elected is less likely to go to war against the will of its own people, and a state that is more interested in economic development and trade is unlikely to invade its trading partners. Thus, democracy and economic interdependence help mitigate the effects of anarchy and promote peace and international cooperation.

Liberals see China's gradual reemergence as an influential player in the international system as primarily a consequence of its successful economic reform and open door policy over the past two decades. A China that is committed to reform and trade should be welcomed by the international community, for economic change will gradually transform the country into more open and democratic one that will in turn be a stabilizing force in Asia- Pacific and global security. In the words of Kenneth Lieberthal, "a reform-minded and modernizing China will continue to advance toward a market-driven system guided by law rather than corrupt families and will better meet the material needs of its citizens, eventually creating a middle class with a moderating influence."⁸⁴ As China becomes more prosperous, it is argued, its emerging middle class will demand more political freedom and a greater degree of participation in the decision-making process. Indeed, economic decentralization, and increasing competition for economic benefits among different groups, organizations, and regions have resulted in the rise of interest-group politics in the PRC. Moreover rapid technological change combined with growing economic and cultural interactions between China and the external world have made it difficult for the regime to maintain tight social and political control. There do now numerous semi-official and unofficial social organizations and publications exist, leading to a scholarly debate on the possible emergence of a civil society in China.⁸⁵ Thus, economic development is seen as "a vital of and a crucial condition for the realization of democratization"⁸⁶.

Liberals have often referred to the transformation of Taiwan, South Korea, and other East Asian countries where economic modernization was followed by political liberalization and

⁸⁴ Kenneth: "A New China Strategy," *Foreign Affairs* 74, no. 6 (November/ December 1995): 36.

⁸⁵ Gordon White: Jude Howell, and Shang Xiaoyuan, *In Search of Civil Society: Market Reform and Social Grange in Contemporary China* (Oxford, UK: Clarendon Press, 1996).

⁸⁶ Chen Jian: "Will China's Development Threaten Asia-Pacific Security?" *Security Dialogue* 24, no. 2 (June 1993): 195.

democratization.⁸⁷ Indeed, the process of political change, according to many scholars, is already underway in China. Before the Tiananmen events in 1989 the Chinese minorities tolerated, if not encouraged, moderate moves toward liberalization. Despite occasional campaigns against Western “spiritual pollution,” professionals and intellectuals became more influential in both articulating their views and providing policy advice to the government. There were also suggestions of legal and political reforms, including making the National People’s Congress, China’s parliament, more effective in examining the work of the government. However, those who had advocated political pluralism faced serious setback and even persecution after June 1989 when Chinese leaders decided to “keep one foot on the economic accelerator and the other foot on the political brake”⁸⁸. Nevertheless, liberals point out, the pre-Tiananmen economic and political change was so profound that “China’s citizens had not retreated to the older pattern of submission”⁸⁹ and that “the old tools of Communist indoctrination are no longer effective.”⁹⁰ Since the late 1980s, they maintain, the trend toward greater liberalization has accelerated as a result of further economic progress, and “China is undergoing greater political change than is generally understood in the West”⁹¹. William Overholt observes, “The media report a range of views rather than just the party line. Individuals’ political speech is relatively free, short of calling for the organized overthrow of the leadership. People change jobs and move around much more freely. Citizens can sue the state.” More significantly, competitive elections at the local level have been introduced that allow Chinese villagers to choose their local officials⁹². All these, according to Overholt, “are not token changes.”⁹³ They will eventually lead to more substantial reform of institutions of a higher level such as the National People’s Congress, and in a longer term, a fundamental change in the political system⁹⁴. The assumption that a democratic China will be a peaceful China is based on the theory of democratic peace that is central to the liberal perspective on international relations.⁹⁵ Liberals believe that democracies are balanced by constitutional mechanisms from fighting wars, as an unjustified war will not be supported by the

⁸⁷ Yoichi Funabashi, Michel Oksenberg, and Heinrich Weiss: **An Emerging China in a World of Interdependence** (New York: The Trilateral Commission, 1994), p. 65.

⁸⁸ B. Conable, Jr., and David M. Lampton: “China: The Coming Power,” **Foreign Affairs** 71, no. 5 (Winter 1992/93): 140

⁸⁹ *Ibid.* p.141.

⁹⁰ Donald S. Zagoria: “Clinton’s Asia Policy,” **Current History** 92, no. 578 (December 1993): 404.

⁹¹ *Ibid.*

⁹² Tianjin Shi: “Economic Development and Village Elections in Rural China,” **Journal of Contemporary China** 8, no. 22 (November 1999): 425-442.

⁹³ William H. Overholt: “China after Deng,” **Foreign Affairs** 75, no. 3 (May/June 1996): 68, 71.

⁹⁴ Minxin Pei: “Is China Democratizing?” **Foreign Affairs** 77, no. 1 (January/February 1998): 68-82.

⁹⁵ Francis Fukuyama: **The End of History and the Last Man** (London: Hamish Hamilton, 1992); R. J. Rummel, “Democracies Are Less Warlike than Other Regimes,” **European Journal of International Relations** 1, no. 4 (December 1995): 457-479. <http://ejt.sagepub.com/>

people who have to bear the burdens of armed conflict. Finally, according to the liberal scholars; within the “pacific union,” war can be prevented by trade interaction and economic interdependence among democratic nations⁹⁶. While the relationship between democracy and peace will no doubt stimulate further academic debates,⁹⁷ liberals are convinced that democratic regimes are more peaceful than other types of regimes. The proposition that democracies do not fight each other is so convincing that even some realists subscribe to it. Based on the democratic peace theory, therefore, liberals argue that a China that is moving toward political liberalization and democratization, albeit at a very slow pace, it is less likely to use force to resolve territorial disputes with neighboring countries and to pursue its great power ambition by military means⁹⁸. More important, a China that is increasingly linked to the world economy and interdependent with its trading partners is less likely to take aggressive actions that will be harmful to its own economic interests. Indeed, the argument that the possibility of war can be reduced by international trade and economic interdependence has long been advanced⁹⁹ and continues to influence the thinking of many liberal scholars and policy-makers.

Liberals believe that “China’s growing economic power and its increasing number of links with global markets will correspondingly support the costs of aggressive or non cooperative behavior” and that “proliferating economic links will enhance other states’ abilities to influence China to play a more constructive role in the world community.”¹⁰⁰ Chinese leaders, says Michael Yahuda, have recognized that economic interdependence plays a vital part in sustaining China’s economic growth, maintaining its social stability, and legitimizing the rule of the Chinese Communist Party¹⁰¹. Some liberals reject the realist assumption that China “has ‘adapted’ its outward behavior but has not ‘learned’ a new way of thinking”¹⁰². Christopher Findlay and Andrew Watson argue that “China’s interaction with the world economy has created a level of trade interdependency that has transformed both China’s international role and the way in which the rest of the world relates to China”¹⁰³. Furthermore, Thomas Robinson argues that

⁹⁶ Georg Sorensen: “Kant and Process of Democratization: Consequences for Neorealist Thought,” **Journal of Peace Research** 29, no. 4 (1992): 398-399.

⁹⁷ **European Journal of International Relations** 1, no. 4 (December 1995). <http://ejt.sagepub.com/>

⁹⁸ Ibid.

⁹⁹ Richard Rosecrance: **The Rise of the Trading State: Commerce and Conquest in the Modern World** (New York: Basic Books, 1996).

¹⁰⁰ Audrey Kurth Cronin and Patrick M. Cronin: “The Realistic Engagement of China,” **The Washington Quarterly** 19, no. 1 (Winter 1996): 145-146.

¹⁰¹ Michael Yahuda: “How Much Has China Learned about Interdependence?” in David S.G. Goodman and Gerald Segal, eds., **China Rising: Nationalism and Interdependence** (London: Routledge, 1997), p. 22

¹⁰² Christopher Findlay and Andrew Watson: “Economic Growth and Trade Dependency in China,” in Goodman and Segal, eds., **China Rising**, p. 107.

¹⁰³ Ibid. p. 84

interdependence in one sphere helps facilitate interdependence in other spheres. “Once the door is open in one arena,” he suggests, “it is easier to open the doors in others and to keep them open.”¹⁰⁴ Chinese IGO and INGO membership, positive participatory experience, and a number of policy adjustments and shifts over such global issues as arms control and disarmament, UN peacekeeping, North-South relations, human rights (until Tiananmen), and science and technology, have been the checkpoints of China with the outside world, liberals believe, it is gradually involved in the global process of “complex interdependence” and restrained by its participation in international institutions and regimes.¹⁰⁵

Economically, China’s reform and open-door policy have provided the outside world with a variety of business and investment opportunities, and many Asian and Western companies and consumers have benefited enormously from the economic change in China in terms of market growth and cheaper products. As the PRC is a trading partner of numerous nations and has extensive economic links with the wider world, an economic failure in the country will seriously undermine the stability and prosperity of the Asia-Pacific region that could have far-reaching consequences for world trade and the global financial market. In the meantime, a poor and unstable China will become a huge burden for the international community. If the world finds it difficult to tackle poverty and famine in the Third World, liberals argue, it will be impossible to deal with similar problems in a country that has a population of 1.3 billion.¹⁰⁶ Related to this issue, is the possibility of mass migration of Chinese citizens to other countries following a major economic disaster, social upheaval, and political turbulence. The world simply cannot cope with a refugee problem of such a massive scale.¹⁰⁷ Moreover, an economically weak and politically insecure Chinese regime will likely be more nationalistic and less cooperative.

Today, China is beginning to matter as much for the rest of the world as Japan, the EU or the US.”¹⁰⁸ The problem is that it has never been easy for the international system to accommodate newly emerging powers. By the way, it is been expected that the rise of China may cause instability or military conflict, so that the outside world must seek to draw China into

¹⁰⁴ Robinson: “Interdependence in China’s Foreign Relations,” p. 198.

¹⁰⁵ Thomas G. Moore and Dixia Yang: “Empowered and Restrained: Chinese Foreign Policy in the Age of Economic Interdependence,” in David M. Lampton, ed., **The Making of Chinese Foreign and Security Policy in the Era of Reform, 1978-2000** (Stanford, CA: Stanford University Press, 2001), p. 228.

¹⁰⁶ Lester Brown: *Who Will Feed China? Wake Up Call for a Small Planet* (Washington, DC: World watch Institute, 1995).

¹⁰⁷ Lieberthal: “A New China Strategy,” p.p. 36-37.

¹⁰⁸ Vincent Cable and Peter Ferdinand: “China as an Economic Giant: Threat or Opportunity?” **International Affairs** 70, no. 2 (April 1994): 259.

the international community peacefully and accommodate China and itself into the current system.

From the liberal perspective, both China and its trading partners have common interests in maintaining stability and prosperity in the post-Cold War world, and they should seek to maximize their absolute gains through international cooperation. Any country in China's position will seek to improve the quality of its weapons and strengthen its military capabilities. However, China is not seeking to overturn the entire balance of power in the Asia-Pacific; it is merely assuming the role of a great power in the region.¹⁰⁹ Given the importance of a peaceful global environment to Chinese economic modernization, China would be unwilling to destabilize the existing regional and international order. Indeed, liberals point out that since the end of the Cold War China has developed cooperative relations with most of its Asian neighbors, promoted regional economic cooperation, participated in bilateral and multilateral security dialogues in Asia, signed the Nuclear Non-proliferation Treaty, and acted on most occasions as a responsible member of international organizations.¹¹⁰ "China is a revisionist power," says Robert Ross, "but for the foreseeable future it will seek to maintain the status quo."¹¹¹

First, the reemergence of China as a great power is generally interpreted by realists as a consequence of the structural change in the post-Cold War international system.

Second, based on historical precedents, realists believe that great-power emergence is destabilizing because rising powers tend to pursue expansionist policies to improve or protect their economic interests. This, it is argued, is determined by states' capabilities rather than their intentions. As a rising power, the PRC will follow the footsteps of its predecessors, which would anger other great powers and provoke armed combat in Asia. Such a deterministic view of the echoes of China's rise is based on the assumption that history will repeat itself. But what happened in the past may or may not repeat in the future. It also ignores domestic constraints on foreign policy such as decision-makers' perceptions and political structures. In this respect, the liberal theory of democratic peace seems far more convincing. All the available evidence seems to suggest that economic modernization does lead to political liberalization, however slowly, and that democracies do not fight democracies. If China manages to sustain its economic growth, maintain its social cohesion and national unity, and become a fully democratic country, it will

¹⁰⁹ Kristof, "The Rise of China," p.p. 68-69

¹¹⁰ Gary Klintworth: "Greater China and Regional Security," in Gary Klintworth, ed., **Asia-Pacific Security: Less Uncertainty, New Opportunities?** (Melbourne, Australia: Longman, 1996), p. 36.

¹¹¹ Robert S. Ross: "Beijing as a Conservative Power," **Foreign Affairs** 76, no. 2 (March/ April 1997): 34.

likely be a peaceful and cooperative member of the international community, but it will probably take several decades for China to reach that stage, if it ever does.

Third the realist apprehension of the potential threat of a prosperous and strong China is largely a reflection of a zero-sum conception of power that one actor's gain will be another's loss. While it is true that each state is seeking to enhance its capabilities in an essentially anarchic world, it does not follow that the growth of one country's strength necessarily means the decline of that of others. The liberal emphasis on absolute gains that encourages China and the outside world to work with each other appears to be more conducive to the furtherance of prosperity and security.

Finally, realists and liberals disagree fundamentally on the adequacy of economic interdependence in managing the effects of an emerging China in the international system. Liberal scholars believe that growing economic and trade interactions between China and the outside world will aid Chinese leaders to appreciate the value of pursuing a peaceful foreign policy. Realists, however, contend that interdependence alone will not restrain the behavior of a rising power. On the contrary, interdependence will increase the probability of conflict between the PRC and its neighbors, as China becomes more dependent on external resources such as oil and grain imports. Given the variability of Chinese foreign policy behaviors in recent years, there is no conclusive evidence to support either of the two arguments, but it does seem that economic interdependence can lead to peace or war, depending on the circumstances.¹¹² But it is obvious that China's expectations of the future trading environment are related with the global and regional security in the region. If Chinese leaders feel that current trade with the outside world would continue to expand, which would help enhance the wealth and power of the Chinese nation, there would be little incentive for them to resort to the use of force to settle unresolved disputes. If, however, Chinese leaders are convinced that their trade prospects would deteriorate substantially in the near future, which would undermine their ability to maintain the long-term prosperity and security of China, they would be likely to take the military option to avert vulnerability and decline. In other words, the PRC's future behavior would be determined not only by the level of interdependence with its trading partners but by its expectations of the future trading environment.

¹¹² Thomas G. Moore and Dixia Yang: "Empowered and Restrained: Chinese Foreign Policy in the Age of Economic Interdependence," in David M. Lampton, ed., **The Making of Chinese Foreign and Security Policy in the Era of Reform, 1978-2000** (Stanford, CA: Stanford University Press, 2001), p.229.

Since the late 1970s, China has gradually emerged as a major trading nation in the world, and its economic and trade relations with most countries have broadened considerably. Indeed, China has been actively involved in global economic activities, and is fully integrated into the Asia-Pacific economy. The PRC is now a member of all the major international and regional economic organizations, including the World Trade Organization, the World Bank, the International Monetary Fund, the Asian Development Bank, and the Asia Pacific Economic Cooperation (APEC).¹¹³ From 1980 to 1997, the Chinese government approved 162 foreign financial institutions to develop business in China.¹¹⁴ Over four hundred of the world's top five hundred multinational corporations have now invested in the country.¹¹⁵ As a result, there has been a huge growth in China's foreign trade over the past two decades. From 1978 to 2002, China's exports grew from US\$9.8 billion to US\$325.6 billion, and its imports grew from US\$10.9 billion to US\$295.2 billion. Between 1983 and 2002, actual foreign direct investment in China increased from US\$916 million to US\$52.8 billion.¹¹⁶ In terms of total trade volume, China has become the seventh largest trading nation in the world.¹¹⁷ China has also benefited from its involvement in a regional division of labor and economic cooperation in East Asia. It is integrated into a number of sub regional economic groupings or "growth triangles" such as the Hong Kong-Guangdong-Shenzhen triangle and the Northeast China-Korea-Japan triangle. In addition, China is closely involved in the development of two new sub regional groupings: the Yellow Sea Economic Zone that includes Liaoning and Shandong provinces, Japan, and South Korea; and the Tumen River project that seeks to promote economic cooperation among China, Japan, North Korea, South Korea, Mongolia, and Russia.¹¹⁸ At the ASEAN Plus Three summit in November 2002 at Phnom Penh, Chinese Premier Zhu Rongji and ASEAN leaders decided to

¹¹³ William R. Feeney: "China and the Multilateral Economic Institutions," in Kim, ed., **China and the World**, p.p. 226-251; Christopher Findlay, "China and the Regional Economy," in Harris and Klintworth, eds., **China as a Great Power**, p.p. 284-305.

¹¹⁴ Kou Bian: "Foreign-Funded Banks Land in Chinese Market," **Beijing Review**, December 29, 1997-January 4, 1998, p.p. 15-16.

¹¹⁵ Shi Guangsheng: Chinese Minister of Foreign Trade and Economic Cooperation, "Remarks at the Reception Hosted by EU-China Business Association and Belgium Chinese Economic and Commercial Council," December 9, 2002, http://english.moftec.gov.cn/article/_200212/20021200056451_1.xml

¹¹⁶ Nicholas R. Lardy: **China in the World Economy** (Washington, DC: Institute for International Economics, 1994), p.p. 30,63; PRC Ministry of Foreign Trade and Economic Cooperation, "The Information on Import and Export Statistics (December 2002)," <http://english.moftec.gov.cn/>

¹¹⁷ Shihoko Goto: "Analysis: Opposition rises to China getting aid", UPI Senior Business Correspondent, November 29, 2004 <http://www.washtimes.com/upi-breaking/20041129-103857-6452r.htm>

¹¹⁸ Peter J. Rimmer: "Integrating China into East Asia: Cross-Border Regions and Infrastructure Networks," in Stuart Harris and Gary Klintworth, eds., **China as a Great Power: Myths, Realities and Challenges in the Asia-Pacific Region** (Melbourne, Australia: Longman, 1995), p.p. 306-327.

establish a China-ASEAN Free Trade area by 2010 that could become the world's third largest trading bloc.¹¹⁹

China's integration into the world economy has brought about much benefit to the country, but it has also increased Chinese vulnerability in a world of growing interdependence. Indeed, foreign direct investment has become the single most important source of foreign capital for the PRC.¹²⁰ It is estimated that "foreign investment may now account for one-quarter of all Chinese exports."¹²¹ In 1996, the total value of foreign-funded firms' import and export trade reached US\$137.1 billion, accounting for 47 percent of the national total of foreign trade.¹²² According to a Beijing Review report, 18 million people, about 10 percent of China's nonfarming population are employed by foreign-funded firms. The investment by these firms covers a whole range of areas that are vital to Chinese economic modernization, including infrastructure, energy, communication, and high-tech projects.¹²³ The Chinese government has also relied heavily on foreign investment to develop the central and western regions of China that are still very poor. In 1996, for example, a total amount of US\$1.34 billion of foreign government loans was utilized for 69 projects in these underdeveloped "regions. In addition, 125 key projects in the PRC are supported by foreign government loans that include the construction of metropolitan underground railways, power plants, airports, telephone networks and other large-scale development plans.¹²⁴ By June 2002 World Bank Group had lent a total of US\$33.9 billion to China, which supported 239 projects in all major sectors of Chinese economy and in a wide range of regions across the country.¹²⁵

In the past decade China has increased its foreign borrowings substantially. Its total external debt is believed to have risen from US\$ 24, 00 million in 1987 to US\$ 116,280 million in 1996.

Besides, many of China's reform projects, such as enterprise restructuring, infrastructure improvement, financial reform, poverty reduction, human development and

¹¹⁹ "China and ASEAN Agree to Create World's Biggest FTA," **Digital Chosunilbo** (English edition), November 5, 2002, <http://english.chosun.com/>

¹²⁰ Lardy: *China in the World Economy*, p.p. 63-72

¹²¹ Christopher Howe: "The People's Republic of China: Economy," in **The Far East and Australasia 1998**, 29th ed. (London: Europe Publications Limited, 1997), p. 234.

¹²² **People's Republic of China Year Book: 1997/98** (Beijing and Hong Kong: PRC Year Book Ltd. and N.C.N. Limited, 1998), p. 270.

¹²³ "Over 314,533 Foreign Projects Approved," *Beijing Review*, October 5-11, 1988, p.5, <http://www.bjreview.com.cn/>

¹²⁴ **People's Republic of China Year Book: 1997/98** (Beijing and Hong Kong: PRC Year Book Ltd. and N.C.N. Limited, 1998), p. 273.

¹²⁵ The World Bank Group, "Country Brief: People's Republic of China," November 2002, <http://www.worldbank.org/html/extdr/offrep/eap/cn2.htm>

environmental protection, are currently supported by the World Bank.¹²⁶ Of all the major sectors of the Chinese economy, energy is probably the most critical one in terms of sustaining the PRC's modernization program. In this sector the role of foreign capital is becoming more significant. For example, a joint venture has been established at the Pingshao coal mine, and the construction of a power station in Guangxi Zhuang is financed entirely by foreign investment. In the areas of petroleum and natural gas, a greater has also been made to attract foreign capital. By 1997, China had signed 126 contracts with 65 foreign oil companies.¹²⁷ Moreover; the progress of Chinese reform is dependent on the availability of advanced foreign technology and equipment. The contract value of Chinese technology imports amounted to US\$159.23 million in 1997. Indeed, important technologies play an important part in major Chinese industries ranging from energy, electronics, and computer software to telecommunications, information, and other high – tech industries.¹²⁸ Clearly, Chinese leaders are aware that the success of China's economic modernization rests ultimately with its access to the global market and with inflows of external funding. If, for political or security reasons, the world were to reduce the level of economic interactions with or apply trade sanctions against China, it would have a devastating effect on Chinese economic development.

However, there is no guarantee that Chinese leaders' positive anticipation of future trade will remain unchanged. In fact, there has been growing concern among Chinese elites over the past few years that some external forces do not wish to see a strong and prosperous China and that they are trying to prevent the PRC from fulfilling its great-power potential.¹²⁹ Beijing is especially sensitive to the suggestion of a "China threat,"¹³⁰ fearing that it will arouse anti-Chinese sentiments in Asian and Western societies and jeopardize the relationship between China and its trading partners. Criticisms of Chinese policies, such as China's Tibet policy, human rights record, and arms sales to Third World countries, have been perceived as Western attempts to weaken China's position both internally and in the international

¹²⁶ **The World Bank and China**, the World Bank Group, <http://www.worldbank.org/html/extdr/offrep/eap/cn2.htm>

¹²⁷ Howe: "The People's Republic of China: Economy," p.p. 232-233.

¹²⁸ China's Technology Imports in 1997: **Beijing Review**, October 19-25, 1998, p. 22.

¹²⁹ Wang Zhenxi: "Huanhe yu duojihua shitou qiangjing, baquan yu lengzhan siwei yicun-yijiujiuqinian guoji xingshi zongshu" (Hegemonism and the Cold War Mentality Coexist with the Potent Forces of Déente and Multipolarity—A Review of the International Situation in 1997), *Guoji guanxi xueyuan xuebao (Journal of the Institute of International Relations)* 4 (December 1997): 6.

¹³⁰ Wang Zhongren: "'China Threat' Theory Groundless," *Beijing Review*, July 14-20, 1997, p.p. 7-8

community. In particular, America's China policy has been viewed by PRC elites with skepticism.¹³¹

Despite Chinese anxiety of containment, Beijing's expectations of future trade remain high at the moment. As Chinese leaders' expected value of trade is positive, they see no benefit in taking the military option to deal with unresolved issues. Consequently, the Chinese have been involved in numerous official and unofficial security dialogues, including the ASEAN Regional Forum and many "track two" meetings. Their attitudes toward - multilateral security cooperation have also become more positive.¹³² Moreover, China has adopted a more flexible approach to its territorial disputes such as the conflict in the South China Sea. While Chinese leaders' position on the Spratly and Paracel islands has not changed, they are willing to shelve the issue of sovereignty for the time being and to negotiate joint development of the resources in the area with other claimants.¹³³ At the November 2002 ASEAN summit in Phnom Penh, China signed an important accord with ten Southeast Asian governments aimed at avoiding armed conflict over contested areas of the South China Sea.¹³⁴ Furthermore, China has been remarkably restrained in handling recent disputes with Japan over the sovereignty of the Diaoyu/Senkaku Islands in the East China Sea. Despite popular demand for taking tougher actions against Japan, the Chinese government has chosen to deal with the issue through diplomatic avenues.¹³⁵ On the Taiwan issue, China did not respond to Chen Shui-bian's victory in the 2000 presidential election in a belligerent manner. One can also discern a relatively muted reaction from Chinese leaders to the DPP (Democratic Progressive Party) government's bolder attempts to promote a Taiwanese identity. Growing economic integration across the Taiwan Strait has no doubt served as a disincentive for Beijing to use force against Taiwan. It is quite obvious that China has optimistic expectations of future trade and does not want to pursue policies that will dramatically alter the current trading environment. Indeed, the Chinese government has been reluctant to utilize the devaluation of

¹³¹ Zhou Qi: "Lengzhan hou de ZhongMei guanxi xianzhuang-gongtong liyi yu zhengzhi" (An Appraisal of Post-Cold War Sino-U.S. Relations—Common Interests and Disputes), *Meiguo yanjiu (American Studies)* 9, no. 4 (December 1995): 30-50.

¹³² Shi Yongming: "Yatai anquan huanjing yu diqu duobianzhuyi" (The Security Environment in the Asia-Pacific and Regional Multilateralism), *Guoji wenti yanjiu (Journal of International Studies)* 1 (January 1996): 41-47.

¹³³ Lee Lai: To, *China and the South China Sea Dialogues* (Westport, CT: Praeger, 1999). For a Chinese view on Beijing's policy toward the South China Sea disputes, see Ji Guoxing, "China versus South China Sea Security," *Security Dialogue* 29, no. 1 (March 1998): 101-112.

¹³⁴ "ASEAN, China Sign Landmark Accord," *The Guardian*, November 4, 2002, www.guardian.co.uk/world/latest/story/0,1280,-2143239,00-htm

¹³⁵ Erica Strecker Downs and Phillip C. Saunders: "Legitimacy and the Limit of Nationalism: China and the Diaoyu Islands," *International Security* 23, no. 3 (Winter 1998/99): 114-146; Phil Deans, "Contending Nationalisms and the Diaoyutai/Senkaku Dispute," *Security Dialogue* 31, no. 1 (March 2000): 119-131.

the Renminbi as a means of stimulating its exports; as such a measure could further destabilize the fragile economies of Southeast Asia that would jeopardize China's future trading environment. While recognizing the negative effects of the Asian financial crisis on Chinese economic development, China sees it as an opportunity of strengthening its political and economic influence in East Asia and demonstrating its credibility as a responsible member of the international community.

For the moment, the governments of the United States, the European Union, Japan, and ASEAN states have all made it clear that they wish to engage China both bilaterally and multilaterally. If, however, these countries were to change their policy to one of containment in the future, leading to a negative trading environment, Beijing might respond by taking military action to secure what it perceives as its vital interests. This could result in a situation similar to that in Germany after 1897 when it felt that other great powers were seeking to undermine German economic and security interests. Indeed, German leaders' trade expectations before World War I were so low that they came to the conclusion that "only a major war would provide the economic dominance of Europe needed for long-term German survival."¹³⁶

Whether China will choose the military option in the future is also dependent on the Chinese assessment of the expected value of war in relation to the expected value of trade. In other words, China will have to think about its capabilities vis-à-vis the capabilities of other states in deciding to go to war.¹³⁷ According to Copeland, a state's expected value of war will be positive if its economic and military power is more superior to that of its adversaries. If a larger state can easily conquer a smaller and weaker one and absorb its economy, the expected value of war will also be positive. On the other hand, if the large state is facing an adversary of similar size or strength, it will have a lower or negative expected value of war because of the high costs involved and low possibility of victory. The most important consideration, however, is the state's estimate of the expected value of war relative to the expected value of trade. "If the expected value for trade is lower than the expected value for invasion," Copeland argues, "war becomes the rational choice, and this is so even if the expected value of invasion is itself negative: war becomes the lesser of two evils."¹³⁸

If Chinese decision-makers were to reach a conclusion that the outside world is determined to impede China's economic progress and suppress its reemergence as a great power,

¹³⁶ Dale C. Copeland: "Economic Interdependence and War: A Theory of Trade Expectations," **International Security**, Vol. 20, no.4 (Spring 1996)

¹³⁷ This line of argument is again based on Copeland's theory, *ibid.* p.p. 20-21.

¹³⁸ "Ibid.," p. 21.

their expected value of war will become greater than the expected value of trade. To guarantee that it can exploit the vast deposits of valuable resources in the South and East China Sea, control important shipping lanes in the areas, and gain strategic advantages over its adversaries, China might contemplate taking the military option. It might decide to use force to take over Taiwan, occupy the Spratly Islands, and reclaim the Diaoyu/ Senkaku Islands from Japan. But in estimating the expected value of war, the PRC will have to consider the balance of power between itself and other states in East Asia. If it were to fight with Taiwan or an individual ASEAN state alone, its expected value of war might be positive. If, however, it had to face a more powerful country or group of countries, the expected value of war would be negative. Barring the intervention of Russia, it would be impossible for China to fight a war if it were to confront a military alliance consisting of the United States, Japan, Taiwan, and ASEAN states. It is generally agreed that China's war-fighting machines are well behind those of America, Japan, and some other Asian states, and that it would take some time for Beijing to develop its power-projection capability. In any case, other countries would continue to improve the quality of their weapons. Nevertheless, should the PRC be in such an isolated and desperate position, Chinese leaders might still choose the option of war because it would be seen as "the lesser of two evils."

When analyzing a state's trade expectations one must also take into account the effects of diplomacy and bargaining, as Copeland suggests. A state can make some economic, political and military concessions to induce its trading partners to relax trade restrictions, thus raising its expectations for future trade. If the price for a higher level of trade is seen to be reasonable, the state would be willing to pay it. However, if the price is unacceptable because it would undermine the state's "internal stability or its external power position," there would be very little that the state could do to improve its trade expectations.¹³⁹

In the case of China, it has made some economic and political concessions to induce the outside world to trade with and invest in the country. On most issues, Chinese leaders find the price of higher trade level reasonable and are willing to make compromises. The concept of "one country, two systems," for example, was basically formulated to assure the Western world that China's priority was economic development. In order to retain the confidence of foreign investors in Hong Kong, Chinese leaders have promised that the territory's capitalist system will remain unchanged for at least 50 years from 1997.¹⁴⁰ China's flexibility on the South China Sea disputes also reflects its desire to maintain harmonious relations with

¹³⁹ "Ibid.," p. 22.

¹⁴⁰ Hsin-chi Kuan, "Does Hong Kong Have a Future?" *Security Dialogue* 28, no. 2 (June 1997): 233-236.

ASEAN countries that are propitious for China's trading environment. Similarly, to demonstrate its respect for the rules and norms in international trade, the Beijing government has taken strong measures to prohibit the violation of intellectual property in Chinese provinces, albeit without much success. Another example of China's willingness to compromise for economic and trade benefits is its agreement to sign the Nuclear Nonproliferation Treaty and the Comprehensive Test Ban Treaty. For the same reason, China did not vote against the U.S.-sponsored United Nations Security Council Resolution 1441 that forced Saddam Hussein to allow UN inspectors to conduct vigorous weapons inspections in Iraq.

On other issues, however, Chinese leaders feel that the price of a higher trade level is unacceptable as it will undermine the PRC's domestic stability, national unity, territorial integrity, regime survival, or security interests. For example, while China appears to be determined to reform its state-owned enterprises (SOEs), especially since the Chinese Communist Party's 15th congress in September 1997 and the appointment of Zhu Rongji as the Chinese premier in March 1998, it has rejected Western pressure to close down all the nonprofit-making enterprises immediately, as the result of these measures would be a huge rise in unemployment that could cause much hardship for many Chinese workers in the absence of a sound social security system. This could, in turn, provoke widespread discontent among the urban dwellers that would seriously destabilize Chinese society and possibly cause a social civic turmoil in the country. Instead, China has adopted a more gradual approach that concentrates on "improving the performance of the large SOEs considered strategic for national development, while letting go of the very large number of smaller enterprises, many of which are simply not viable."¹⁴¹ Meanwhile, the Chinese government has introduced a series of reforms that are linked to a modern enterprise system, including pension, welfare, health care, and housing reforms.¹⁴²

Beijing is also loath to succumb to any foreign pressure to change its policy toward Tibet that is viewed as an "inalienable" part of Chinese territory. To grant more independence to Tibet, Chinese leaders fear, would encourage other regions to break away from the center, thus jeopardizing China's "national unity and territorial integrity. It is inconceivable that Beijing did not expect strong reaction from the outside world to its belligerent actions that heightened tension across the Taiwan Strait, but it rather risked the possibility of confronting

¹⁴¹ **The World Bank and China**, the World Bank Group, <http://www.worldbank.org/html/extdr/offrep/eap/cn2.htm>

¹⁴² Ibid.

U.S. military forces and destabilizing the entire Asia-Pacific region, which could be detrimental to Chinese economic interests. Equally important is Chinese leaders' reluctance to compromise on issues relating to regime survival. The Tiananmen tragedy in 1989 is a classic example showing how far the Communist leadership is prepared to go when it comes to quelling activities that would challenge its authority and legitimacy to govern the country. It is, therefore, not surprising that the Chinese government has treated its political dissidents harshly, despite constant criticisms and protests from the West. Thus, the price for a higher trade level that the outside world expects Chinese leaders to pay will play a substantial part in shaping China's expectations for future trade

D. Chinese Nationalism and Pragmatic Foreign Policy Behavior

1. The Resurgence of Chinese Nationalism

As faith in communism declined among the Chinese people, the Chinese Communist Party (CCP) rediscovered the utility of nationalism. Shortly after the 1989 crackdown, the Communist state launched an extensive propaganda campaign of education in patriotism. The core of the patriotic education campaign was the so-called *guoqing jiaoyu* (education in national condition), which unambiguously held that China's *guoqing* (national condition) was unique and not ready for adopting a Western-style, liberal democracy. Instead, the current one-party rule would help maintain political stability, which was a precondition for rapid economic development.

The government emphasized the Chinese tradition and history as the CCP tried to link Communist China with its non-Communist past and defined patriotism in terms that had everything to do with Chinese history and culture and almost nothing to do with imported Marxist dogma.

The patriotic education campaign also emphasized national pride and territorial integrity. In the midst of Western-imposed sanctions after Tiananmen, the Chinese Communist regime made the accusation that "a small number of Western countries feared lest China should grow powerful, thereby exercised sanctions against her, contained her, and added great pressures on her to pursue Westernization and disintegration. Defending China's national interests, the Communist regime presented itself as the fighter for China's entry into the World Trade Organization (WTO), the maintenance of the Most Favored Nation (MFN) *

* The term "Most Favored Nation" meant that exports from China would enter the United States on the same terms as those of all friendly countries, in spite of the fact that China was a Communist dictatorship and sharply restricted imports from the United States. To prevent the Soviet Union and other pro-Soviet or Communist

status, or the Permanent Normal Trade Relations (PNTR) in the United States, and the successful bid for the Olympic Games in Beijing.

The other theme of patriotic education was national unity against ethnic separatist movements, which were among the social and political problems confronting the Chinese Communist leaders in the post-Cold War era. The central point was that “the Han nationality cannot do without ethnic minorities and vice versa, so that they will consciously safeguard national unity and the motherland’s unification.”¹⁴³ The national unity theme was particularly emphasized in ethnic minority concentrated areas, such as Tibet, Xinjiang, and Inner Mongolia, where so-called narrow-nationalism or separatism was targeted in the campaign. The Chinese nation was said to have a great power of national cohesiveness.

2. Chinese Nationalist Perspectives

Nationalism is a modern concept, which combines the political notion of territorial self-determination, the cultural notion of national identity, and the moral notion of national self-defense in the anarchical world. Nationalism appeared with the emergence of the nation-state system in Europe and spread to the rest of the world after non-European countries were brought into the system.¹⁴⁴ The modern nation-state is a unique form of political organization, which was born as a result of the struggle between empire and nation and between tradition and modernity.

China was an empire but not a nation-state before the nineteenth century as Chinese people were not imbued with an enduring sense of nationalism based on loyalties to the nation-state. According to Benjamin Schwartz, nationalism “represents a fundamental ‘turn’ in modern Chinese culture.”¹⁴⁵ The catalyst for this turn was China’s defeat by British troops in the 1840 -1842 Opium War. This defeat paved the way for the eventual disintegration of imperial China and led the Chinese elite to reject the European concept of nationalism that would provide a new basis for China’s defense and regeneration. In the twentieth century, all Chinese leaders—from Sun Yat-sen, Chiang Kai-shek, Mao Zedong to Deng Xiaoping and Jiang Zemin—have shared a deep bitterness resulting from China’s humiliation and have determined to blot out that humiliation and restore China to its rightful place as a great power.

regimes from obtaining the benefits of trade with the U.S., American law for decades had prohibited granting those countries Most Favored Nation access. President Carter was the first to recommend a waiver of this prohibition for China.

¹⁴³ Zhongguo Gongchandang Zhongyang Weiyuanhui: (the CCP Central Committee), “Aiguo Zhuyi Jiaoyu Dagang” (Guidelines for Education in Patriotism), **Renmin Ribao (People’s Daily)**, September 6, 1994, p. 1.

¹⁴⁴ Eric J. Hobsbawm: **Nations and Nationalism since 1780**, Cambridge, UK: Cambridge University Press, 1990.

¹⁴⁵ Benjamin I. Schwartz: “Culture, Modernity, and Nationalism Further Reflections,” in Tu Wei-ming, Ed., **China in Transformation**, and Cambridge, MA: Harvard University Press, 1993, p. 247.

	Nativism	Antitraditionalism	Pragmatism
<i>Sources of China's Weakness</i>	Imperialism and subversion of indigenous Chinese virtue	Chinese tradition and culture	Lack of modernization, particularly economic backwardness
<i>Best approach to national revitalization</i>	Return to Confucian tradition and self-reliance	Boundless adoption of certain foreign cultures and models of modernization	Whatever works, whether modern or traditional, foreign or domestic
<i>Periods of Dominance</i>	<ul style="list-style-type: none"> - The Boxer Rebellion in the late 1980s - The Great Leap Forward in late 1950s - The Cultural Revolution in the late 1960s - The Cultural Fever In the 1980s 	<ul style="list-style-type: none"> - The new Cultural Movement in 1916 – 1919 - The May Fourth Movement in 1919 - The Westernization in the 1980s 	<ul style="list-style-type: none"> - The Self- strengthening Movement in 1864-1895 - The post- Mao reform in the 1980s

Table 1: Perspectives of Chinese Nationalism

The nativist perspective has been advocated largely by international elites and was at times supported by a vast population in China. It calls for a return to Confucian tradition and asserts that China's decline is primarily due to foreign transgressions. In the nativist view, national salvation must be attained through exclusive reliance upon indigenous virtue and ideas. Nativism is a powerful call because its stress on national independence is appealing to a nation that had, for about a century, been the victim of foreign imperialist expansion. The aim of building an independent modern nation – state to resist any foreign threat has been infused into the discourse of Chinese nationalism since the late nineteenth century. To counter imperialist challenges, The Chinese Communist Party strove to make China completely

independent of foreign influence by economic self – reliance and military strength. Mao’s policy of (*zili gengsheng*) self-reliance was consonant with the potent spirit of nativism. Nativism was strongly expressed during the Cultural Revolution when Mao carried out a policy of autarchy by isolating China almost completely from the rest of the world. China stressed the maximization of internal auto centric development, the minimization of external dependency, and the long-term transformation of the capitalist world system.

Nativism lost its momentum in the 1980s, but regained some ground in the 1990s when some scholars took Chinese culture as a symbol against Western cultural hegemony and cultural colonialism and suggested that Asian values are superior to their Western counterparts and should, therefore, be the basis for the values of the world in the twenty-first century. Some politically motivated Nativists warned about “cultural pollution” and “peaceful evolution” conspiracies by the West. Nativists are particularly hostile to the United States because the United States represents an opposing value system of liberalism and individualism. Nativist sentiments are against Japan as well, due mainly to the humiliation and injustices suffered by the Chinese people at the hands of Japanese imperialists during World War II. In comparison, the hostility of nativism against the United States is due to the fact that the United States represents the Western value system while the animosities toward Japan-does not have this value dimension. Thus, the United States is treated in a very different way in Nativist sentiments. To a certain extent, nativism is anti-Americanism or anti-Westernism. Nativists have used confrontations with foreign powers to rouse emotional, nationalist reactions by tapping the deep-rooted feeling of Chinese cultural superiority and resentment at foreign efforts to be little or humiliate China in an attempt to rally the Chinese people against any foreign infiltration.

In contrast to nativism, antitraditionalism sees China’s tradition as the source of its weakness. Early advocates of antitraditionalism were the so-called new elite, including intellectuals in new schools and treaty port merchants, who found China’s frailty in stark contrast to the traditional Chinese vision of the Middle Kingdom, built on a superior culture extending back for millennia. To revive China, these new elites took a hostile view toward China’s past, calling for the complete rejection of Chinese tradition and boundless adoption of Western culture. They thus established an important connection between nationalism and at times almost ferociously iconoclastic antitraditionalism.

Antitraditionalism received its first forceful expression during the May Fourth Movement in 1919. One extreme but nevertheless instructive example of the May Fourth era is Qian Xuantong’s letter to Chen Duxiu, who later became one of the founders of the CCP. In response to Chen’s proposal to abolish Confucianism, Qian concurred in the letter that “it is

now the only way to save China” and suggested that the Chinese language had to be replaced by Esperanto in order to save the country. One study found that Qian did not seem to have been concerned with the extent to which his program might be supported by China’s masses, since in his view they were the problem.¹⁴⁶ Antitraditionalism provided China’s new elite with the ideological underpinning for its cultural remoteness from the much larger traditional sector of the population. As Myron L. Cohen indicates, “the modern Chinese nationalism articulated since the beginning of this century by China’s new elite has involved a forceful and near-total rejection of the earlier traditional and culturally elaborated sense of nationhood.” Cohen believes that this is “ironic” and “most problematic” for many of the Chinese people.¹⁴⁷

According to the Chinese pragmatic view, the reason of foreign economic exploitation and cultural infiltration as a source of weakness is pragmatism. The lack of modernization is the reason why China became an easy target for Western imperialism. The nationalist pragmatists would like to adopt whatever approach that make China strong. Pragmatic nationalist leaders have set economic growth as China’s top priority because they know that the CCP’s continued leadership vitally depends on its ability to improve Chinese people’s standard of living.

Each of the three perspectives of Chinese nationalism has its unique foreign policy implications. Nativism infuses xenophobia into a confrontational policy toward foreign powers; antitraditionalism tries to adapt to the modern world by invocation of certain foreign models; and pragmatism lies between the two, asserting China’s national interests by both reacting to and absorbing from the outside world.

In contrast to nativism, antitraditionalism calls for boundless adoption of foreign models of modernization, but its orientation is adaptation rather than accommodation to foreign powers. Adaptation is a human learning process in which old ways of coping with the outside world are changed into new ones. This change can create a readiness to respond to a given international situation in a characteristic and repetitive fashion. In the China case, disagreement about what foreign models China should adopt has resulted in adaptation efforts that did not follow the path delineated by any one foreign model.

In the early period of the PRC, the foreign model that Mao brought to China was Marxism-Leninism. China was going to adopt the Soviet model of economic and political development and adapt to the Soviet-led Communist world. This orientation was evident in

¹⁴⁶ S. Robert Ramsey, *The Languages of China* (Princeton: Princeton University Press, 1989), 3.

¹⁴⁷ Myron L. Cohen, “**Being Chinese**: The Peripheralization of Traditional Identity” in Tu Wei-ming.

Mao's historical announcement on June 30, 1949, that China would "lean towards one side" in the struggle between imperialism and socialism. China must ally itself "with the Soviet Union, with every New Democratic country, and with the proletariat masses in all other countries."¹⁴⁸ However, the adaptation to the Soviet-led world was a total failure. This maladaptation resulted in his passionate engagement in the polemics with the Soviet Union and repudiation of the Soviet brand of communism in the 1960s.

In the adaptation process of China to the capitalist Western World, turning key symbols of China's glorious past into symbols of its modern backwardness, the series used images of the West as symbols of the new civilization, which were summoning China. This antitraditionalism gave voice to a nationalism that was urgent but simplistic and idealistic because of its over criticalness of Chinese tradition and over enthusiasm about Western culture. Many Chinese intellectuals soon realized that antitraditionalism could not make China strong and alive, because a viable dream should link the legacies of the past with the hopes for the future. After the initial "culture shock" in the early years of China's reform and opening to the outside world, Westernization prompted less and less enthusiasm among Chinese people in the 1990s. It was thus recorded as another maladaptation.

Pragmatic nationalism is national interest-driven. Its orientation in world affairs is assertive in defending and seeking China's national interests. As one advocate of Chinese pragmatism states, "Its main objective is to build a politically, economically, and culturally united nation-state when foreign and largely Western influences are seen as eroding the nation-state's very foundation."¹⁴⁹ For pragmatic nationalists, "both the nation's problems and most of the possible solutions were perceived as coming from outside."¹⁵⁰ Pragmatic nationalism thus gains its power both from reacting to and absorbing from the outside world.

Pragmatic nationalists are no less determined than both nativists and antitraditionalists to establish China as a powerful nation. They have constantly revealed their pride in China's national heritage and their dedication to making China a leading power in the world. However, unlike nativists who believe that Chinese cultural tradition may be of universal human value, pragmatic nationalists insist that the universal cultural claims, whether modern or traditional, Chinese or foreign, are subject to the promotion of China's national interest or the enhancement of national pride. They want to see China being a full-fledged participant in

¹⁴⁸ Mao Zedong: "On the People's Democratic Dictatorship," **Selected Works of Mao Tse lung**, vol. IV (Beijing: Foreign Language Press, 1969), p. 415.

¹⁴⁹ Wang Jisi: "Pragmatic Nationalism: China Seeks a New Role in World Affairs," **The Oxford International Review** (Winter 1994): 30.

¹⁵⁰ Andrew J. Nathan and Robert S. Ross: **The Great Wall and the Empty Fortress: China's Search for Security** (New York: W. W. Norton, 1997), p.p. 32-33.

international affairs and occupying a prominent position in the world. Compared with antitraditionalists who look to foreign models for China's future, pragmatists are more critical toward any imported universal principles, including both Marxism and liberalism. They emphasize the gap between these Western models and the Chinese condition (*guoqing*). This has led some pragmatists to look toward an Asian path of modernization. The economic success of many East Asian countries seemed to have proved that modernization is not necessarily tantamount to Westernization and China can accumulate wealth without simply following any foreign models.

Pragmatic leaders have fashioned nationalism because it has the effect of removing differences within the country and replacing it with a common, hegemonic order of political values. Nationalism has been used to rally popular support behind a less popular Communist regime and its policies by creating a sense of communality among citizens. Pragmatic nationalism thus does not have a fixed, objectified, and eternally defined content. Instead, it has been continually remade to fit the needs of its creators and consumers. Narratives of pragmatic nationalism, including interpretations of nationalistic symbols, are “invented histories or traditions.”¹⁵¹

The emergence of pragmatic nationalism in post-Mao China was in response to a legitimacy crisis of the Communist regime starting in the late 1970s when the regime was deeply troubled by what was popularly called *sanxin weiji* (three spiritual crises), namely, a crisis of faith in socialism, a crisis of confidence in the future of the country, and a crisis trust in the party. After Communist ideology lost credibility, some intellectuals turned to Western, liberal ideas and called for Western-style democratic reform. *Sanxin weiji* thus resulted in the pre democracy movement and the large-scale demonstrations in the spring of 1989. How to restore legitimacy and build a broad-based national support became the most serious challenge to the post-Tiananmen leadership. It was during this time that the instrumentality of nationalism was discovered. Deng Xiaoping and his successor, Jiang Zemin, began to wrap themselves in the banner of nationalism, which, they found, remained a most reliable claim to the Chinese people's loyalty and the only important value that was shared by both the regime and its critics. After the Tiananmen incident, pragmatic leaders began to emphasize the party's role as the paramount patriotic force and guardian of national pride. In the face of Western sanctions against China, they moved quickly to position themselves as the representatives of the Chinese nation and Chinese economic interests, including China's entry into the WTO (World Trade Organization),

¹⁵¹ Ernest Gellner: “Nationalism in the Vacuum,” in Alexander Motyl, ed., **Thinking Theoretically about Soviet Nationalities** (New York: Columbia University Press, 1992)

and maintenance of the low-tariff treatment on exports to the United States, known as Most Favored Nation (MFN) status. One dramatic example of its effort to identify the regime with Chinese national pride was the bid to host the year 2000 summer Olympic Games in Beijing. Although China failed to get the games at that time, now China is expecting the 2008 Olympic Games in Beijing and the games of the XXIX Olympiad – Beijing 2008 will take place from 8 August 2008 until 24 August 2008. The Games in Beijing will play host to the 28 summer sports currently on the Olympic program comprising 302 events in total. Approximately 10,500 athletes are expected to participate in the Games, with around 20,000 accredited media bringing the Games to the world.¹⁵²

Led by the state, pragmatic nationalism identifies the nation closely with the Communist state. Nationalist sentiment is officially expressed as *aigu*, which in the Chinese language means “loving the state,” or *aiguo zhuyi* (patriotism), which is love and support for China, always indistinguishable from the Communist state. As Michael Hunt observes, “By professing *aiguo*, Chinese usually expressed loyalty to and a desire to serve the state, either as it was or as it would be in its renovated form.”¹⁵³ From this perspective, Chinese patriotism can be understood as a state-centric or state-led nationalism. The Communist state is portrayed as the embodiment of the nation's will and seeks for the loyalty and support of the people that are granted the nation itself. The Communist state tries to create a sense of nationhood among all its citizens by speaking in the nation's name and demanding that citizens subordinate their interests to those of the state. Freedom is sought not for individuals but for the nation-state. This means all power is given to the rulers of the Communist state.

The formation of nationalism in Europe as an indigenous process driven by mercantilism and liberalism, nationalism in China was initially borrowed from West by the Chinese elite to defend China against foreign invasions in the late nineteenth century. Since the end of the Cold War, China has been under heavy pressure from Western countries. In particular, Sino-U.S. relations have become entangled over many issues, such as human rights, intellectual property rights, trade deficits, weapons proliferation, and especially the Taiwan issue.

¹⁵² http://www.olympic.org/uk/games/beijing/index_uk.asp

¹⁵³ Michael Hunt: “Chinese National Identity and the Strong State: The Late Qing Republican Crisis,” in Lowell Dittmer and Samuel S. Kim, **China's Quest for National Identity** (Ithaca, NY: Cornell University Press, 1994), p. 63.

3. Characteristics of Chinese Nationalism

While nativism and antitraditionalism have continued to lurk in the background, pragmatic nationalism has become the dominant thinking of Chinese people and their leaders since the 1980s. Pragmatic nationalism reveals its three characteristics: instrumentality, state centeredness, and reactiveness.

3.1. Instrumentality

For a long time, the axis of difference in the explanation of nationalism has been primordialism in contrast to instrumentalism. Primordials argue for an essential nationalism based on an unchanging national identity, whereas instrumentalists attribute nationalism to manipulation by interested elites and see nationalist consciousness as a situational matter. Those in power and authority are at an advantage in creating and propagating a national identity that promotes their own interests, because they can marshal all the institutional apparatus at their disposal.¹⁵⁴ Chinese nationalism has been characterized by its instrumentality to the communist government in compensating for or, to a certain extent, replacing the all-too-evident weaknesses of communist ideology since the 1980s. Pragmatic leaders have fashioned nationalism, because it has the effect of removing differences within the country and replacing it with a common, hegemonic order of political values. Nationalism has been used to rally popular support behind a less popular communist regime and its policies by creating a sense of communality among citizens.

After communist ideology lost credibility, instrumentality of nationalism was discovered along with the development of a conservative tendency that seeks to defend the vested interests of an authoritarian political system.

This conservative tendency started in the late 1980s is known as neo-authoritarianism (*xinquanwei zhuyi*), a less-Marxist-colored but non-democratic political discourse. Neo-authoritarianism urged a strong and authoritarian state to enforce modernization programs and argued that the economic miracle of the four “little dragons” in East Asia was created because they all shared Confucianism and patriarchal power structure. In the early 1990s neo-authoritarianism was repackaged as neo-conservatism (*xinbaoshou zhuyi*) with an emphasis on strong state control as well as moral values based on the conservative elements of Confucianism. Immediately after the Tiananmen Incident, He Xin, a Beijing-based scholar, became the most

¹⁵⁴ Ernst B. Haas, *Nationalism, Liberalism, and Progress: The Rise and Decline of Nationalism* (Ithaca, NY: Cornell University Press, 1997).

visible symbol of neo-conservatism. He used the official slogan “stability above everything” to defend government action suppressing student demonstrations.¹⁵⁵

With the renewed discovery of the power of nationalism, Deng Xiaoping and his successor, Jiang Zemin, began to wrap themselves in the banner of nationalism, which they found remained a most reliable claim to the Chinese people’s loyalty and the only important value that was shared by both the regime and its critics. Nationalism may appeal to Chinese of all walks of life; no matter how uninterested they are in other aspects of politics. It was ironic that pro-democracy demonstrators in the Tiananmen Square in 1989, while confronting the government, claimed that patriotism drove them to take to the streets. After the Tiananmen Incident, pragmatic leaders began to emphasize the party’s role as the paramount patriotic force and guardian of national pride. In the face of Western sanctions against China, they moved quickly to position themselves as the representatives of the Chinese nation and Chinese economic interests, including China’s entry into the WTO (World Trade Organization), and maintenance of the low-tariff treatment on exports to the United States, known as most favored nation (MFN) status¹⁵⁶.

In response to the argument that China needs more political freedom and democracy to pave the way for world peace and stability, they asserted that the state has an obligation to implement effective and forceful measures to maintain domestic order and unity. They reminded the Chinese people that weakness, disunity, and disorder at home would invite foreign aggression and result in the loss of Chinese identity, as China’s century-long humiliation and suffering before 1949 demonstrated. Beginning in 1994, for the first time since university entrance examinations were reinstated in the late 1970s, students applying for science subjects at colleges were exempted from the notorious Marxist political science exam, which had been widely resented. Instead, patriotic education courses were added to the curriculum of high schools and colleges. These courses concentrate on the great achievements of the Chinese people and especially the Communist party. The aim was to win more respect for the party by demonstrating what it had done for the people of China¹⁵⁷.

Nationalism is an effective instrument for the communist regime. Prior to the Tiananmen tragedy, the passion of Chinese intellectuals had been focused on political liberalization, and the

¹⁵⁵ He Xin, *Zhonghua Fuxing yi Shijie Weilai (Renovation of China and the Future of the World)* 2 vols. (Chengdou: Shichuan Renmin Chubanshe, 1996)

¹⁵⁶ Iain Alon: *Chinese Economic Transition and International Marketing Strategy*, Praeger Publishers, March 30, 2003.

¹⁵⁷ *Chinese Nationalism in Perspective : Historical and Recent Cases (Contributions to the Study of World History)* (Hardcover), Greenwood Press August 30, 2001, p.123

most popular international political figure on Chinese university campuses was Mikhail Gorbachev. Many college students took Gorbachev's *perestroika* (reorganization) as the ideal course of action for the CCP. In the 1990s, however, worry about disorder and disunity outweighed concern about political lethargy or oppression, let alone a demand for liberty and human rights. The economic difficulties of the former Soviet states provided an expedient pretext for the government to relegate political liberalization to the background. The need for political stability, a precondition for steady economic growth, became an overriding mission of the Chinese leadership.

3.2. Statism

Led by the state, pragmatic nationalism identifies the nation closely with the communist state. Nationalist sentiment is officially expressed as *aiguo*, which in Chinese language means "loving the state," or *aiguo zhuyi* (patriotism), which is love and support for China, always indistinguishable from the communist state. As Michael Hunt observes, "by professing *aiguo*, Chinese usually express loyalty to and a desire to serve the state, either as it was or as it would be in its renovated form."¹⁵⁸ From this perspective, Chinese patriotism can be understood as a state-centric or state-led nationalism. The communist state is portrayed as the embodiment of the nation's will and seeks for the loyalty and support of the people that are granted the nation itself. It tries to create a sense of nationhood among all its citizens by speaking in the nation's name and demanding citizens subordinate their interests to those of the state. Freedom is sought not for individuals but for the nation-state. This means all power to the rulers of the communist state. As asserted by the People's Daily editorial on the 1996 National Day, "Patriotism is specific. Patriotism requires us to love the socialist system and road chosen by all nationalities in China under the leadership of the Communist Party." By identifying the party with the nation, the regime makes criticism of the party an unpatriotic act.

State-led nationalism can produce passionate ideology when political leaders appeal to emotive nationalism for the defense of the state or use nationalism as an instrument to bring together disparate groups within the state and mobilize public support for their policies. For this purpose, the communist state launched a patriotic education campaign in the early 1990s. As a state-led campaign, it emphasized the need to remember earlier sufferings at the hands of the West and Japan, to prevent the loss of Chinese identity through foreign cultural and political

¹⁵⁸ Lucian W. Pye, "How China's Nationalism was Shanghaied," *Australian Journal of Chinese Affairs* 29 (January 1993): 126

intrusions, and to accept the need for strong government controls over society.¹⁵⁹ The campaign drew upon traditional attitudes that favored a “well-ordered and hierarchical political structure,” strong popular emotions regarding past injustices suffered at the hands of foreign powers, and “deeply rooted desires for growing sense of pride felt among ordinary Chinese citizens concerning China’s recent economic and diplomatic accomplishments.”¹⁶⁰ The campaign presented the image of a strong Chinese state capable of redressing past grievances, resisting current and future foreign intrusions, and wielding a high degree of influence in the international arena, at least on a par with other major powers.

The communist state was repackaged in the campaign. The leadership of the CCP was claimed because of its patriotism in China’s long struggle for national independence and prosperity, not because of its communist ideals. A special emphasis of the campaign was on China’s national essence (guoqing): where China is strong, where it lags behind, and what its favorable and unfavorable conditions are. Patriotism was used as a national call, while the peculiarity of the national essence offered a rationale for that call. A communist state, which would otherwise be hardly acceptable to the Chinese people after the collapse of communism in other parts of the world, was justified by the national essence. As a result, some intellectuals, including those who had sharply criticized the government during the spring of 1989, changed their attitudes. They accepted the themes of the patriotic education campaign about China’s special conditions—that is, the argument that sudden democratization in China would result in rapid social disintegration, as witnessed in the former Soviet Union and Eastern European countries. Some of them joined neoconservativists in arguing that a centralized state must be strengthened in order to maintain social stability and economic development.

3.3. Reactiveness

Pragmatic nationalism is reactive. It tends to become strong in response to perceived foreign pressures that are said to erode, corrode, or endanger the national interest of China. As Liu Ji said, “Chinese nationalism has a unique characteristic: in peaceful times, there are often ‘internal struggles’ (wolidou) within the nation... When confronted with foreign invasions, this nation is prone to respond with a narrow kind of nationalism.”¹⁶¹ A reactive sentiment to foreign

¹⁵⁹ Suisheng, Zhao, Chinese Nationalism and Its International Orientations, *Political Science Quarterly*, Vol. 115, No. 1. (Spring, 2000), pp. 1-33.

¹⁶⁰ Michael Hunt, “Chinese National Identity and the Strong State: The Late Qing-Republican Crisis” in Lowell Dittmer and Samuel S. Kim, eds., *China’s Quest for National Identity* (Ithaca, NY: Cornell University Press, 1994), 63.

¹⁶¹ Lui Ji, “Making the Right Choices in Twenty-first Century Sino-American Relations,” *Journal of Contemporary China* 7 (March 1998): 90.

suppressions is the starting point of Chinese nationalism. Unlike the formation of nationalism in Europe as an indigenous process driven by mercantilism and liberalism, nationalism in China was initially borrowed from the West by the Chinese elite to defend China against foreign invasions in the late nineteenth century. That is why Xiao Gongqin calls Chinese nationalism “yingji-zhiwei xing” (reactive-defensive type). According to Xiao, Chinese nationalism has risen in response to “negative stimulus” (buliang ciji) from certain foreign forces. It is therefore reactive to specific issues and has little to do with abstract ideas, religious doctrines, or ideologies. “The intensity of the reaction is in proportion to the intensity of negative stimulus from abroad.”¹⁶²

The effort to identify the communist regime with the Chinese nation was particularly effective when China faced challenges from hostile foreign countries. The Korean War was a typical example. With the perceived imminent invasion of American forces via Korea, the communist government launched a kangmei yuanchao (Resisting America and Assisting Korea) campaign that mobilized popular energy and coupled with nationalistic rhetoric to defend the nation. Since the end of the cold war, China has been under heavy pressure from Western countries. In particular, Sino--U.S. relations became entangled over many issues, such as human rights, intellectual property rights, trade deficits, weapons proliferation, and especially the Taiwan issue. The voice of containment of China reached its peak in the Western media when China launched military exercises in the Taiwan Strait following President Lee Teng-hui’s visit to the United States in May 1995. Suspicion of U.S. intentions prevailed among many Chinese people after the United States sent two aircraft carrier battle groups to protect Taiwan in March 1996. In this case, nationalist sentiment was not the sole province of the communist regime. A truly remarkable phenomenon was that Chinese intellectuals became a driving force of nationalism in the 1990s.¹⁶³

Response to the change in the international environment is a central concern of the intellectual discourse on nationalism. Two popular views in the West were especially cited by Chinese intellectuals as a challenge to the Chinese national interest. One is Fukuyama’s statement that the end of the cold war is a triumph of capitalism and Western liberalism. The second view is Huntington’s argument that geopolitical struggles in the post-cold war world are not ideologically motivated but defined by different civilizations. Many Chinese intellectuals

¹⁶² Xiao Gongqin, “Zhongguo Minzu Zhuyi de Lishi yu Qianjing” (**The History and Prospect of Chinese Nationalism**), *Zhanlie yu Guanli*, 2, 1996, 62.

¹⁶³ Suisheng Zhao, “Chinese Intellectuals’ Quest for National Greatness and Nationalistic Writing in the 1990s,” **The China Quarterly** 152, December 1997, 725-745.

reading their works were convinced that a confrontation between different nation-states and cultures under the banner of nationalism is going to replace opposition between communism and capitalism. They paid special attention to Huntington's argument that the biggest threat to Western civilization is Islamic and Confucian culture; thus the West should be alert to a Confucian and Islamic alliance. This argument faced vociferous attacks from Chinese intellectuals. In a rebutting article, Wang Xiaodong (using a pen name, Shi Zhong) argues that there is no desire on the part of the Chinese to confucianize the rest of the world. Any future conflicts will depend on economic interests, and China may come into conflict with other powers because of its growing economic strength. In another article, Wang suggests that nationalism is indispensable and a rational choice to advance national interests of China.¹⁶⁴

Although the intellectual discourse on nationalism overlaps, to a certain extent, the patriotic rhetoric of the Chinese government, its emergence was largely independent of official propaganda. Those who have contributed to the intellectual discourse on nationalism are from various political backgrounds. As observed by Wang Xiaodong, "among those under the banner of nationalism, there is a full array of people: some of whom advocate authoritarianism, others who support expansionism; while some people believe in more state controls, and others uphold the total freedom in the market economy. There are also those who propose a return to tradition and others opposing this restoration."¹⁶⁵ The important common denominator that brings together intellectuals of different political views is the concern over international pressures after the end of the cold war.

4. The Constraint on Chinese Nationalism

Nationalism is a double-edged sword. While nationalism may be used by the regime to replace the discredited Communist ideology as a new base of legitimacy, it may also cause a serious backlash and place the government in a hot spot facing challenges from both domestic and international sources.

China's modernization continues to depend on cooperation with United States and Japan. When the nationalist issues have fired up the general public about the conduct of the United States and Japan, it often does more harm than good to the Communist government. The CCP rose to power partly because it gained nationalistic credentials by fighting the Japanese invasion

¹⁶⁴ Shi Zhong, "*Weilai de Chongtu*" (Future Conflicts), Zhanlie yu Guanli, 1, 1993, 46-50; and "*Zhongguo xiandaihua mianlin de tiaozhao*" (The Challenges to China's Modernization), Zhanlie yu Guanli, 1, 1994.

¹⁶⁵ Shi Zhong, "*Zhongguo de minzu Zhuyi yu zhongguo de weilai*" (Chinese Nationalism and China's Future), Huaxia Wenzhai (China Digest), an internet electronic magazine, 1996.

during the war. Now being widely criticized as too chummy with Japan, while it has failed to provide more compensation for wartime injuries, laid claim to Tiaoyu Islands, and allegedly waged economic imperialism by flooding China with Japanese products, the party suffers from losing some of its dwindling legitimacy. The Chinese leadership has worried about the patriotic movement against Japan that may evolve into a protest movement against the Chinese government itself by those people who are jobless or angry about corruption in the government. In addition, coming at a time when China urgently needs Japanese trade and investment, the government does not want to see the surge of nationalism jeopardizing Sino-Japanese economic relations. Ironically, when Chinese patriots blamed Japan for economic imperialism, the *China Daily* reported that “Chinese products have edged their way into the Japanese market so steadily.” According to the report, the trade between China and Japan hit a record \$57.47 billion in 1995, up 19.9 percent from 1994. Of the total, China’s exports soared 31.7 percent to stand at \$28.46 billion. China’s trade deficit was narrowed. While Chinese statistics claimed a \$540 million trade deficit with Japan, Japan reported a \$13.99 billion trade deficit with China in 1995.¹⁶⁶

Internationally, the rise of Chinese nationalism has coincided with a presumption in the international community that nationalism has assumed an irrational and dangerous quality that might distort a state’s true interests and threaten other states in the late twentieth century. Many analysts, sobered by two centuries of imperialism, revolution, and war, have taken a negative view of nationalism. Hans J. Morgenthau’s classic study found nationalism of the late twentieth century “essentially different from what traditionally goes by that name and what culminated in the national movements and the nation-state of the nineteenth century.” According to Morgenthau, “Traditional nationalism sought to free the nation from alien domination and give it a state of its own,” while the nationalism of the late twentieth century “claims for nation and one state the right to impose its own initiations and standards of action upon all the other nations.”¹⁶⁷ Because it is thought to unite and strengthen a nation internally, embracing traditional nationalism is often thought to be the right course for a country fighting for unity and independence. The rise of Chinese nationalism is seen as “a potent force in a country that is striving to shake off its image as the sick man of Asia and regain ancient glory”¹⁶⁸ Chinese military exercises in March 1996 may have fired a shot across the bow of Taiwanese

¹⁶⁶ Gao Bianhua: “Chinese Products Find a Home in Japan,” *China Daily*, April 1, 1996, p. 2.

¹⁶⁷ Hans J. Morgenthau: **Politics among Nations: The Struggle for Power and Peace** (New York: McGraw-Hill, 1993), p.p. 272-273.

¹⁶⁸ Steven Mufson: “China’s New Nationalism: Mix of Mao and Confucius,” **International Herald Tribune**, March 20, 1996

independence, but it, in the meantime, set off alarms all over East Asia, causing a series of moves that were against China's national interests. The Japan-U.S. relationship was strengthened. The American military withdrawal from Okinawa was shelved temporarily. Indonesia was drawn closer to Australia and protested China's claim to gas fields in the South China Sea. The Philippines strengthened its military and unproved relations with Taiwan.

4.1. Conclusion

Pragmatic nationalism is assertive in international orientation and is particularly powerful when China's national interests or territorial integrity are in jeopardy. But it has not made China's international behavior particularly aggressive. That is why David Shambaugh characterized Chinese nationalism as "defensive nationalism," which is "assertive in form, but reactive in essence."¹⁶⁹ Defensive nationalism has made Chinese leaders very assertive in defending China's national interests, particularly on the issues concerning national security and territorial integrity, as seen in the continuing drama of PRC efforts to regain Hong Kong, Macao, and Taiwan, which ensure a steady diet of nationalistic themes in the official media. The same defensive nationalism has also prevented China from assuming international responsibilities beyond its immediate concerns and capabilities.

To be sure, pragmatic leaders have displayed a consistently real politic worldview. Nevertheless, their preferred ends have predominantly remained the defense of their own political power and the preservation of China's territorial integrity. They have played up a history of painful Chinese weakness in the face of Western imperialism, territorial division, unequal treaties, invasion, anti-Chinese racism, and social chaos, because eliminating "the century of shame and humiliation" is at the heart of a principal claim to CCP legitimacy. The regime's legitimization has always been based on its ability to defend China's national independence against foreign enemies. Even Mao, who pursued a nativist policy, claimed legitimacy not on his ability to carry out international aggression but on his success in defending China. Mao relied on deterrence and defense in depth in an attempt to wall out enemies. A three-fronts strategy formulated by Mao in the 1960s typically manifested this defensive strategy.¹⁷⁰

¹⁶⁹ David Shambaugh: "Containment or Engagement of China," *International Security* 21, no. 12 (Fall 1996): 205.

¹⁷⁰ Wang Jisi: "Pragmatic Nationalism: China Seeks a New Role in World Affairs," *The Oxford International Review* (Winter 1994): 29.

II. HISTORICAL BACKGROUND OF PEOPLE'S REPUBLIC OF CHINA TRADITION AFTER THE COMMUNIST REVOLUTION

A. THE COMMUNIST REVOLUTION 1949 - 1965

1. Mao Zedong

The Chinese people saw in Mao someone they could trust. He had an everyday common-man touch. He came from an upper peasant background, worked hard in the fields, studied China's past, wrote in a fairly good calligraphic hand, and used to compose poems on the grueling Long March. He had been for so long as fully accepted as the ideological leader that he could afford to seem to treat lightly the orthodox statements of the Communist Party, yet he was an absolutely convinced Marxist.



Figure 2: Mao Tse-tung

It is often a matter of convenient shorthand to attribute all leadership to Mao Zedong himself, but this conveys a false impression. Mao acted within the leadership circle of the Party, and the decisions under Party discipline were joint ones. Before surveying the various phases in Mao's revolutionary activity, it is useful to recall at the outset the extent to which his project corresponded to the spirit of the age in China. Despite the uniqueness of his historical role, Mao's own youthful personality and goals were formed in the matrix of the May Fourth period, and bore the stamp of that defining moment which imparted a radical character to the dominant intellectual and political currents in China throughout much of the 20th century.

Mao Zedong's concerns at that time were those of most young Chinese of his generation: how to maintain China's existence and integrity in a world dominated by the great powers; how to draw for this purpose on the knowledge and ideas which had led to Western superiority, while preserving what was valuable in China's own tradition. In other words, he sought to promote the twin enterprises of national resurgence and cultural transformation. At the outset, Mao Zedong

believed that these goals could be achieved without substantial changes in the framework of the existing order, but he soon came to the conclusion that a profound revolution was the necessary precondition for national salvation and renewal.¹⁷¹

Mao was, of course, not simply a Marxist, but a Marxist-Leninist. Indeed, he espoused Leninism, and the Soviet model of proletarian dictatorship, long before he learned much of anything about Marx's own theories. He ultimately drew both on Marx and on Lenin, but for better or for worse, he owed more to Lenin, and to his disciple Stalin, than to Marx. During a large part of Mao's life, from the Revolution of 1911 to the victory of 1949, military force was the decisive instrument of struggle in China. The axiom that "political power grows out of the barrel of a gun," which Mao put forward as early as 1927 at the 7 August emergency conference.¹⁷² On the whole, Mao is a vastly different personality from both Lenin and Stalin. Every revolutionary is a product of the culture and tradition against which he rises in revolt. This is especially true of revolutionaries, who, like Stalin and Mao, for all practical purposes never left the country of their birth, never experienced the challenging and enriching confrontation of a different tradition or milieu. Born and reared in the conservative province of Hunan, Mao has spent most of his life away from the Westernized, urban centers of China and is intensely Chinese.¹⁷³ There is in his personality a touch of both the eclecticism of the Chinese scholar and the earthy sense of humor of the Chinese peasant; we find in him a deep hue of revolutionary romanticism and a versatility, which even the elevation of his thought as official dogma cannot completely hide.

Mao wrote that the initial economic structure should consist of a state economy where the government controlled the major industries, mines, and utilities; an agricultural economy, in which individual farms would develop into collective farms; and a private economy, in which private middle- and small-sized businesses would be allowed to continue.

The political structure in the first phase would be one of "democratic centralism," meaning that the Chinese Communist Party (CCP) would rule but that a few other political parties would be permitted to exist under strict control. Most of these political parties still exist, though they were and always have been captive parties with leadership being used occasionally to add some legitimacy to Communist actions. In the New Democracy era there would be a coexistence of the

¹⁷¹ Stuart R. Schram: "Mao Zedong a Hundred Years On: The Legacy of a Ruler", *The China Quarterly*, No. 137. (Mar., 1994), p.p. 125-143.

¹⁷² S. Schram: *The Thought of Mao Tse-tung*, Cambridge: Cambridge University Press, 1989, p. 46.

¹⁷³ Rene Goldman: "Mao, Maoism and Mao logy", *Pacific Affairs*, Vol. 41, No. 4. (Winter, 1968-1969), p.p. 560-574.

four defined “classes” under the leadership of the Communist Party, which represented the proletariat. Those classes were to be workers, peasants, the small bourgeoisie (middle-income professionals, merchants, etc.), and the national bourgeoisie (owners of large enterprises, assets). These were represented in the flag of the People’s Republic by the four small stars surrounding the large star symbolizing the Communist Party leadership as the guiding element of the new state. In cultural terms, Mao’s concept was that China would develop a “scientific, anti-feudal mass culture,” with the selective acceptance of “useful elements of foreign cultures,” and that the state would be “anti-imperialist, able to advocate the dignity and independence of the Chinese nation.”¹⁷⁴

The first National People’s Congress adopted a new constitution, recognizing the “alliance of four classes” as well as the four types of ownership: state, cooperative, individual, and capitalist. It also included a bill of rights that applied to all citizens, the exception being that the government maintained the right to “reform traitors and counterrevolutionaries.”¹⁷⁵ In the first years of the People’s Republic of China, Mao dominated in fact and in forms both the Party and government. In the Party, he was Chairman of the Central Committee, of the Politburo, and of the Central Secretariat. In the government, Mao was Chairman of the People’s Republic, of the Revolutionary Military Council, and of the National People’s Congress.¹⁷⁶ The existence of a formal government also provided the Communist Party with a means of holding real power while having another set of institutions that could be held responsible for problems or setbacks.

2. The Take Over

When the civil war ended in 1949 with the victory of the CCP, the takeover of the country as a whole was rendered much easier. The question which puzzles many is how the Chinese people, with deep roots in tradition and a strong sense of family, could accept with such apparent ease the coming of the alien philosophy of communism. The discipline and helpfulness shown by the Red Army, now called the People’s Liberation Army, or “PLA”, was a second reason for the acceptance of the CCP government in spite of the usual view of soldiers as little better than bandits, the contrast with the traditional and especially with the warlord armies was so marked as to create a very favorable image of the new regime. These men said “please” and “thank you,” paid for what they took for supplies, and had strict instructions not to commandeer even a needle

¹⁷⁴ Immanuel Chung-Yueh Hsu, **Rise of Modern China** (Cambridge: Oxford University Press, 1999), p. 646.

¹⁷⁵ Immanuel Chung-Yueh Hsu, **Rise of Modern China**, p. 649.

¹⁷⁶ Immanuel Chung-Yueh Hsu, **Rise of Modern China**, p. 650.

from a civilian home.¹⁷⁷ The government at first took a soft line with the propertied classes, with certain exceptions in areas where land reform was put into operation before the takeover. Glowing promises were made concerning the new day of benefits for all which was dawning with the coming of the Communist power.

Apart from this element of propaganda, there was a greater similarity between the new Communist and the old Confucian order than is commonly realized by those little acquainted with the traditional inner dynamics of Chinese rule. The Chinese had always had various and sometimes clashing views on many subjects but expressed differences openly on matters concerning the government only on rare occasions. There was a state orthodoxy and experts. Who were the officials old or new, put in place to guard the orthodoxy and administer the country in accordance with it. It was the duty of the ruled to obey the rulers and within the allowed framework to carry on their lives and their production in their own way. When the Communists came to power, few guessed how penetrating and all-embracing would be the interference of the rulers with the private life of every citizen, but the framework was somewhat the same. Then there was an undoubted positive element in the Marxist interpretation of history; which, after the decades of conflicting views, appealed to the intellectuals.

When the CCP took over control of China, the first form of government was the People's Political Consultative Council set up in September 1949 with 662 delegates¹⁷⁸. This was in theory a coalition government, and some non-Communists were given important official posts. But in the controlling committee of 56 persons, 51 were members of the CCP. The premier was Zhou Enlai. To ensure a rapid exercise of control, the country was divided into six regions, each under a bureau with military and political authority.

Most of the existing administrators at the local and some higher levels were retained in their jobs.

3. Land Reform

Before land reform, China's rural economy was characterized by a large amount of waste. Landlords acquired money from rents, interest, and profits, and used it largely for luxury consumption. They lacked the willingness (or incentives) to invest their surpluses in either agricultural or industrial production. One of the first tasks of the new government was land

¹⁷⁷ Robert C. North: "The Rise of Mao Tse-Tung", **The Far Eastern Quarterly**, Vol. 11, No. 2. (Feb., 1952), p.p. 137-145.

¹⁷⁸ John W. Garver: "The Chinese Communist Party and the Collapse of Soviet Communism", **The China Quarterly**, No. 133. (Mar., 1993), p.p. 1-26.

reform, the redistribution of land confiscated from landlords and given to the poorer peasants.¹⁷⁹ Land reform had the effect of taking these flows of income from the wealthy, and redirecting them to the poor. At the same time, however, the state manipulated the price ratio of farm products to consumer and industrial goods so that most (but not all) of these income flows went back to the state to supply funds for investment. In this way, the poor could get some short-term benefits in income, while the rate of investment in the whole economy could be raised substantially, permitting long-term growth. Also, as a result of the Land reform, it had stopped the exploitation, and made the rural economy more accessible to government extraction, much of which could be used for productive investment. By rising the price of industrial goods sold in rural areas the state was able to obtain more billion Yuan, all of which went to investment.

Peasant associations were set up, which arranged the classification of land by productivity, the confiscation, and the redistribution to those designated to receive it. The first two classes, landlords who lived on rents and rich peasants who tilled part and leased part of their land, would have some or all of their land taken. Middle peasants were usually left their own holdings, which they were already farming.¹⁸⁰ The lowest two classes, poor peasants and landless farm laborers, received a new allotment. The number of the accused whose land was confiscated would be different in different districts and usually proportional to the amount of land required in that area to provide a minimal amount for the poor peasants and farm laborers.

The objectives of land reform were to improve the lot of the poor and make them feel they had a stake in the country and a loyalty to the new government. In many though by no means all cases, the victims had in the past shown greed and cruelty in their dealings with the peasants. But the objectives of land reform also included information and control. The CCP by means of the cadres obtained an insight into conditions in every part of China and useful lists of enemies of the people. By implicating the local population in the “judicial” process and the killings, control through fear was quickly established. Those most enthusiastic in carrying out Communist principles, particularly among youth, were also revealed to the Party and could thereafter be enlisted and trained. From the point of view of short-term agricultural growth, land reform had very little impact because it could not change the basic technology of production. “In reality, no distribution’s land reform can remedy the rural economic problem arising from overpopulation.”¹⁸¹

¹⁷⁹ Ben Stavis: “China and the Comparative Analysis of Land Reform”, *Modern China*, Vol. 4, No. 1. (Jan., 1978), p.p. 63-78.

¹⁸⁰ Ben Stavis: “*Ibid* “, p.p. 63-78.

¹⁸¹ Szelenyi, Ivan: *Privatizing the Land : Rural Political Economy in Post-Communist Societies*, Routledge, 1998

But in its social and political aspects, land reform was profoundly radical and revolutionary. Land reform was a crucial first step in the destruction of the political power of the rural elite. This not only transformed rural politics but also changed the character of urban-rural relationships. By eliminating a political ally of the urban based political system, land reform contributed to ending the urban exploitation of the countryside. It was also an important step in a psychological transformation of peasants from a mode of passivity in the face of social and natural conditions to a realization of their power to change society and nature. Estimates are that between two to five million persons were executed, another four to six million ostensibly “rich peasants” were sent to forced-labor camps, while an additional eight to twelve million were placed under strict observation by the Communist neighborhood committees.¹⁸² At times, “people were tortured to death in attempts to force them to reveal the whereabouts of alleged treasure. Interrogations were systematically accompanied by torture with red-hot irons. Families were executed and the tombs of their ancestors robbed and destroyed.”¹⁸³ This confidence and power of the peasants has continued, and this is one of the reasons that the central government must be responsive to peasants’ needs today.

In China, since there was a clear political commitment to land reform and to rural social transformation, land reform was implemented with remarkable effectiveness. Crucial for this implementation was a very sophisticated combination of central leadership and mass participation, expressed through a wide range of local organizations. Land reform committees and people’s tribunals were set up at county and higher levels; peasant associations were set up as mass organizations at township levels. People’s militia and special land reform police supplemented the regular arm. This bloody process introduced the Chinese people to the power and methods of the new Communist rulers. It also was the beginning of two of the fundamental methods of control established by the regime: the classification of citizens and the mass campaign in which people were directed by the regime to persecute others who had been officially designated as “counterrevolutionaries” or “class enemies.”

Those land reforms produced the basis for significant improvements in the living conditions of people in the countryside, as well as the savings and capital which made a major contribution to the industrialization and movement toward prosperity of those countries, each of which leapt economically far ahead of China during the Mao years and after forces to discourage landlords from opposing land reform violently.

¹⁸² Jean-Louis Margolin, “China: A Long March into Night,” in **The Black Book of Communism: Crimes, Terror, Repression**, ed. Courtois et al., Cambridge, Mass.: Harvard University Press, (1999) p. 479.

¹⁸³ Jean-Louis Margolin, “Ibid,” p. 479.

4. Thought Reform

The Chinese Communist program of *szu-hsiang kai-tsao* or “thought reform” is unique both as a social experiment and as a laboratory for cross-cultural psychiatric study. Applied to Westerners and Chinese, to professors, students, and peasants, it combines a remarkably widespread dissemination with impressive emotional force and depth.¹⁸⁴

The most intensive of these all-Chinese thought reform programs for intellectuals is that conducted in the “revolutionary colleges”—set up all over China immediately after the Communist take-over. These were particularly active between 1948 and 1952 when they represented an ideological hard core for the entire thought reform movement, an extreme model for reform efforts throughout the population. Their techniques can give us a key to the understanding of all Chinese Communist thought reform programs, whether applied to Chinese intellectuals, United Nations prisoners of war, or Western missionaries.

The forms (criticism, self-criticism, “struggle,” and confession) as well as the content (the allegedly scientific Marxist doctrine) of the program appear to be carried over from Russian Communist practice. But the Chinese have integrated these into a comprehensive process, contributing an emphasis upon reform rather than purge, as well as the nuances of group and individual psychological pressures.

As the decade of the 1950s progressed it was possible to reduce the emphasis on fear and increase the use of methods of persuasion. Some of these were copied from the Soviet Union. The People’s Republic has been free of the wholesale purges and liquidation of leading figures which marked the Stalin regime in the USSR. But the methods of persuasion included severe psychological pressures on individuals, which were justified by the CCP as necessary to turn the thinking of the entire country around. The system of self-criticism, and criticism by others in small groups, was adopted as standard in the retraining process in which thousands, then millions, were involved. Feelings of guilt, shame, and “face” were used as manipulative devices in brainwashing (the literal translation of *xi-naa*). Silence was no defense; everyone had, sooner or later, to take part. When the confession was finally accepted, the individual experienced an enormous sense of relief and cleansing. He or she came to associate this new “liberation” with the Communist way of life and with service to the people.¹⁸⁵ Emotions, sentiments, individual plans all were to find their place only in the battle for a new society. These highly intensive

¹⁸⁴ Robert J. Lifton: “Thought Reform of Chinese Intellectuals: A Psychiatric Evaluation”, **The Journal of Asian Studies**, Vol. 16, No. 1. (Nov., 1956), p.p. 75.

¹⁸⁵ Robert J. Lifton: “*Ibid.*” p. 83.

methods of persuasion were effective in raising trained cadres, winning over enemies, extracting confessions, and gaining control of the masses.

Thought reform has played a large part in superimposing a new Chinese Communist “culture,” particularly in the intellectual and ideological spheres. As the younger intellectuals emerge with their educations increasingly limited to Communist teachings, there may be less emphasis upon “reform” and more focus on continuing indoctrination. This trend has already begun, as evidenced by the conversion of most revolutionary colleges into more conventional Marxist schools and training centers. But thought reform is nonetheless a continuing program, and much attention is still given to the “correction of ideological errors” throughout the population.¹⁸⁶ Since one never can achieve god-like perfection in the Communist rites, the Chinese intellectual is likely to continue to find his “human feelings”¹⁸⁷ under cyclic bombardment from this strange combination of psychological pressures developed for his “reeducation.”

B- THE CULTURAL REVOLUTION AND ITS AFTERMATH 1966 -1978

Unquestionably the major event of the 1960s in China was the Great Proletarian Cultural Revolution (*ywuthan jieji ivciibua da Renting*). That it had resulted with shaking the Party and the country to their foundations, closed schools and universities, slowed production, and virtually shut down all diplomatic activity. It reached its most virulent and terrifying stage in the first two years, 1966 to 1968. Mao appeared to think it ideologically worthwhile, although for a period the revolution was almost out of control.¹⁸⁸ The basic values of the Cultural Revolution, however, were sustained until Mao’s death in 1976.

The struggle that became the Cultural Revolution took shape during the years of recovery after the Great Leap Forward. At first Mao withdrew from the policy-making process, referring to himself as a “dead ancestor,” but from 1962 to 1965 he worked to increase his influence and reassert his ideas.¹⁸⁹

In all types of organizations visited - industrial, agricultural, and educational - the Cultural Revolution resulted in remarkably few permanent dismissals of cadres or expulsions of Party members. First, young Cultural Revolution activists have gained positions in many

¹⁸⁶ Morton, W Scott: **China: Its History and Culture**, McGraw-Hill Companies, 2004, p. 208.

¹⁸⁷ Morton, W Scott: “*Ibid*”, p.211.

¹⁸⁸ Ellis Joffe: “China in Mid-1966: “Cultural Revolution” or Struggle for Power?” **The China Quarterly**, No. 27. (Jul. - Sep., 1966), p.125.

¹⁸⁹ Morton, W Scott: “*Ibid*”, p. 215.

organizations.¹⁹⁰ Hundreds of thousands Mao-made young people, worshipping their maker with the little Red Book of his thoughts their hymnal, made radical puritanical and zealous revolution in his image. In June 1966 the anarchy in China began. Many young students left their studies and joined the exciting new movement to protect Chairman Mao and his Thought from revisionists.¹⁹¹

These huge Red Guard rallies were possible because students all over China simply quit school and adventurously traveled all over China to “make revolution” and do quixotic battle against the phantom counterrevolutionaries and reactionaries.¹⁹² They were given free passage on China’s train and bus system to just about anywhere, which enabled the Red Guard generation to see more of China than any other generation in Chinese history.¹⁹³ The ultimate destination for millions of Red Guards was, of course, Beijing. Through this movement the youth of China became involved in the most basic and powerful levels of the Chinese political process.¹⁹⁴

The Cultural Revolution was an exciting time for the Red Guards and other perpetrators, but for its victims (variously called counterrevolutionaries, reactionaries, revisionists, capitalist readers, and the like) it was a time of enormous suffering and hardship. And to these problems there was soon added a new issue: As the military took charge in the provinces they handled the Red Guards roughly in the interest of rapidly restoring order. Many Red Guards were arrested; Red Guard activities were restricted and “rebel” privileges withdrawn; and some Red Guard groups were suppressed outright. Moreover, the military were making the real decisions at the provincial level. In effect, military regional and district commanders and their subordinates had become a new set of “persons in authority.”¹⁹⁵

The fall of 1968 was the end of the Cultural Revolution proper, and it was officially declared over in the spring of 1969. Its lingering effects however, continued to resound with echoes until Mao’s death in 1976. After 1969 movements reminiscent of the Cultural Revolution

¹⁹⁰ Frederick C. Teiwes: “Before and after the Cultural Revolution”, **The China Quarterly**, No. 58. (Apr. - Jun., 1974), p.p... 333.

¹⁹¹ Stanley Rosen; Hong Yung Lee; “The Radical Students in Kwangtung during the Cultural Revolution”, **The China Quarterly**, No. 70. (Jun., 1977), pp. 390-406.

¹⁹² W. Richard; Amy A. Wilson: “The Red Guards and the World Student Movement, **The China Quarterly**”, No. 42. (Apr. - Jun., 1970), p. 101.

¹⁹³ John Israel: “The Red Guards in Historical Perspective: Continuity and Change in the Chinese Youth Movement”, **The China Quarterly**, No. 30. (Apr. - Jun., 1967), p.13.

¹⁹⁴ Juliana Pennington Heaslet: “The Red Guards: Instruments of Destruction in the Cultural Revolution”, **Asian Survey**, Vol. 12, No. 12, The Cultural Revolution and Its Aftermath. (Dec., 1972), p.1032.

¹⁹⁵ Charles Neuhauser: The Impact of the Cultural Revolution on the Chinese Communist Party Machine, **Asian Survey**, Vol. 8, No. 6. (Jun., 1968), p. 479.

flared up occasionally but were not given the full rein they had in 1966 and 1967.¹⁹⁶ Mao knew that his Cultural Revolution was, like his Great Leap Forward of the late 1950s, a monumental failure. It ended with the deaths of more than one million Chinese and massive disruptions in the lives of almost all of China's urban population. Mao's will was to force the people to harness their energy and restlessness for the revolutionary cause, but instead of furthering the revolution they plunged China into social and economic chaos. They the Party and its officials and they attacked each other. Workers and peasants were drawn into the fight, first in reaction to the Red Guards and then, formally, by invitation from Peking, to make revolution themselves.

Although important changes have taken place in Chinese politics and society since the launching of the Cultural Revolution, in many respects the situation in 1973 appears different from 1965 only in degree.

It is worth asking whether the results of the Cultural Revolution manifest in 1973 could have been achieved at less cost by a combination of traditional rectification methods and administrative measures. The prospect for the "cultural revolution," in the short term, then, is for continued turmoil and disorder.¹⁹⁷ It is important to remember, however, that this disorder has been decreed by Mao as essential for the success of the revolution and that there are limits to the disorder beyond which even Mao will not go. At the very least, it is premature to conclude that the party and state system in Communist China has been irreparably damaged.

1- Economic Policies

The political radicalism of The Great Proletarian Cultural Revolution (GPCR) was paralleled by an economic radicalism that profoundly affected China's industrial organization. Fearful of Russian pressures on the northern borders and American aggression in Vietnam, Mao pressed for a massive relocation of military-industrial development to the interior of the country.¹⁹⁸ Railways, mines, hydroelectric dams, steel mills, and ball-bearing factories were constructed deep in mountain or desert regions where they would be safe from foreign invasion. As part of this strategy, everyone became involved in the construction of underground tunnels, subways, and bomb shelters. It has been estimated that China spent over 140 billion Yuan on these programs, a vast redirection of capital investment away from coastal regions; however, the new construction was so inefficient and wasteful that in the end much of it had to be abandoned.

¹⁹⁶ Guobin Yang: "The Liminal Effects of Social Movements: Red Guards and the Transformation of Identity, **Sociological Forum**", Vol. 15, No. 3. (Sep., 2000), p.398.

¹⁹⁷ Philip Bridgham: "Mao's "Cultural Revolution": Origin and Development", **The China Quarterly**, No. 29. (Jan. - Mar., 1967), p.p... 1-35.

¹⁹⁸ Morton, W Scott: "Ibid", p. 219.

Besides the relocation of China's industries, its management was also decentralized, giving local governments autonomy to set up small-scale rural industries.

In the mid-1950s, the Maoists were successful in securing the rapid reorganization of agricultural production through the logical succession of stages commensurate with their objectives: the elementary agricultural producer's cooperative, the advanced agricultural producer's cooperative, and finally the commune in the Great Leap Forward (1958). The steady erosion of the limited free market activity, private plots and production, differential money-wage payments, and the steady erosion of the unilateral, vertical control of the Central Government's bureaucracy over the economy accompanied these successive reorganizations.¹⁹⁹

In industry, the Soviet model and its centralized allocation of resources was abandoned in favor of local initiative and adaptation to the productive powers inherent in the spontaneous enthusiasm of the masses. This program too was hasty, inefficient, and badly managed. But heavy investment in these programs contributed to a dramatic industrial growth, estimated at 13.5 percent annually between 1969 and 1976,²⁰⁰ while rural productivity and living standards were stagnating. By 1976 China's leaders could no longer control the economy, while new local elite of Party managers had gained excessive influence.

In general, therefore, agricultural production did not appear to have been seriously affected by the GPCR during 1966, even though little increase was registered during the year. Industrial production and transportation suffered, but only during the latter half of the year and perhaps not in very many places or for protracted periods. Foreign trade, a mirror of production, thus actually attained a record level of \$4.2 billion for total exports and imports.²⁰¹ Thus far, therefore, the GPCR had not noticeably affected the level of aggregate economic activities.

The estimate of agricultural production in 1967 was equally puzzling. At the end of September 1967 the summer harvest was said to be 10% above the corresponding figure for 1966.²⁰² The same was claimed for the early autumn harvest. In contrast to these, there was no overall claim for all crops or for the whole year. The increase in production, if any, lagged behind that of government collection, and the latter may have served to alienate the peasants from the PLA. Thus, economically, 1967 was probably a worse year than 1966. In general,

¹⁹⁹ Robert F. Dernberger: "Radical Ideology and Economic Development in China: The Cultural Revolution and Its Impact on the Economy", *Asian Survey*, Vol. 12, No. 12, The Cultural Revolution and Its Aftermath. (Dec 1972), p. 1053.

²⁰⁰ Choh-Ming Li: "China's Industrial Development, 1958-63" *The China Quarterly*, No. 17. (Jan. - Mar., 1964).

²⁰¹ Robert F. Dernberger: "Ibid." p. 232.

²⁰² Robert F. Dernberger: "Ibid." p. 233.

industry has suffered. On the other hand, there is no evidence that the declines which occurred were of a permanent nature.

The Cultural Revolution, of course, was a unique historical phenomenon which had its origin in a complicated matrix of domestic and international political developments and ideological debates, the emergence of serious domestic economic problems, and the normal play of private ambitions spawned and seeking legitimacy in an unstable revolutionary situation. Initially, the economy was isolated from disruptive effects from the Cultural Revolution, but once the workers became active participants, serious disruptions in transportation and then production soon followed.

Without the necessary macro-data, it is impossible to assess the short-run impact of the Cultural Revolution on the economy. In April 1968, Chou Enlai admitted the 1967 plan had not been fulfilled and that the output of some products fell below the level attained in 1966. Western estimates show a decline in industrial production in 1967 of 18 per cent and, while increasing in 1968, the level of industrial production did not regain the peak level of 1966 until 1969. See Table 2²⁰³ below:

One Set of Major Economic Indicators: People’s Republic of China

	1963	1964	1965	1966	1967	1968
Agricultural Production (a)	90.00	96.04	100.63	105.75	114.51	105.75
Grain Output (b)	177.5	182.5	192.5	197.5	212.5	197.5
Industrial Production (*)	121.92	137.41	154.43	172.77	141.14	153.57
GNP (c)	82.46	89.99	97.15	104.96	101.11	99.71
Population (d)	721.3	735.4	750.5	766.3	782.5	799.6
Per capita GNP (e)	89.56	95.86	101.41	107.30	101.22	97.69

* Preliminary Index,
 a 1957 = 100 b Million metric tons
 c Billion 1970 U. S. dollars d Million persons, midyear
 e 1970 U. S. dollars

Table 2: One Set of Major Economic Indicators: People’s Republic of China

In regard to the economy itself, two significant changes can be observed since the Cultural Revolution. The Maoists have always attacked the existence of large differences in income or economic well-being as counter-productive to the elimination of class differences. Thus, income

²⁰³ Dongping Han: “Impact of the Cultural Revolution on Rural Education and Economic Development: The Case of Jimo County” **Modern China**, Vol. 27, No. 1. (Jan., 2001), pp. 59-90.

differentials are the monetary bases for the existence of “capitalist” values in a socialist society. Nonetheless, forced to admit the wage differentials also are the basis for increases in labor productivity and efficiency in economic activity, these have been allowed to remain. At the same time, however, these differentials are based, to a large extent, on seniority which serves welfare as much as an incentive purpose, and bonuses—a major source of income differentials in the Soviet Union—have either been reduced or eliminated. According to the available evidence, this attempt to reduce income differentials has not been entirely successful and serious income differences continue to exist among individual communes, between agriculture and industry, among industries, and within industries.

A second major ingredient of Maoism is the need for self-reliance. Large-scale, modern factories rely not only on imported equipment, but also require reliance on the technical expertise possessed by a relatively small core of Chinese technicians and foreigners. Again the Maoists realize the need for this technology and expertise and do not argue in favor of abandoning modern, large-scale industry.²⁰⁴ Rather, an attempt is being made to supplement urban, modern, large-scale industry with rural small-scale industries operated by the local authorities at the lowest level or by the commune or by production brigades within the communes. Employing less than 500 employees and utilizing self-provided equipment or used machinery provided by modern enterprises, these rural factories often resemble workshops. But they perform a most valuable function in utilizing agricultural and rural raw materials, training a rural industrial labor force,²⁰⁵ and producing the basic needs of the agricultural sector for iron, cement, coal, and machinery. According to published reports, these rural factories accounted for approximately 40% of China’s total output of cement and 60% of the total output of chemical fertilizer in 1971.²⁰⁶ Unlike the abortive attempt to sponsor rural, small-scale industries during the Great Leap, the current campaign is founded in a much more rational appreciation of the capabilities and needs of the rural areas and, therefore, has a much greater chance of success.

Finally, a basic objective of the socialist economic development of China is reliance on a planned allocation of resources instead of a blind reaction to short-run market forces. Yet there is no evidence to support the argument that the Chinese have recreated the Soviet model of planning utilized in the 1950s. Every factory is a socialist enterprise, i.e., under the authority of

²⁰⁴ Dongping Han: “Impact of the Cultural Revolution on Rural Education and Economic Development: The Case of Jimo County” **Modern China**, Vol. 27, No. 1. (Jan., 2001), pp. 59-90.

²⁰⁵ Paul J. Hiniker: “The Cultural Revolution Revisited: Dissonance Reduction or Power Maximization” **The China Quarterly**, No. 94. (Jun., 1983)

²⁰⁶ Lloyd G. Reynolds: China as a Less Developed Economy, **The American Economic Review**, Vol. 65, No. 3. (Jun., 1975), p. 423.

some level of the government, central, provincial, or commune. As a public enterprise, it receives its output and other economic goals from that authority, after consultation and deliberation by the Revolutionary Committee of the enterprise. These goals constitute the plan. Western observers have been unable to determine the exact nature of the planning mechanism in operation in China today, but there obviously is no nation-wide plan which incorporates the enterprises at all levels of the economy. Rather, each level of authority appears to be responsible for planning and coordinating the activities of those enterprises it controls, with each successive level of authority responsible for planning and coordinating only the resource flows between those political units directly under it. In other words, planning in China today consists of several tiers of planning from the lowest to the central government on the top, a planning system which can best be described as decentralized-planning or a decentralized-command economy in contrast to a market economy.

All of these innovations add up to a considerable adaptation of the Chinese economy as it existed before the Cultural Revolution. Furthermore, that process of adaptation is still being carried out, and, thus, it is impossible to depict the present situation as the end result of the Cultural Revolution. While considerable changes in economic institutions and policy may occur in the near future, enough empirical evidence is now available to judge the effect of those adaptations already made. Quite simply, insofar as aggregate economic performance is concerned, these adaptations appear to have worked very well.

According to the estimates published in reports recently submitted to the Joint Economic Committee of the U. S. Congress²⁰⁷, the average annual rate of growth in 1963-71 was 8.8% for industry, 3.1% for agriculture, and 5.7% for total Gross National Product.²⁰⁸ While not spectacular, especially in agriculture, these rates of growth, if sustained, would allow for a steady, but small, annual increase in the standard of living and a doubling of GNP in 12 years. Nonetheless, China is still a relatively underdeveloped country by almost any quantitative measure and the favorable results in the last few years do not warrant the euphoric conclusion presented in the report submitted to the Joint Economic Committee.

Almost from the start, the Cultural Revolution concentrated on the political aspects of the power struggle at the highest levels of the Party and Government. Discussion or debate over well-specified economic programs or institutions were conspicuously lacking and the general debate over economic policy the keystone of the ideological struggle taking place was often

²⁰⁷ <http://www.house.gov/jec>

²⁰⁸ Robert F. Dernberger: "Ibid." p. 1064.

obscured by the more terrible details of the power struggle.²⁰⁹ In fact, the Maoists quickly gained control over the national media and launched an attack on the economic policies of their opponents.

A new economic pragmatism gradually emerged under the direction of Zhou Enlai. In 1973, Zhou achieved the rehabilitation of his protégé, Deng Xiaoping, an economic moderate. At the meeting of the National People's Congress in January 1975, as one of his last public acts, Zhou called for a strategy based on the Four Modernizations (agriculture, industry, science and technology, and the military).²¹⁰ The Congress passed new regulations in a constitutional charter, which included the right of farmers in communes to maintain private plots for "sideline production", and the right of factory workers to perform limited work for themselves (provided they did not hire employees) and to engage in demonstrations and strikes.

It gradually became clear to the Chinese that the autarkic policies in force from 1964 to 1971 were immensely costly. Vast quantities of investment in the Third Front were simply wasted, and much investment was never completed. Regional self-sufficiency in grain imposed huge costs on agricultural productivity. Most significantly, China's technological and administrative capabilities fell increasingly behind advanced world levels, if they did not actually decline in absolute terms. By 1972, domestic economic considerations had begun to put pressure on the overall isolationist policy, and recognition of accumulating economic problems clearly made some Chinese leaders more receptive to a diplomatic opening to the United States. Yet here again, rapprochement with the United States can easily be explained by the Chinese need to establish a countervailing force to the Soviet Union, which was increasingly seen by the Chinese as an immediate strategic threat. While economic considerations reinforced that crucial foreign policy decision, it is unlikely that economic factors could have compelled such an important reorientation on their own.

For nearly thirty years, then, China's assessment of its international relations shaped its domestic economic strategy more than the reverse. Once a particular domestic strategy was chosen, it inevitably tended to reinforce the international policy orientation from which it emerged, but domestic development strategy cannot plausibly explain the choice of foreign policies in the first place. In order for domestic economic policies to shape foreign policy, it was essential that the international environment appear less threatening to the Chinese leaders. As

²⁰⁹ Michael B. Yahuda: "Chinese Foreign Policy after 1963: The Maoist Phases", *The China Quarterly*, No. 36. (Oct. - Dec., 1968), p.p. 93-113.

²¹⁰ W. Klatt: "China's New Economic Policy: A Statistical Appraisal", *The China Quarterly*, No. 80. (Dec., 1979), p. 716.

relations with the United States improved, and the danger of war with the Soviet Union receded somewhat, more weight could be given to economic considerations themselves.

The development strategy of China in these years has had six major components:²¹¹

1. The reduction in investment rates, and a stress on improved consumption,
2. A shift from a heavy industry strategy to a diversified industry strategy. Besides providing consumer goods for the Chinese people, this also began to build capacity to produce goods values on the international market.
3. Demilitarization.
4. A shift from a strategy that stressed regional autarky and inland development to one that envisioned a more differentiated regional structure and more rapid development of advanced coastal regions.
5. Entry in international markets and a greater reliance on international division of labour.
6. The declaration that future economic policy would be based on increasing productivity, rather than on equity or national defense considerations.

China's foreign trade expanded tremendously in the 1970s after the slow and fluctuating growth of the 1950s and 1960s. The amount of exports and imports increased from 2, 26 and 2, 33 billion U.S. dollars (in foreign market prices), respectively in 1970 to 18-12 and 1939 billion U.S. dollars in 1980. Discounting the world inflation factor, the real annual rate of increase for these 10 years is considered to be about 9 per cent for both exports and imports.²¹² Side by side, the commodity structure changed. The emergence of oil as a staple export commodity was one aspect and as a result China was able to withstand to a considerable extent the oil shock which occurred in and after 1973. The import of food grains became chronic and substantial. China's policy regarding the acceptance of foreign loans, credits and even joint ventures located within the country was significantly liberalized.

However, China's economic system remained semi-closed to international trade in the sense that the basic aim of the system was to achieve a domestic equilibrium (or optimum

²¹¹ Barry Naughton: "The Foreign Policy Implications of China's Economic Development Strategy" in Thomas W. Robinson and David Shambaugh, eds., **Chinese Foreign Policy: Theory and Practice** (Oxford, UK: Clarendon Press, 1994), pp 50-51.

²¹² These figures are obtained from the World Bank. Regarding the world inflation factor, refer also to the following IMF index for unit value of world exports and imports (with 1975 = 100) in International Financial Statistics, Supplement Series No. 2 IMF 1981.

resource allocation within the framework of the domestic economy) and exports were made available only to the extent that was necessary for import substitution, in particular, of heavy industrial products. The foreign trade expansion in and after the 1970s, though rapid, was still aimed at accelerating the import substitution of heavy industrial products within the framework of this system. The policy was weak in that, although a comprehensive system of heavy industries was built up, its technological level was in most fields far behind international standards. Therefore, the export substitution of industrial products for primary products could not proceed quickly, while the necessity of importing high-technology industrial products increased.

By the end of the Cultural Revolution, China faced a faltering economy and an ineffective and unproductive bureaucratic system.²¹³ Instead of producing a better life for the Chinese people, the Communist Party produced unneeded goods while the demands of the Chinese consumers remained unfulfilled.

In conclusion, while still a long way from having successfully solved its economic problem, the Chinese have emerged from the Cultural Revolution with considerable adaptations in their approach which have, thus far anyway, secured a modest, but positive and steady rate of economic growth. At times during the past two decades, China has appeared to the Western observer as a nation gone mad and the Cultural Revolution was certainly an unexpected or unpredictable period of instability.²¹⁴ Yet the Cultural Revolution is an integral part of the Maoists attempt to carry out one of the greatest social experiments in the world's history: an attempt which began in the early 1920s and continues to this day.

If it proves possible to achieve economic growth while at the same time achieving equality of income distribution, popular participation in decision making and in production itself, an education adequate for the needs of society which does not generate an elite based on sophisticated, but irrelevant intellectualism, and an allocation of resources which is coordinated according to what a society plans rather than the "blind" forces of the market, then the Chinese experiment indeed will have developed a new model for the other underdeveloped countries of the world. Following the disasters resulting from the Great Leap Forward in 1958, it appeared that the Maoists would not have a second chance to apply the Maoist model in China. The outcome of the Cultural Revolution has given them that second chance. China, however, is still underdeveloped and the experiment is just beginning. Thus we can't pass judgment on the basis

²¹³ Andrew G. Walder: China's Transitional Economy: Interpreting Its Significance, *The China Quarterly*, No. 144, Special Issue: China's Transitional Economy. (Dec., 1995), p. 966.

²¹⁴ Marshall I. Goldman and Merle Goldman, "Soviet and Chinese economic reform," *Foreign Affairs*, Vol. 66, No. 3 (1988), pp. 551-573

of the satisfactory, but not spectacular, results in the last few years. In other words, the long-run impact of the Cultural Revolution on China's economic development is yet to be determined by the course of future events. At the present time, there is no evidence to warrant excluding the possibility of either success or failure, but the Maoists are still alive and well in Peking.

2- The United Nations and the Wider World

After having suffered from the self-inflicted wounds of internal convulsions and diplomatic isolation during the Cultural Revolution, the People's Republic of China (PRC) has returned to the world diplomatic scene with a new, vigorous, and imaginative foreign policy. To appreciate its dimensions fully, one must recall that China's foreign policy was left largely unprotected from the disruptive spillovers of the domestic quarrels during the Cultural Revolution.

Relations between the People's Republic of China and the United States had all but terminated during the Korean War, and thereafter the United States pursued an anti-Communist "cold war" against China.²¹⁵ China's policy towards the United States did not greatly change in this period. The reappraisal of policy in Peking did not affect attitudes and policies towards the United States as such, except that Peking was attempting to isolate the Americans from their Western allies. The United States was already the explicit target for the CPR's projected international united fronts. Furthermore, hostility towards the United States provided a continuing bond between China's nationalistic aspirations and the development of revolutionary movements in the world at large.

U.S.A. refused to shake hands with Zhou Enlai at the Geneva Conference over Vietnam in 1954. The United States consistently led the opposition to the admission of "Mainland China" to the United Nations and supported the Nationalist Government on Taiwan, which had represented China since the United Nations was founded. The Geneva Conference of 1954 represented an important event in the development of China's foreign policy. For the first time, Beijing's diplomacy became the focus of attention in an international meeting. Despite American opposition and delaying tactics, the conference was a diplomatic triumph for China. It greatly enhanced Beijing's international status. China's leaders clearly perceived their role in global rather than in regional terms. Zhou Enlai played an important role in the Geneva Conference. He excelled in playing British and French realism off against the rigidity and inflexibility of American Cold War policies. His diplomacy epitomized the "United Front" strategy which has

²¹⁵ Allan R. Millett: "Ibid", p. 933.

been a distinct feature of the PRC's foreign policy: to unite with all possible forces to isolate China's most dangerous enemy.²¹⁶

The turnabout came in 1971 when President Richard M. Nixon publicly altered his own stand on China and prepared to pay an official visit to Beijing. How can we explain this extraordinary shift of policy by both countries: On the American side, the motive for reconciliation arose from the perception by Nixon and his secretary of state Henry Kissinger that China's growing influence, together with the rise of Japan and Western Europe, had created a new global power structure into which China should have to be reintegrated. Moreover, the new Sino-Soviet tensions seemed to offer an opportunity for the United States to use China for diplomatic leverage against Russia.²¹⁷ The Chinese, for their part, hoped that American support might deter a Soviet attack. It also seemed to them that Nixon might be helpful in Beijing's taking over the UN seat then occupied by Taipei and that Nixon would be supportive of the integration of Taiwan into the mainland.

On August 2, 1971, with negotiations for a Nixon visit well advanced, the United States announced it would support action at the fall meeting of the UN General Assembly to seat the PRC, but it would still oppose the expulsion of Nationalist China. On October 25, a resolution to expel the Republic of China and give the Chinese seat to the People's Republic, sponsored by Albania and twenty other minor nations, was approved in a historic vote of 76 for, 35 against, and 17 abstentions. The overwhelming majority for the PRC seemed to come as a surprise to the U.S. delegation.

The new foreign policy adopted by the PRC leadership demonstrated an extraordinary, almost unprecedented degree of flexibility and moderation by extending the permissible limits of normalization toward former enemies such as the United States, Japan, and Yugoslavia. Under the impetus of this new policy, the PRC's attitude toward the United Nations also assumed a direct, conciliatory, and flexible posture.²¹⁸ All the polemical indictments against the United Nations and the extraneous preconditions for participation disappeared. Instead, the PRC began to launch a new and sophisticated campaign to join the family of nations.

²¹⁶ Zhai Qiang: "China and the Geneva Conference of 1954", **The China Quarterly**, No. 129. (Mar., 1992), p. 121.

²¹⁷ Frank C. Zagare: "The Geneva Conference of 1954: A Case of Tacit Deception", **International Studies Quarterly**, Vol. 23, No. 3. (Sep., 1979), p. 397.

²¹⁸ Samuel S. Kim: "The People's Republic of China in the United Nations: A Preliminary Analysis", **World Politics**, Vol. 26, No. 3. (Apr., 1974), p. 303.

President Nixon's visit to China, thoroughly prepared for by Henry Kissinger and American China experts, took place in February 1972 amid much publicity and unprecedented television coverage. In this instance, personal summit diplomacy did serve a useful purpose in creating a new climate of opinion worldwide and influencing favorably the attitudes of the people of China and the United States toward each other after many years of isolation. A joint communiqué issued in Shanghai at the end of the visit pledged both countries to resume normal diplomatic relations as soon as they could be arranged. U.S. authorities were clear that this implied significant changes in their relations with Taiwan, although it was left open at this point exactly what these would be. In 1973 China and the United States established liaison offices in each other's capitals, another step toward full diplomatic relations which nevertheless did not come for another six years. Meanwhile, other countries had granted formal diplomatic recognition to the PRC. In March 1972 Great Britain, which had earlier recognized the PRC, established full diplomatic relations and acknowledged that Taiwan was a "province of China." In September, Prime Minister Tanaka of Japan visited China and established relations between Beijing and Tokyo. Altogether, in 1971-1972, thirty countries granted formal recognition to the PRC. China's hostile relations with the Soviet Union, however, continued and large concentrations of troops continued to be deployed on both sides of the Sino-Russian border.

The PRC began to pursue its Third-World diplomacy in the United Nations by supporting the economic, colonial, racial, nationalist, and anti-imperialist issues which make up the core of the main concern for most developing nations. To strengthen its support of Latin American countries further, the PRC, in an apparent contradiction of its own stand of 1958,²¹⁹ supported the struggle of many Latin American countries to stretch their territorial seas to 200 nautical miles. Moreover, the PRC vigorously and successfully endorsed the demand of most Latin American states to hold the United Nations Conference on the Law of the Seas in Santiago, Chile, in 1974.* Thus the PRC, through its Third-World diplomacy, has projected itself as a new and different kind of superpower which protects and promotes, rather than exploits and plunders, the economic resources of the "have-not member states of the United Nations."

The PRC's Third-World diplomacy also seems to be effective among the African states.²²⁰ In these years PRC was supporting African complaints or charges against colonialism, neo-

²¹⁹ Hungdah Chiu; R. R. Edwards: "Communist China's Attitude toward the United Nations: A Legal Analysis", **The American Journal of International Law**, Vol. 62, No. 1. (Jan., 1968), pp. 20-50.

* The site of the Conference has since been changed to Caracas, Venezuela.

²²⁰ George T. Yu: "Africa in Chinese Foreign Policy, **Asian Survey**", Vol. 28, No. 8. (Aug., 1988), pp. 849-862.

colonialism, and apartheid.²²¹ Huang Hua* reiterated the five principles of China's policy toward Africa: (1) support the African peoples in their struggle to oppose imperialism, colonialism and neo-colonialism and to win and safe-guard national independence; (2) support the pursuance of a policy of peace, neutrality and non-alignment by the governments of the African countries; (3) support the desire of the African peoples to achieve unity and solidarity in the manner of their own choice; (4) support the African countries in their efforts to settle their disputes through peaceful consultation; and (5) hold that the sovereignty of African countries should be respected by all other countries and that encroachment and interference from any quarters should be opposed."²²² The PRC's Third-World diplomacy in the United Nations also bears testimony to the strategy of translating weakness into strength. Indeed, this is a rational strategy of attempting to narrow the gaps between the ambitious objectives of the new foreign policy and the limited means and resources available to support or sustain them. China has been championing the causes of the Third World without assuming too much cost or obligation.

Despite her periodic protestations and disclaimers, the PRC is likely to continue to exploit and expand her economic, military, political, and diplomatic power potentials in order to achieve the status of a superpower. Yet the PRC finds the United Nations extremely useful in advancing her foreign policy interests in a number of ways. The United Nations serves as a marketplace for seeking and expanding her diplomatic relations. The United Nations is also a shield and a sword in the struggle against the Soviet Union.

3- The Death of Zhou Enlai

In 1949, with the establishment of the People's Republic of China, Zhou assumed the role of Prime Minister and Minister of Foreign Affairs. In June 1953, he made the five declarations for peace. He headed the Communist Chinese delegation to the Geneva Conference and to the Bandung Conference (1955). He survived an assassination attempt by Kuomintang (KMT) on his way to Bandung. In 1958, the post of Minister of Foreign Affairs was passed to Chen Yi but Zhou remained Prime Minister until his death in 1976.

²²¹ Winberg Chai: "China and the United Nations: Problems of Representation and Alternatives, *Asian Survey*, Vol. 10, No. 5. (May, 1970), pp. 397-409.

* Huang Hua (born January 25, 1913) was the foreign minister of China from 1976 to 1982

²²² Samuel S. Kim: "Ibid." p. 314.



Figure 3: Zhou Enlai

Zhou's first major domestic focus after becoming premier was China's economy, at an ill stage after decades of war. He aimed at increased agricultural production, from the even re-distribution of land. Industrial progress was also on his to-do list. He additionally initiated the first environmental reforms in China.

In 1958, Mao Zedong began the Great Leap Forward, aimed at increasing China's production levels in industry and agriculture with unrealistic targets.²²³ As a popular and practical administrator, Zhou maintained his position through the Leap. The Cultural Revolution (1966-1976) was a great blow to Zhou. At its late stages in 1975, he pushed for the "four modernizations"²²⁴ to undo the damage caused from the campaigns.

Known as an able diplomat, Zhou was largely responsible for the re-establishment of contacts with the West in the early 1970s. He welcomed US President Richard Nixon to China in February 1972, and signed the Shanghai Communiqué. Of all the Communist leaders, Zhou was the most knowledgeable concerning the world outside China. He was foreign minister from 1949 to 1958 and premier of the State Council from 1949 until his death. In all the ups and downs of politics, Zhou showed a remarkable ability to survive, even during the Cultural Revolution when his management of domestic strife made him indispensable to Mao.²²⁵ He constantly played a pivotal role in foreign affairs; for example, he was a key figure in China's split with the Soviet Union in 1961 and the approach to the United States in 1972.

²²³ http://en.wikipedia.org/wiki/Zhou_Enlai#Death_and_reactions

²²⁴ The Four Modernizations (Agriculture, Industry, Science and technology, National Defense) were designed to make China a great economic power by the early 21st century. These reforms essentially stressed economic self-reliance. The People's Republic of China decided to accelerate the modernization process by stepping up the volume of foreign trade by opening up its markets, especially the purchase of machinery from Japan and the West. By participating in such export-led growth, China was able to speed up its economic development through foreign investment, a more open market, access to advanced technologies, and management experience.

²²⁵ Lubell, Pamela; **Chinese Communist Party during the Cultural Revolution: The Case of the Sixty-One Renegade**, Palgrave Macmillan, (2001), p. 145.

What Zhou had done was for China's favor. Zhou was always interested in international politics. He went to France and then to Germany where he began to take interest in what was happening in the world. It was perhaps during his stay in Europe that he developed a world view. Zhou's great asset in negotiations was that he was a great listener, which is also very Chinese. Besides, Zhou came from a family of intellectuals which also must have greatly contributed to his talent as a negotiator. It must be remembered that even before the 1949 Revolution, he had acquired great experience in negotiating. His negotiations with the Russians and with the Kuomintang gave him the necessary skills. Zhou also negotiated with different American delegations which arrived at the Communist Party Headquarters in Yanan. So already, much before the Chinese Revolution, Zhou had developed the reputation of an expert in foreign affairs. It was, therefore, only natural and logical that he, in addition to other responsibilities as prime minister, was given the mandate to look after foreign affairs.

There is no doubt that Zhou played a crucial role in designing China's foreign policy. Zhou must have had an influence on Mao, if for no other reason but the sheer fact that Zhou was more knowledgeable about foreign affairs. He was familiar with the different configuration of forces operating in the international system. Mao respected Zhou's judgment, his analysis and his evaluations. But Mao also had his own views regarding the global international picture. Take, for example, the famous decision to open up to the Americans in the seventies.²²⁶ Clearly, it was Mao's decision, but once it was taken all the diplomatic input that went into the development of Sino-American relations was that of Zhou and his staff.

Take the Blooming of the Hundred Flowers, Zhou, through this movement, tried to introduce something like Chinese style perestroika. Though Mao and Zhou agreed with the idea behind the Hundred Flowers movement, they differed in their interpretation of the movement. For Zhou, the movement meant freeing the intellectuals from party dogmas and restraints. He was particularly concerned with China's technological development and thought that the movement should permit unrestrained research that the country badly needed. Mao, on the other hand, seemed to see the Hundred Flowers movement only as part of a total social mobilization and re-motivation of the people. And it is also possible that he looked forward to a bit of bashing within his own party, where power was increasingly falling from his hands into the hands of the others.

²²⁶ Zhou Enlai: Master of Diplomacy, **World Affairs**, Vol 2, Number 2 (Apr-Jun 1998). From: In an exclusive interview with World Affairs, eminent writer Han Suyin, highlights three major aspects of Zhou Enlai, his role as a diplomat, his task of a moderator in Chinese politics, and his feat of a protector of people during periods of extremism. (http://www.ciaonet.org/olj/wa/wa_apr98interview.html)

Discovering he had cancer, he began to pass many of his responsibilities onto Deng Xiaoping. Zhou came to know about his terminal illness in 1972; but it was kept a secret. Many hold Jiang Qing responsible for his death, for due to her constant intervention, he was not given proper treatment. But he worked right up to the end. By the end of November 1975, to give you an idea of his illness, Zhou had six major surgical interventions, eight blood cauterizes and one hundred blood transfusions. But despite all this, between June 1974 when he entered the hospital, and December 1975, he received sixty-three heads of state or foreign delegations, held one hundred and sixty-one meetings and managed to get out of the hospital twenty times.

4. Death of Mao and the Purge of Gang of Four

By 1970 Mao was so concerned about the perceived threats posed to China by the Soviet Union that he began to make his first tentative openings to the outside world. He tried to oust the Chinese Nationalists from the United Nations and to seat representatives of his own government

In early October, less than a month after Mao's death, over thirty radical leaders were purged, in the Chinese, not the Stalinist, sense: that is, they were arrested and deposed from their offices but not killed. Chief among them were Jiang Qing, Mao's widow and an initiator of the Cultural Revolution; Wang Hongwen, a Shanghai radical and deputy chairman of the Party; Zhang Chunqiao, a vice premier; Yao Wenyuan, another Shanghai radical; and Mao Yuanxin, a leader in the Manchurian province of Liaoning and a nephew of Mao Zedong.²²⁷ All but the last were soon designated "the Gang of Four," and a series of charges were brought against them for causing the disasters of the Cultural Revolution.

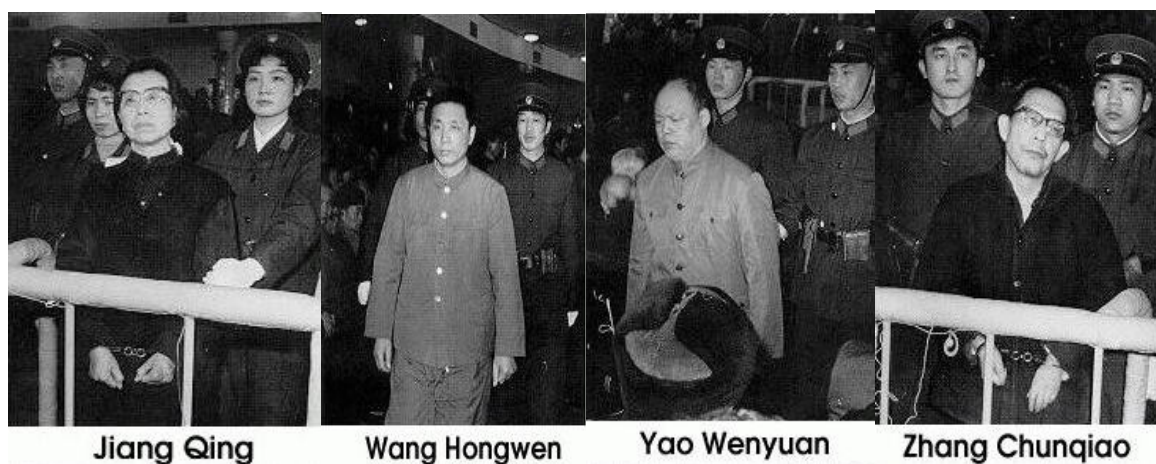


Figure 4: Gang of Four

They fell because they lacked sufficient force at the proper time. This lack, however, reflects a general political weakness, and the ideological weakness contributed to the political

²²⁷ Morton, W Scott: "Ibid.", p. 222.

weakness. The four did not have direct control over the major institutions of political power, but had relied instead on alliances with those who did have such control.²²⁸

The only “institution” fully controlled by the radicals was the city of Shanghai, and this was not enough since the lower-ranking members of Shanghai’s municipal committee appear to have come over to the victors’ side very rapidly. The radicals also seem to have had great influence within, if not control of, the central mass media. This allowed them to set the ideological tone of politics in China and to prevent the moderates from articulating any extended principled defense of their position. But influence within the media did not in itself allow the radicals to exercise control over concrete policy, nor did it allow them to consolidate their power.

The basic ideological weakness of the gang was the incompleteness of their radicalism, a necessary precondition if they were to enjoy power at all. In order to retain power, the radicals could not maintain an uncompromising rejection of “existing reality”; they had to make concessions. The year 1967 was perhaps the high point of mass radicalism in China. The “revolutionary masses” the Red Guards were “unleashed” and urged to overthrow the “power holders within the Party taking the capitalist road.” The mass movement, however, rapidly degenerated into anarchic gang wars, sabotage, and murders,²²⁹ and by late summer a coalition of the army and the state bureaucracy had begun to clamp down on the movement. The radical faction of that time, the “Central Cultural Revolution Group” (of which the gang of four was the last residue), had formed a kind of general headquarters for the Red Guard Movement.

Since the Cultural Revolution, and thanks in part to the compromises they had made, the gang of four had acquired their own comfortable bureaucratic stakes in “existing reality,” and these served only to underline the hollowness of their position. Their stake in the status quo was combined with a stake in the forms of radicalism; but this meant that their vested interest in the forms of radicalism was combined with a healthy fear of its content. Everyone knew that Mao did find the Gang of Four useful at times and occasionally gave his support to them as he saw fit, but Mao was still too much a revered figure to share in the blame. Mao was the unnamed fifth man in what was really a gang of five.²³⁰

The gangs of four leave a tradition behind them, however. Ironically, the force of this tradition might generate a further liberalization of the Chinese polity. While Mao was alive there

²²⁸ Jürgen Domes: “The “Gang of Four” and Hua Kuo-feng: “Analysis of Political Events in 1975-76”, **The China Quarterly**, No. 71. (Sep., 1977), pp. 473-497.

²²⁹ Peter R. Moody, Jr.; *The Fall of the Gang of Four: Background Notes on the Chinese Counterrevolution*, **Asian Survey**, Vol. 17, No. 8. (Aug., 1977), p.715.

²³⁰ Wright, David C.: **History of China**, Greenwood Publishing Group, Incorporated, 2001, p.165.

could be no fundamental change. The opposition of the Gang of Four and other radical diehards which led to the abrupt dismissal of Deng in April 1976 forestalled plans for modernization. But extreme Maoist convictions were likely to lead to economic stagnation since they discouraged the international cooperation on which technological change increasingly depends. The death of Mao and the weakening of ideology allowed more pragmatic policies to prevail.

5- Implications of the Cultural Revolution for China's Future

Was the Cultural Revolution a nightmare for the people and Communist rulers of China with no relevance for the future of that country? Some might define the Cultural Revolution as an event connected with Mao and his power over one faction of the Communist Party, the military, and urban privileged youth of the time. That was an important part of what happened, but the essence of the Cultural Revolution is that it was a technique used by one group in the Communist Party to remove and punish those whom it opposed.

During the time of Mao, first, the Chinese Communist Party succeeded in establishing a totalitarian regime. Its rule met the characteristics of the classic definition of totalitarianism, including a comprehensive ideology, a single ruling party led by a dictator, secret police or other methods for carrying out political terror, a monopoly of mass communications, a monopoly on political organizations, and dominant control of the economy.²³¹

Second, the Communist regime caused immense human suffering to the people of China. During the period of consolidating power from 1949 to 1956, it is estimated that the regime killed from 30 to 60 million persons.²³² This number includes the estimated 20 million people who died among the 50 million who were sentenced as “counterrevolutionaries” to many years of forced labor in prison camps. To these victims must be added the 20 to 30 million persons estimated to have starved to death as the result of the decision by Mao to establish agricultural communes and to continue them despite evidence of enormous suffering.²³³ By one carefully researched estimate nearly eight million persons were killed during the Cultural Revolution. Taken together, these estimates indicate that during the Mao years, 1949-1976, the total victims include from 50 to more than 100 million persons killed, and more than 134 million persons were subjected to severe deprivation of human rights and punishment, whether through long

²³¹ Byung-joon Ahn: “The Cultural Revolution and China’s Search for Political Order”, **The China Quarterly**, No. 58. (Apr. - Jun., 1974), p. 261.

²³² Lubell, Pamela; “Chinese Communist Party ...”, Palgrave Macmillan, (2001)

²³³ Lawrance, Allan: “China under Communism..”, p. 40.

confinement in forced-labor camps or by being sent away from their homes and forced to live for years in remote areas in poverty performing hard manual and agricultural labor.

A third characteristic is that factional conflicts within the Communist ruling elite often resulted in sudden, wrenching changes in regime policy, often leading to immense human suffering (e.g., mass starvation resulting from Mao's shift to rural communes).

Fourth, on repeated occasions, the military institution and military leaders played a major role in determining the outcome of policy and factional disputes within the communist party, and therefore in deciding national policy. Though arguably the military is now more professional, and senior military officers constitute a smaller proportion of Politburo members than in past decades, highly influential role of Chinese military leadership has continued from the Mao era to present.

Fifth, the relationship of Communist China with the Soviet Union involved a complex intertwining of Communist Party factional politics in both countries, with groups in both regimes trying to use the relationship for their own purposes. Mao began with a positive view of the Soviet Union as a key ally, but within several years he shifted to seeing the Soviet Union and its allies within the Chinese Communist Party as a threat to his hold on power and the Soviet Union as a potentially grave international danger to China. In many respects, Mao launched the Cultural Revolution to weaken what he perceived to be the pro-Soviet elements of the Chinese Communist Party. This pattern has important echoes in the newly close relationship between post-Soviet Russia and China which developed in the 1990s. Each seeks certain benefits from the other but with the recollection of past suspicions.

Sixth, Communist China initiated major military attacks suddenly and with large forces. This included the military occupation of Tibet in 1950; the intervention in the Korean War (1950-53), with nearly one million Chinese troops; the attack on India in 1962; the preemptive invasion of Communist Vietnam in 1979; and a number of smaller military occupations of disputed territories in the 1990s into the present.

Seventh, during the Mao years China was consistently able to deceive and mislead a significant proportion of international observers, both in Western democracies and among developing countries, about the realities of life in China and its internal and international policies. This deception is reflected in China's proclamation since 1955 of the "Five Principles of Peaceful Coexistence" as the basis for its international policies, even while attacking India and providing weapons training and support for insurgencies seeking to overthrow the governments

in a number of neighboring countries. The deception was also reflected in the ability of Mao's China to project an apparent sense of purpose, order, and success that led many in the West—not only those sympathetic to Communism—to view China, even at times of its greatest internal upheavals, as a model society and an example to be emulated. This pattern of successful deception has continued.

There is a lesson pertaining to China's future: As long as China is ruled by the Communist Party, there is always the possibility of severe factional conflict, leading to apparently sudden and major changes in the domestic and international policy of the regime. In turn, the regime's new wealth and military capabilities would permit the hardliners within the Party and the military to accomplish their international objectives, including the taking of Taiwan. The Cultural Revolution warns that hard-line elements of the Communist Party and the military could in the future work together to remove or subordinate the economic pragmatists, leading to a China that is even more repressive at home and far more aggressive internationally.

C. DENG XIAOPING ERA 1978-1992

Deng's Xiaoping's era has seen the unprecedented opening-up of Communist China. Since the later nineteenth century China had been subject to increasing western influences. But after 1949 the circumstances of the Cold War tended to isolate China from the world economy, and Maoist introspection, if for a time it tolerated Soviet Russian ideas, did not welcome Western thought. Both as proud nationalists and as ideological (lag bearers in the 1950s and 1960s the Chinese saw virtue as the reward for the necessity of being self-reliant. This was in contrast to the other developing countries which had the benefits and disadvantages of being economically tied to the developed world often in a colonial, post-colonial or neo-colonial relationship. With the ending of the Cultural Revolution it fell eventually to the Dengists to oversee a wide and growing interaction with the rest of the world. Economic growth led to a political problem. In place of the economic dead end of Maoism there arose the contradiction between international mores the rule of law and democracy and the totalitarian traditions of the Communist party, determined to maintain stability by enforcing conformity. Democracy was arguably too novel in China to be absorbed painlessly if at all. It has caused a big question mark to hang over Deng's regime.

It was Deng above all others who masterminded China's remarkable development in the 1980s. Was he driven by principles he had held long and consistently? For much of his career he was a loyal and respected follower of Mao but he appears less ideologically dogmatic in his

commitment to communism than many other Party leaders. He has a reputation for pragmatism but it would be misleading to describe him as just a pragmatist. He was a revolutionary whose commitment to modernization was linked to the pursuit of economic growth by which living standards would rise.

Deng Xiaoping's rise to power in 1978 set the conditions for a new period of planned reform within the framework of the Communist political order. This period may be said to have begun with the Third Plenum of the Eleventh Central Committee in December 1978, when Deng Xiaoping's leadership was formally recognized. Deng's program of reforms, launched under the banner of the Four Modernizations and called "socialism with Chinese characteristics," attempted to open the country to the global economy yet preserve the existing Party-state. There was a struggle here who tried to adopt Western technology and methods while preserving the imperial state and Confucian social values. In the case of Deng's reforms, the Communist Party-state did not seem to be in immediate jeopardy, but the Hood of Western ideas and institutional changes that tried to been adopted into China in the 1980s and 1990s raised questions about Party control and forced the Party to adopt new ideas and methods to sustain its legitimacy.

1. Politics in the Early 1980s

The members of the Gang of Four, although purged in 1976 following the death of Mao Zedong, were not formally put on trial until November 1980. Among the charges against the Gang of Four and the others tried with them were sedition, conspiring to overthrow the government, persecution of Party and state leaders, suppression of the masses, persecuting to death 34,380 persons during the Cultural Revolution (among them 16,322 in Inner Mongolia), plotting to murder Mao Zedong, and fomenting an armed rebellion in Shanghai.

Meanwhile, the episode of the Gang of Four raised questions about the historical role of Mao Zedong himself. The first open sign of a change in thinking came at the time of the trial when, on December 22, 1980, the People's Daily carried a front-page article saying that Mao Zedong had made-mistakes in his late years, especially in initiating and leading the Cultural Revolution, mistakes which had brought grave misfortunes to the Party and the people. But the assessment of Mao's historical role was a delicate matter for the Party. Many of the leaders, formerly associates of Mao, had themselves been the victims of his policies during the Cultural Revolution.²³⁴

²³⁴ Morton, W Scott: **China: Its History and Culture**, McGraw-Hill Companies, 2004, p. 229.

After the arrest of the “Gang of Four” and the marginalization of the Leftists, Deng Xiaoping consolidated his power and became China’s paramount leader. Deng Xiaoping’s political line was established during the Third Plenary Meeting of the Eleventh Central Committee of the CCP held in December 1978. The three major tasks laid down for the 1980s and 1990s for the CCP were domestic economic construction, national unification, and the maintenance of world peace. In essence, political struggle and world revolution were no longer in vogue. China’s relations with the West should be improved so that Western capital, markets, and technology could be utilized to promote China’s development.²³⁵

By the end of 1981 Deng had gathered into his hands control of China’s three pillars of power, the army, the government and the Party. Recalling Mao’s arbitrary exercise of power, which had brought on the Cultural Revolution, Deng did not assume the highest offices himself. Instead, he worked through his protégés, Zhao Ziyang, who had been named premier in September 1980, and Hu Yaobang who became the general secretary (a new and less pretentious title) of the Party in 1981. With the getting rid of Hua Guofeng from the Party that June, Deng assumed control of the Central Military Commission and thus maintained direct control of the army. Deng’s position as paramount leader of China had become impregnable.

It was now possible for Deng and his colleagues to institute political reforms designed to prevent recurrence of the chaos of the Cultural Revolution. The first step was to prevent the concentration of power in a single person. Government leaders were now allowed limited terms instead of life tenure, and the prime minister was to serve no more than two five-year terms. A complete review of Party membership was undertaken to eliminate those with extreme views. All members of the Party were considered to have resigned en masse, and Party leaders in factories and offices decided on ideological grounds who could rejoin and who would be dropped from membership. Reeducation through study of the works of Deng and Marx was required, and there was a nod to the hard-liners in the form of a warning against “spiritual pollution” through the corrosive influence of China’s contacts with the West. No figures were published, but foreign estimates indicated that from 1 to 3 million probably lost their Party membership.²³⁶

Deng himself had resigned as vice premier in 1980 because of old age (he was then seventy-six), along with two other vice premiers, Li Xiannian and Chen Yun.

²³⁵ Lau Siu-kai, **Pragmatic Calculations of National Interest: China’s Hong Kong Policy from 1949 – 1997** in *Chinese Foreign Policy: Pragmatism and Strategic Behaviour* (2004), An Eastgate Book, London.

²³⁶ Morton, W Scott: **China: Its History and Culture**, McGraw-Hill Companies, 2004, p. 230.

2. Social Changes and Open Door Policy

In 1978 it was noticed that making economic modernization central to all Party work and to play down ideology and class struggle. At the time of Mao's death the countryside was organized on the basis of communes (dating from the Great Leap Forward), under which were production brigades and production teams. The communes had been the main instrument for centralized planning and distribution, which had been proven inefficient. The new economic policies attempted to promote market incentives to overcome these inefficiencies. Following practices that had been initiated in Sichuan, where Zhao Ziyang had been Communist Party secretary after 1975, farm families who agreed to sell an amount of grain to the state were permitted to assume responsibility to market the surplus. This so-called household responsibility system brought bumper grain harvests in 1982, 1983, and 1984, and other crops such as cotton also surged.²³⁷ Private markets quickly emerged, and rural towns again became bustling centers for exchange. As the rural household became the basis of production instead of the brigades and teams, the system of collectives was gradually abandoned. In 1982 the new state constitution revived the old township structure and reduced the scale of administration: 96,000 township governments replaced 55,000 peoples' communes.

Meanwhile, in the cities, reform proceeded more slowly. Workers in state-owned enterprises were accustomed to the "iron rice bowl" of subsidized food and housing, permanent employment, and pensions on retirement. Urban enterprises were overstaffed, increasingly so as young people were no longer sent to the countryside and others had returned. Only in the years 1980-1981 did the government turn to reform of the industrial sector. In 1981 it declared an end to guaranteed employment and in 1982 it began to experiment with an employment merit system. In this system, first initiated in Beijing, newly hired workers were first placed on probation, and then required to sign a contract with conditions imposed by the employer. This new merit system was openly stated to be the "end of the iron rice bowl." The government also permitted small entrepreneurs to set up private or collective businesses, such as restaurants and repair shops. Those who couldn't get work in the state-owned enterprises now had incentive to engage in nongovernmental enterprises.²³⁸

Economic development proceeded most quickly along China's eastern and southern coastal cities. In 1980 Deng announced the formation of four Special Economic Zones on

²³⁷ Yusheng Peng: "Agricultural and Nonagricultural Growth and Intercounty Inequality in China," 1985-1991, *Modern China*, Vol. 25, No. 3. (Jul., 1999), p. 238.

²³⁸ Dwight Heald Perkins: "Reforming China's Economic System" *Journal of Economic Literature*, Vol. 26, No. 2. (Jun., 1988), pp. 601-645.

China's southern and eastern coastline where exports, joint ventures, and foreign investment would be encouraged and facilitated. The largest of these was Shenzhen (north of Hong Kong), today a thriving metropolis of crass commercialism and unbridled capitalism. Other areas in the Chinese hinterland, away from the prosperous coastal regions, lagged behind in economic development and began to nurse a sense of resentment and alienation from the rest of the nation.

“The five main components of China's economic strategy”²³⁹ during the time of Deng Xiaoping were:

(1) It is aimed at eliminating sectoral imbalances by giving greater priority to light industry, and by stimulating agriculture through increasing the purchase prices for rural products and giving peasants greater incentives. A prosperous peasantry (and farm sector) is seen as a prerequisite for further economic development. It will provide a market for light industrial products as well as some of the raw materials (such as cotton) for light industry. Similarly, an expansion of the light industry sector is seen as a vital component of China's development for a number of reasons.

(2) Increased production of consumer goods is seen as essential in order to provide immediate tangible rewards to those who can succeed in amassing wealth. Light industry also promises to provide the quickest and cheapest means of absorbing the massive number of unemployed, while its profitability holds out the hope of generating funds for self-sustaining investment. Indeed, the incentive packages, devolution of decision-making powers and right to retain and invest profits are designed to encourage such self-funded development, leaving central state funds free for investment in much needed infrastructure (transport networks and power generation) and the importation of advanced technology.

(3) Individual enterprise has been encouraged as a valuable adjunct to the ‘socialist economy’ and family enterprises have mushroomed. This has resulted from recognition that a system totally reliant on state and collective ownership is incapable of providing the necessary employment and services.

(4) There has been a switch from an extensive development strategy based on continuous investment in new productive capacity to one of intensive development based on improvements in existing capacity. As a result of this change,

²³⁹ Dennis Woodward: “China's Industrial Reform Policy” *The Australian Journal of Chinese Affairs*, No. 14. (Jul., 1985), p.87.

(5) There has also been a remarkable reversal in China's willingness to become involved in the international economy. This has taken the forms of a preparedness to incur foreign debt, to expand trade and to allow foreign investment. Underlying this move to an 'open door' policy is an appraisal that relative isolation from the world economy has kept China technologically backward and that there is much to be learnt from advanced industrial countries even though they may be capitalist. Included in this is a partial reliance on market mechanisms to improve quality and efficiency and to overcome the numerous problems inherent in a centrally planned and controlled economy administered by a burgeoning bureaucracy. It is to these problems and the solutions proposed that this paper will now turn.

To obtain access to foreign technology, China began to offer foreign firms the opportunity to enter into joint ventures. An example was the joint venture begun in 1983 between the American Motors Corporation and the Beijing Automotive Works to build jeeps. China already had basic technology for building automobiles and was using it in its Beijing factory; the objective now was to gain advance technology as well as access to an expanded market. The plan was eventually to use AMC engines in the cars and produce an improved model based on an American design. For foreign managers, these early ventures produced much frustration because of a state-controlled economy and their own insensitivity to cultural differences.²⁴⁰ Only in the 1990s did these joint ventures take off.

An even more complex joint venture was the building of China's first nuclear power plant at Daya Bay in Guangdong.²⁴¹ China owned 75 percent of the project and the Hong Kong Light and Power Company the remaining 25 percent. Negotiations took seven years, culminating in 1985, and provided for obtaining nuclear reactors from France and turbines and generators from Great Britain. By the early 1990s, more nuclear power plants were being built, but they would not come on line for several years.

²⁴⁰ Dennis Woodward: "Ibid".

²⁴¹ <http://dayawane.ihep.ac.cn/docs/location.html>

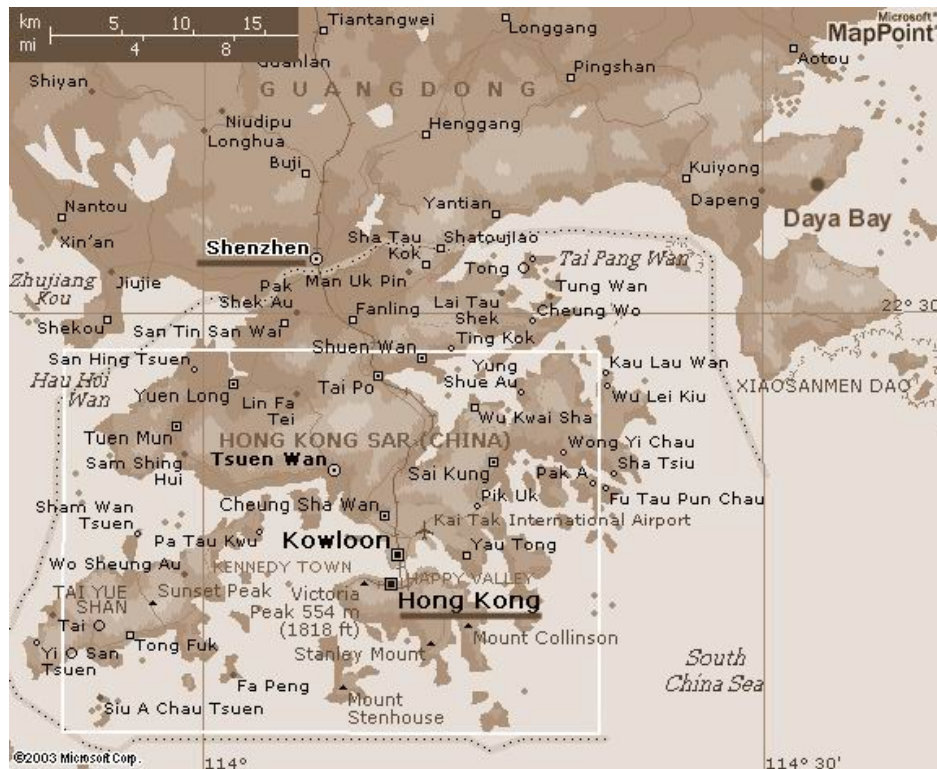


Figure 5: Location of Daya Bay Nuclear Power Plant

A related attempt to attract foreign capital was the opening of special economic zones that offered preferential tax treatment. Four of these areas were established on the coast in 1979, and four more were added in 1985. Among the locations chosen was the Pearl River estuary close to Guangzhou, Shantou in northern Guangdong, Xiamen (formerly Amoy) in Fujian and the peninsulas of Shandong and Liaodong opposite each other in the north. One of the principal sites, Shenzhen, just over the border from Hong Kong's New Territories, quickly became a boomtown with many of the characteristics of its wealthy neighbor. Foreign investment began slowly, but in the late 1980s it increased dramatically as China's East Asian neighbors, particularly Hong Kong, began moving their industries to China to take advantage of lower labor costs. Deng had deliberately wooed Chinese businessmen in Hong Kong, Thailand, Malaysia, Indonesia, Singapore and (in the 1990s) Taiwan to invest and trade in China. By the early 1990s overseas Chinese were contributing almost 80 percent of China's foreign investments. China's southeast coast became the most dynamic region not only in China but in all of Asia. By the early 1990s development had begun to spread inland like ripples, visible in the changing skylines of provincial capitals in the interior provinces.²⁴²

These trends were aggravated by a dangerous inflation as domestic markets expanded. By 1980 prices were already up by 7 percent, and by 1988 China was experiencing the worst

²⁴² Morton, W Scott: **China: Its History and Culture**, McGraw-Hill Companies, 2004, p.232.

inflation in PRC history. The government turned again to a program of economic retrenchment, making cuts in oil and coal production, capital construction, and defense. Farmers began to experience fluctuating grain prices and policies, while urban workers suffered layoffs. In addition, serious corruption had appeared in the state-owned enterprises as officials diverted funds from the state enterprises into their own private investments. China lacked both the legal controls and an independent judiciary that could make corrupt officials accountable. The social fallout from these developments threatened political stability around the country.

By the help of the Open Door Policy, no longer are capitalist foreign countries seen as a source of contamination which would undermine the socialist system, but rather as a source of advanced technology, expertise and investment considered essential for China's rapid modernization.²⁴³ Foreign management techniques are influencing industrial reform policies, while foreign technology is being enthusiastically sought to boost output levels and quality. As industrial reform progresses, a managerial and bureaucratic clientele is emerging with a vested interest in maintaining the 'open door' policy.

The driving force behind this 'open door' policy is clearly the desire to acquire the most advanced technology which is seen as the linchpin of economic development. This is associated with the shift in economic strategy from extensive to intensive development policies. Both trade and foreign investment are being directed towards this end. This is not surprising when one considers that a 1980 report estimated that as much as 60 per cent of China's capital stock should have been scrapped or renovated.²⁴⁴ Despite occasional xenophobic worries and uneasiness from some leaders, the 'open door' policy was reaffirmed in the document from the Third Plenum of the Twelfth Central Committee in terms of expanding foreign economic cooperation and technological exchange on the basis of independence, self-reliance, equality and mutual good faith'.²⁴⁵ Moreover, foreign investment is to be actively sought in all forms:

Using foreign funds and attracting foreign businessmen for joint ventures, cooperative management or exclusive investment in enterprises are also a necessary and beneficial complement to China's socialist economy.²⁴⁶

This marks the culmination of the gradual extension of the limits which had been placed on foreign investment. The notion of allowing exclusive foreign investment in China is

²⁴³ http://www.state.gov/www/regions/eap/970318_bader_china.html

²⁴⁴ Mary Lee: "The Curtain Goes Up" *Far Eastern Economic Review* (FEER), 31 January 1985, p. 50.

²⁴⁵ Robert Delfs: "Rapid Growth to a Small Role" *Far Eastern Economic Review* (FEER), 28 February 1985, p. 95.

²⁴⁶ Decision of the Central Committee of the Communist Party of China on Reform of the Economic Structure (hereafter, Decision), *Beijing Review* (BR), vol. 27, no. 44 (29 October 1984), p. VI.

something which would have been unthinkable only a few years ago and it is indicative of the total dominance which Deng and his supporters have over the Party that they can proclaim such a policy.

After many false starts, the lure of the China market appears to be justified as more and more impediments to expanded trade and investment are being removed. Reports have suggested that China is planning to spend US \$14.2 billion of its foreign exchange reserves to buy foreign technology; and the Bank of China has announced more flexible loan policies which will enable domestic enterprises to borrow foreign exchange to import equipment and to repay the loans in Renminbi. In similar moves to cut through bureaucratic delays which have bedeviled foreign trade, it has been announced that trading is to be handled by specialized enterprises and co-operatives which will act as agents on a commission basis (allowing importers and exporters to select their agents) and that the Bank of China's monopoly on foreign exchange is to be eased to the extent that some 23 financial organizations in China will be authorized to issue hard currency guarantees for loans to Chinese enterprises and joint ventures with foreign firms.²⁴⁷ These moves will partly ease the contradiction between moving towards more decentralized foreign trade while still maintaining centralized control over foreign exchange operations, although one should be wary of expecting too great a decrease in such controls.

Although not dramatic in terms of total world trade, China's entry into world markets has been significant and promises to be even more so in the near future. There was a rapid increase in imports to China in the period 1977-81, with China's share of world imports tripling to 1.2 per cent but this then grew only marginally to constitute 1.3 per cent of world imports in 1984.²⁴⁸ With the success of rural reforms, there has been a notable reduction in grain imports, and China's main imports have been motor vehicles, transport equipment and machinery. Thus far Japan has been the main beneficiary of this expanded trade and it has been estimated that Japanese sales to China increased by some 55 per cent in 1984.²⁴⁹ The total volume of imports and exports increased by 39.7 per cent in 1984 over 1983 levels, according to Zhao Ziyang, which in real terms (after adjusting for price fluctuations and exchange rates) represented a growth of 19.6 per cent.²⁵⁰ He also boasted that contracts for over 1000 "technological imports" were signed in that period and that this constituted a substantial rise in such transactions.²⁵¹ It can

²⁴⁷ Robert Delfs, "Reform upon Reform" **Far Eastern Economic Review** (FEER), 7 March 1985, p. 60.

²⁴⁸ Robert Delfs, "Rapid Growth to..." p. 97.

²⁴⁹ Robert Delfs: "Ibid".

²⁵⁰ Zhao Ziyang: "The Current Economic Situation and the Reform of the Economic Structure", **BR**, vol. 28, no. 16 (22 April 1985), p. X.

²⁵¹ Zhao Ziyang: "Ibid"

be expected that such contracts will continue to increase now that the impediment of not having a patent law has been removed.

Foreign investment in China has followed a somewhat tortuous path. It has been hampered by its lack of an adequate legal framework (although this is being progressively rectified) and by the frustrations of foreign business representatives having to deal with numerous different government bodies. The restrictions placed on foreign investment have also meant that it has not been particularly attractive on purely commercial grounds. Initially foreign investment was only to be in the form of joint Sino-foreign ventures, to be confined to the newly created Special Economic Zones (notably Shenzhen) and to concentrate on production for export rather than for China's internal market. As a result, the overwhelming bulk of foreign investment in the zones has come from business firms of overseas Chinese in Hong Kong and Macao, and most of this has been concentrated on land development, real estate construction and travel services rather than industry.²⁵²

There has been a gradual lifting of these restrictions on foreign investment. It is no longer denied access to China's internal market (the major lure), need not take the sole form of joint ventures, and the number of 'open' areas has been markedly expanded. In recent years, the four special economic zones have had another fourteen coastal cities (the former treaty ports) and the island of Hainan added to them, with specifically designed tax and other incentives to entice foreign investors.²⁵³ While these areas have advantages in terms of established infrastructure, it seems unlikely that foreign investment will be confined to them as almost every provincial capital is also attempting to attract foreign investment.

An upsurge in foreign investment has accompanied the above-mentioned policy changes. For example, in 1984 approval was granted to 741 Chinese-foreign joint ventures which was 'more than the combined total of the previous five years'.²⁵⁴ That year also saw US \$2.66 billion of foreign funds put to use in various forms in China, a 35.7 per cent increase over the preceding year.²⁵⁵ The current leadership is firmly committed to continuing this course which is intermeshed with industrial reform policy.

Open Door Policy in China was an important stepping stone for China to enter the world economic market. With the attractive low production costs and huge local market, foreign investments were dramatically increased in the last decades in China. Many transnational

²⁵² Dennis Woodward: "Ibid." p. 97.

²⁵³ Mary Lee, "The Curtain Goes Up", FEER, 31 January 1985, p. 50.

²⁵⁴ Zhao Ziyang: "The Current Economic Situation..."p. VI.

²⁵⁵ Dennis Woodward: "Ibid."

corporations from the rest of the world had their assembly line established in China. New advanced technology was introduced from the other countries and many new jobs were created. The Open Door Policy also more or less led to decentralization of decision-making because market based economic development required that the locus of economic decision-making shift to lower levels of the state. So, it may be said that the economic development headed by the Open Door Policy will eventually change the political system in China.²⁵⁶

In July 1979, China had a gross national product of approximately \$250 billion dollars and Deng said that his goal was to increase that to one trillion dollars by the end of the twentieth century, with a per capita income that would rise to about \$800 dollars per person for the projected population of 1.2 billion.²⁵⁷ As this process began, Deng assured the Party that the open door to foreign capitalism would not erode the Communist regime because the state would continue to own most of the means of production, would maintain the socialist principle of distribution, and would assure that any ventures funded by foreign capital would be at least 50 percent Chinese owned. Deng also made clear that different regions would develop at different rates, and those that became more successful first would constitute examples for the others to imitate.

In conclusion, China is committed to a changed economic strategy which includes major industrial reform. This new strategy seeks a better balance between sectors, a tolerance of a degree of individual economy, a shift from extensive to intensive development, an increased market role and the 'open door' policy of integration into the world economy. Industrial reform is aimed at overcoming problems which have dogged Chinese industry for a considerable time. Such problems as poor quality products, excessive inventories, unused capital and labor resources, low efficiency and low output have been attributed to excessive bureaucratic controls and a lack of incentives. Reforms, therefore, have sought greater autonomy for enterprises and their managers in all areas of their operations. There has been a shift towards profitability as the criterion for success, with enterprises entitled to retain their profits and pay state taxes. There has also been a move towards a three-tiered planning and pricing system with mandatory planning and state pricing and distribution for those products considered vital to the economy, a system of 'guidance planning' (with a limited range of price flexibility) for other products, and completely free market conditions for a small number of others. Increasingly also, as control and co-

²⁵⁶ <http://www.geocities.com/colamon1/colamon.WBP.html>

²⁵⁷ Merle Goldman and Roderick Mcfarquar: "Dynamic Economy Declining Party-State" in ed. Goldman and Mcfarquar- **The Paradox of China's Post-Mao Reforms** (Cambridge, Mass.; Harward University Press; 1999)

ordination functions of state bodies are phased out or made indirect, banks are being given the task of checking and co-coordinating enterprise operations.

Industrial reform has given rise to a number of problems and promises to continue to do so. These problems include excessive capital investment, inflation and corruption. As the reforms progress, moreover, other weaknesses in the economy are exposed. For example, the need for more skilled managers, price reform, a free labor market, a market in means of production, and a capital market. There is also considerable tension between reforms which give enterprises greater decision-making powers and the effects on the economy as a whole of their uncoordinated individual decisions. Yet these problems have not deflected the Chinese leadership from its course of pursuing industrial reform, and a program of gradually rectifying problems has been proposed. For the immediate future, therefore, it can be expected that China will persist in its policies of industrial reform which will demand even more far-reaching changes than have already taken place.

3. Changes in China's Economic Interface

Over the past two decades, East Asia has been the fastest-growing region in the world, and China has been the fastest-growing country in East Asia, with an average annual growth rate of approximately 10 percent since its economic reforms began in 1979. Between 1979 and 1996, Chinese real GDP has quintupled from US\$150 billion to US\$750 billion (all in 1990 prices). During the same period, real GDP per capita has increased more than fourfold, from US\$150 to US\$610 (again, all in 1990 prices). China is one of the very few socialist countries that have made a successful transition from a centrally planned economy to a market economy.

Why China has been successful in its economic reforms while others such as the former Soviet Union appeared to have failed? Two principal reasons may be identified. First, China has implemented economic reforms in such a way that there are no losers. In other words, no Chinese citizen is made worse off as a result of the Chinese economic reforms. Second, through its high saving rate — approaching 40 percent in some years — China has had an abundant supply of new resources, most of which it has invested efficiently. The resulting rapid economic growth also makes it much easier to assure that there are no losers.²⁵⁸ The abundance of new resources also makes it far less urgent a matter to try to redeploy the old assets efficiently, which requires the more likely to be painful reform and restructuring of the state-owned enterprises. Our estimates show that almost 80 percent of the fixed capital stock in 1996 is due to gross fixed

²⁵⁸ Lawrence J. Lau: “**Gain without Pain, Why Economic Reform in China Worked**” in Wang Gungwu, John Wong: *China's Political Economy*, Singapore University Press, World Scientific, p. 43.

investments made since 1979. A “gain without pain” strategy might not have been possible if the saving rates were not as high as they were.

Four essential elements of Chinese economic reforms since 1979 may be identified. They are:

1- The “open door” — meaning opening the Chinese economy to international trade and foreign investment.

2- Marketisation — the introduction of markets in goods, factors, and foreign exchange to initially supplement and eventually supplant the plan.

3- The devolution of decision-making power on the basis of the “contract responsibility system” — the de-communisation of agriculture, empowering provincial and local governments, professionalisation of the management of enterprises, and the granting of autonomy and incentives to enterprises on the margin.²⁵⁹

4- The creation of new, non-state-owned modes of organization for production. This includes, in agriculture, the return to a system of individual cultivators with fixed rents and taxes in 1979 and in industry, the emergence of “Township and Village” enterprises (TVEs), (foreign) joint-venture, wholly foreign, and private enterprises since 1984. Some state-owned enterprises and/or their subsidiaries have become publicly traded joint stock companies since 1990, with many private citizens becoming shareholders and hence partial owners. The trend corporatisation of state-owned enterprises (SOEs) is poised to accelerate this year.

We have mentioned the function of the Open Door Policy above by the help of Open Door Strategy Chinese international trade has increased by leaps and bounds. With the inclusion of Hong Kong, the People’s Republic of China is now the world’s fourth largest trading nation.

3.1 Marketisation

Marketisation has also been extremely successful. The prices of all consumer goods and more than 95 percent of the producer goods are determined in the market. The price of low-grade grain is controlled (subsidized), only for social welfare purposes. The price of energy is at world market levels. The dual exchange rates were unified in January, 1994. Current account convertibility was achieved in December, 1996. The labor markets have also been liberalized. The state no longer has the responsibility of placing college and university graduates. In return,

²⁵⁹ Justin Yifu Lin: “Rural Reforms and Agricultural Growth in China,” *The American Economic Review*, Vol. 82, No. 1. (Mar. 1992), p. 41.

college and university graduates can work wherever they wish. Stock and bond markets were also established in the 1990s.

3.2 The Devolution of Economic Decision Power

A great deal of power has been devolved to the provincial and local government levels. For example, foreign direct investment projects of below US\$30 million can be directly approved by the provincial authorities. The managers of enterprises have more autonomy and power than before.

3.3 The Growth of the Non-State Sector and Its Impact in China Economy

This logic did not escape Deng Xiaoping whose infrequent discussions of political reform were linked to economic reform. However, rhetoric aside, political reforms in China were modest, seeking to create a more rationalized and liberalized authoritarian system while resisting any political pluralism or democratization.²⁶⁰ Deng, many would say, had learned from Gorbachev's fate, resisting any reforms that would weaken China's Leninist political system.

The discrepancy between the nature of the political system and extent of economic reform prompted a widely accepted view that China has defied both the systemic logic and historical experience of other socialist states by being transformed "from a command economy to one in which the market and non-state-owned enterprises dominate economic life"²⁶¹ without political reform. For most who accept the logic of the big bang, economic reform in the absence of political reform can yield only partial change. Yet those economists such as John McMillan and Barry Naughton who ascribe China's success to gradualism argue that such partial reform can fundamentally transform a Soviet-style system. They present the "key features of China's economic reforms" as:

"First, massive entry of non-state firms; second, a dramatic increase in competition, both among state firms and between state firms and non-state firms; and, third, improvements in the performance of state-owned firms resulting from state-imposed market-like incentives."²⁶²

In this view, while certain of the post-Mao reforms (such as dual pricing, greater autonomy in production and marketing, increased managerial authority) have been aimed directly at the

²⁶⁰ Nina Halpern: "Economic reform and democratization in Communist systems: the case of China," **Studies in Comparative Communism**, Vol. 22, No. 2/3 (Spring/Autumn, 1989), pp. 139-152.

²⁶¹ Susan Shirk: "**The Political Logic of Economic Reform in China**" (Berkeley: University of California Press, 1993), p. 346.

²⁶² John McMillan and Barry Naughton, "How to reform a planned economy: lessons from China," **Oxford Review of Economic Policy**, Vol. 8, No. 1 (Spring 1992), p. 131.

planning system, more significant change has been affected indirectly through the creation of a more marketized, “non-state” sector outside the state planning system.

The state-owned sector has continuously shrunk relative to the aggregate economy; it currently accounts for no more than 30 percent of the aggregate output. The proportion of aggregate economy-wide gross fixed investments accounted for by state-owned enterprises was 72 percent in 1979. It stood at just over 50 percent in 1996. Because of the de-communisation of the agricultural sector, the state-owned sector accounts for only a very insignificant proportion of aggregate agricultural output. In industry, the state-owned sector’s share of gross value of production fell from almost 80 percent in 1979 to just above 30 percent in 1995. This decline was caused primarily because of the considerably faster growth of the non-state sector. The growth of the non-state sector has far outstripped the growth of the state sector which has been largely propelled by the growth of the output of the township and village enterprises (TVEs). As of 1994, TVEs accounted for almost half of the aggregate industrial output and almost two-thirds of the aggregate industrial employment of China.

The principle of Chinese economic reform is that no one loses as a result. This implies the “grandfathering” of the status quo ante, protection of “vested interests” and “discriminating” between the old and the new. For this reason, the availability of new resources and its efficient utilization takes on additional importance, because they determine how fast transition economic reforms without losers can be. We have already seen that new enterprises and the new activities have been primarily responsible for the phenomenal economic growth of China since 1979. The new resources come mostly from the high saving rates of between 35 percent and 40 percent.²⁶³ There has been little or no privatization of existing enterprises as well as little or no successful restructuring of existing enterprises until recently.

3.4 Liberalization of the Market

Under the strategy of market liberalization, the central plan is completely abolished. All markets are instantaneously open. Producers are completely free to plan their production. Consumers are completely free to plan their consumption. The quantities and prices of all goods are determined through the equilibration between supply and demand in the market. Under the dual-track strategy, the central plan remains (and is frozen except for new increments of state-financed production capacity) but the rights and obligations under the central plan continue to be enforced. All markets are instantaneously open. Producers are completely free to plan their

²⁶³ Lawrence J. Lau: “Gain without Pain, Why Economic Reform in China Worked” *Ibid* p. 52.

production and sales, provided output delivery obligations under the plan are fulfilled. Consumers are completely free to plan their consumption, given allocated consumption goods. Aggregate quantities and market prices of all goods are determined through the equilibration between supply and demand in the market with planned prices remaining fixed.²⁶⁴

3.5 The Role of State Power and dual-track approach

A dual-track strategy may be defined as follows:

(1) In one track, the “plan track”, the existing (often inefficient) central economic plan, and the distribution of rents under it, are left intact; and

(2) In the other track, the “market track”, liberalization is carried out at the margin, that is, economic agents have both the right and the incentive to participate in the free market provided that the obligations under the original plan are fulfilled. In particular, market resales of plan-allocated inputs and consumption goods, and market purchases of outputs for redelivery are allowed.

Under the dual-track approach, the state is required, even after market liberalization, to enforce the rights and obligations under the pre-existing central plan (as well as any new contracts entered into through the market).^{*} However, as soon as economic agents are allowed to participate in the market, the enforcement of the plan by necessity must shift to the enforcement of specific sales to and purchases from other economic agents as mandated in the pre-existing plan. Simple enforcement of the planned aggregate production no longer suffices because an enterprise, for example, can fulfill its planned aggregate production target and yet at the same time fail to make any planned deliveries to other enterprises at the plan prices. Thus, even if the planned aggregate production target is fulfilled, the plan itself may not be fulfilled because the mandated sales and purchases are not made. But if enforcement is shifted to plan-mandated purchases and sales, it is most likely that enforcement actions are taken in response to complaints by other economic agents whose rights have not been honored by specific enterprises. The potential recipients of the planned output deliveries must complain before the state planning commission will begin enforcement actions.²⁶⁵ The enforcement is not on total production, but on the actual delivery of goods as provided for in the plan. This also makes it likely that absent specific complaints, no enforcement actions are likely to be taken.

²⁶⁴ Lawrence J. Lau: Ibid, p. 54

^{*} It is important to point out that the enforcement required here is no different from the enforcement of contracts in a market economy.

²⁶⁵ Lawrence J. Lau: Ibid.

Whether the dual-track approach works depends on the credibility of state enforcement, and expectations thereof. If the state is not credible, then the economic agents will have no incentive to fulfill their obligations under the pre-existing plan. And if anyone thinks that the plan-mandated deliveries at planned prices are not going to be received by him or her, he or she will not make the plan-mandated sales at the fixed plan prices either. Thus, if the overall belief or expectation is that there will not be effective enforcement, no one will comply, and the dual-track approach reduces to the big-bang approach. Perceived credibility therefore affects enterprise (and household) behavior, and hence compliance with the pre-existing plan (post reform). If economic agents do not comply with the pre-existing plan, it is no longer possible to assure that there are no losers.

In general, multiple equilibrium (outcomes) are possible under a dual-track approach, depending on expectations of the credibility of state enforcement. If everyone thinks that the state will be able to enforce effectively, everyone will comply, then “gain without pain” can be achieved. If everyone does not expect that there will be credible state enforcement, the dual-track approach will degenerate into the big-bang approach. Thus, in technical terms, there are multiple “rational expectations” (or self-fulfilling) equilibrium (a typical example is a bank run).

The dual-track approach of the Chinese economic reform is not gradualist because efficiency is instantaneously achieved as if under a big-bang reform. Efficiency is achieved because both the prices and quantities of goods allocated within the plan are fixed, and on the margin all economic agents face the market prices. Chinese economic reform appears gradualist because the population is protected from shock (pain). However, the pre-existing central plan is “phased out” gradually.

We provide below nine examples of economic reforms implemented in China that utilize the dual-track approach since Chinese economic reforms began in 1979. Although different in each case, the economic reforms all share the common features described above.²⁶⁶ The examples are:

- (1) The agricultural reform (the introduction of the “contract responsibility system” in agriculture);
- (2) The industrial-reform;
- (3) The “dual track” price system in urban consumer goods and services;

²⁶⁶ Lawrence J. Lau: *Ibid*, p. 57.

- (4) The foreign exchange reform;
- (5) Special economic zones and foreign direct investment;
- (6) The tax-reforms;

3.6 The Agricultural Reform

The agricultural reform undertaken in China in 1979 may be regarded as the first successful application of the dual-track approach. Under this reform, the contract responsibility system was introduced in agriculture. The commune is assigned the responsibility to (1) sell a fixed quantity of grain (or other) output to the state procurement agency as previously mandated under the plan at predetermined (plan) prices and (2) to pay a fixed amount of taxes to the state as well as the right to (3) receive a fixed quantity of inputs, principally chemical fertilizers, from state-owned suppliers, again at predetermined (plan) prices. Subject to fulfilling these conditions, the commune is free to do whatever it wishes, e.g., it can produce whatever it considers more profitable, and sell any excess output on the free market, and retain any profit. In fact, under this system, the communes as well as its members are permitted to purchase grain or other output in the market to fulfill the delivery quota (an example of a “wash sale”) — it is not required to actually produce the grain or other output itself.

In the implementation of the contract responsibility system, both the mandatory delivery quota and the taxes for the commune are fixed at their original planned levels. The commune in turn reassigns the collective responsibilities (and rights) to the individual farm households, allocating to them their shares of the commune’s land and capital (and chemical fertilizers), and making them individually and directly responsible for the fulfillment of their shares of the delivery quota and taxes.

Thus, there is both a plan track and a free market track, each with different prices; however, the quantities of outputs and inputs under the plan track are fixed. It is therefore clear that under this system, only the market prices, and not the plan prices, are relevant for the allocation of resources. Note that both the commune (and its individual members) and the state cannot be worse off than before under this new arrangement. Moreover, as long as the state is not worse off in terms of the quantities of grain and other outputs and taxes delivered to the state, it will continue to be able to supply the urban consumers with food grains and industries with agricultural raw materials (such as cotton) at plan prices, with the consequence that even the urban consumers and industrial enterprises are no worse off as a result of the agricultural reform.

These significant changes in the relationship of government and producers in agriculture and industry led to very positive results for China. Between 1978 and 1986, the agriculture and industrial sector both increased output at annual rates of about 10 percent, while national income increased at an average annual rate of about 8.7 percent, among the highest in the world.²⁶⁷ There was also a large increase in capital construction outside the government budget from about 17 percent of total investment in 1978 to about 57 percent in 1984. This led to a construction boom that was visible in many parts of the country.²⁶⁸

The dual-track price system has some historical antecedent. Even prior to the introduction of the contract responsibility system, there were two prices for grain — the plan price paid for mandated grain deliveries to the state and the negotiated (market) price for above-quota transactions.

3.7 The Industrial Reform

Industrial production in Communist China had been patterned on the Soviet system with an emphasis on heavy industry and complete state planning and management of production. This meant that industrial firms were given quotas of products to produce, that the costs of their inputs were set by a central pricing board as were the sale price of the products produced irrespective of the real cost of production. Workers were essentially given lifetime employment with management having little opportunity to dismiss those who were not working effectively.

Deng and his associates decided to move carefully and gradually in changing industrial production because of the intrinsic complexity and to avoid the risk of inflation which was seen as creating the risk of disaffection and protests in the urban areas. The first phase of industrial modernization was focused on reestablishing incentives for more effective and enthusiastic work. During this period, 1978 to 1984, the method used was to provide a financial incentive for enterprises and workers to produce more effectively. This was done by establishing an “industrial responsibility system,” whereby a state enterprise agreed to a “profit and loss contract” with its government supervising organization. The enterprise would provide the state with a share of its “basic profits,” but any further profit could be retained by the state enterprise and paid as bonuses to managers and employees or for innovations in production. By the end of 1982, all industrial enterprises had become part of this industrial responsibility system.²⁶⁹

²⁶⁷ Immanuel Chung-Yueh Hsu, *Rise of Modern China*, p. 854.

²⁶⁸ Immanuel Chung-Yueh Hsu, *Rise of Modern China*, p. 855.

²⁶⁹ Constantine C. Menges: *China: The Gathering Threat...* p. 85

The results are included an upturn in worker enthusiasm, the ability of plant managers to fire and hire employees, set wages, bonuses, and prices within a range of prices preapproved by the state. By January 1985, plant managers themselves were to be appointed for four-year terms, which could be renewed up to three times rather than for life, as had been the situation previously.²⁷⁰ These changes improved the standard of living and led to a construction boom in the cities, but “there was little evidence of improvement in the efficiency of the enterprises. The performance of Chinese industry had not become more effective as ... first expected.”²⁷¹ There was also a sharp reduction in the funds the government received from the enterprises as they and the localities kept more of the money they received for the sale of their products. As a result, in June 1983 the government established an income tax on the profits of the enterprises. By 1984, it is estimated that 30-40 percent of industrial production derived from Central Planning, 40-50 percent resulted from “locally planned or guidance planned output,” and 20 percent derived from market demands.²⁷²

The industrial reform represents, in part, an attempt to extend the contract responsibility system to the industrial sector, based on the successful experience of the agricultural reform. Under the reform, the mandatory delivery quotas as well as the quantities of plan-allocated inputs for each enterprise were frozen at their then-existing levels, and the enterprises are free to produce whatever they deem profitable and sell their output on the free market and retain any profit as long as they fulfill their delivery quota. At the same time, parallel free markets for the above-quota outputs of enterprises were introduced, while the within-quota outputs continued to be sold at the generally lower plan prices to authorized purchasers.

This example highlights the crucial elements in a dual-track approach. First, the “market track” must provide for full liberalization (that is, no intervention of any kind), albeit only at the margin (but as we know, liberalization at the margin is sufficient for efficiency); second, the enterprises must be allowed to reap the full marginal reward; and third, input and output quotas on the plan track must be enforced as outputs of some enterprises are needed as inputs of other enterprises. The ability of enterprises to meet their planned output quota may depend crucially on their timely receipt of the planned input delivery quotas.

²⁷⁰ Immanuel Chung-Yueh Hsu, *Rise of Modern China*, p. 845.

²⁷¹ Immanuel Chung-Yueh Hsu, *Rise of Modern China*, p. 849.

²⁷² Immanuel Chung-Yueh Hsu, *Rise of Modern China*, pp 849-851.

3.8 The Dual-Track Price System in Urban Consumer Goods and Services

Prior to the economic reforms of 1979, many essential consumer goods and services, such as grain, cooking oil, meat, electricity, housing, and monthly pass for mass transit, are rationed in the urban areas at lower than what would have been free market prices.²⁷³ With the introduction of the free markets and the dual-track price system, urban residents continued to be able to purchase grain, meat, electricity (lifeline rates), and housing (for those who had it) at the same pre-reform prices within the limits of the pre-reform rationed quantities, at the same time that they were able to purchase freely any quantity of any good at free market prices. They were thus no worse off than before. The state was also no worse off because the quantities of goods that it would be obligated to supply at the plan prices remained the same.

3.9 The Foreign Exchange Reform

Dual markets were permitted to exist for foreign exchange in China from the mid-1980s to the end of 1993. Between 1985 and 1994, there was an official exchange rate, available only for certain limited approved transactions, as well as an officially sanctioned swap rate, that was determined in Foreign Exchange Adjustment Centers (more commonly referred to as “swap markets”) in major cities around the country, among exporters and importers qualified to trade in those markets. The supply of foreign exchange in the swap markets was provided by the exporters through the foreign exchange they were allowed to retain from net increases in their export earnings relative to the base period.²⁷⁴ The government did not control the transactions in the swap market, and the swap market exchange rate was mostly determined by supply and demand. The swap rate was, not surprisingly, significantly higher than the official rate during this period.

At the same time, foreign visitors to China were required to use “foreign exchange certificates” (FECs), which were available at the official exchange rate, rather than the “renminbi”, the Chinese domestic currency, for their transactions.

The dual exchange rate system functioned until January 1, 1994, when the two exchange rates — the official rate and the swap rate — were merged into a single rate, with its level determined in a market consisting of exporters and importers, and the foreign exchange certificates were finally withdrawn from circulation. Under the new system, domestic exporters are required to sell all of their foreign exchange to the interbank market (thus, rights of retentions

²⁷³ Lawrence J. Lau; Yingyi Qian; Gerard Roland: “Reform without Losers: An Interpretation of China’s Dual-Track Approach to Transition” *The Journal of Political Economy*, Vol. 108, No. 1. (Feb., 2000), pp. 120-143.

²⁷⁴ Immanuel Chung-Yueh Hsu, *Rise of Modern China*, p. 845.

were abolished); in return, they are allowed to purchase foreign exchange as needed for legitimate business purposes.

At the time of this reform, the share of centrally allocated foreign exchange already fell to only 20 percent of the total. In this last step of the foreign exchange reform, central allocation of foreign exchange was completely abolished, but for those organizations which used to receive cheap foreign exchange, annual lump-sum subsidies in the domestic currency sufficient to enable the purchase of the pre-reform allocation of foreign exchange were offered for five years to assure a smooth transition (in other words, the state tried to maintain the same level of hitherto fore implicit subsidies received by these organizations).

The exchange rate reform turned out to be a complete success: the exchange rate has remained stable and even appreciated slightly from 8.7 Yuan per US\$ to 8.3 Yuan per US\$ today. Since July 1 of this year, foreign and joint-venture enterprises, which hitherto fore must use technically separate foreign exchange swap markets, have been permitted to use the same foreign exchange markets maintained by the banks for the domestic enterprises. The best way to characterize the current exchange rate system is that it is “current-accounts convertible”, but not “capital-accounts convertible”.

3.10. Special Economic Zones and Foreign Direct Investment

In the almost two decades since economic reform began in China the role of the foreign sector has burgeoned in ways that no one anticipated. The volume of foreign trade and the role of foreign capital are both far greater than could have been foreseen based on the modest Chinese economic reforms initiated in the late 1970s. By the mid-1990s China had become one of the world’s largest trading nations, the recipient of more foreign direct investment than any other country in the world, the largest borrower from the World Bank, the largest recipient of official development assistance in the form of low-interest, long-term concessionary loans from industrialized countries, and, except for the Czech Republic, the only transition economy with ready access to international capital and equity markets.

Chinese data on foreign direct investment are given in Table 5. The data show it grew from modest amounts of a few hundred million dollars annually in the late 1970s and early 1980s to almost four billion dollars annually in the late 1980s. Because many foreign invested projects were delayed in the aftermath of Tiananmen, actual investment showed no growth in 1990. However, beginning in 1991, China attracted greatly increased amounts of foreign direct investment.

Table 3: Foreign Direct Investment in China, 1979-94²⁷⁵ (millions of US\$)

Year	Contracted	Actual
1979-82 (cumulative)	6,999	1,767
1983	1,917	916
1984	2,875	1,419
1985	6,333	1,959
1986	3,330	2,244
1987	4,319	2,647
1988	6,191	3,739
1989	6,294	3,773
1990	6,987	3,755
1991	12,422	4,666
1992	58,736	11,292
1993	111,435	27,514
1994	81,406	33,787

It is more than doubled in both 1993 and 1994 and rose a further one-fifth in 1994 to reach almost \$34 billion actual investment.

The dramatic increases in foreign direct investment in the first half of the 1990s appear to be caused by four factors. First, the magnitude of aggregate foreign direct investment flowing to developing countries increased significantly in the 1990s. Average annual flows in 1990-93 were double those of 1987-89.²⁷⁶

This is not unlike the entry of new enterprises but takes place at the level of a country. The institution of special economic zones was chosen early as a reform measure in part to minimize its impact on and interaction with the rest of the economic system, which still operated under the state plan. Initially, special economic zones allowed only firms engaged in “material

²⁷⁵ Ministry of Foreign Trade and Economic Relations, *Zhonghua renmin gongheguo duiwai jingjimaoyibu xinwen gongbao* (The Bulletin of the Ministry of Foreign Trade and Economic Relations of the People’s Republic of China), No. 2 (25 April 1994), p. 10. Xinhua News Service, “Zhongguo qunian liyong waizi duo meiyuan” (“Last year China’s utilized foreign direct investment exceeded US\$33.7 billion”), *Jinrong shibao* (Banking Times), 26 January 1995, p. 1.

²⁷⁶ Nicholas R. Lardy: *The Role of Foreign Trade and Investment in China’s Economic Transformation*, **The China Quarterly**, No. 144, Special Issue: China’s Transitional Economy. (Dec., 1995), p. 1066.

reprocessing”, that imported all of their inputs, except labor, and export all of their outputs thus creating no disruption to the domestic aggregate supply and demand, labor being in surplus. The same rule applied to foreign and joint-venture firms operating in China but outside the special economic zones. The principal purpose of this approach is to minimize the impact of the new economic activities on the old-style domestic state-owned enterprises.

3.11 The Tax Reforms

The experiment of the fiscal contracting system between the central and provincial governments started in 1980 and the system eventually covered all provinces by the mid-1980s. Under the fiscal contracting system, the province/municipality assumed the responsibility of collecting the taxes for the central government and were committed to deliver to the central government a fixed amount of revenue per year, and allowed to retain any excess. (Thus, this is similar to a tax-farming system.) Since the committed amount to be delivered to the central government would not be based on the historical experience, the central government, nor the provinces/municipalities, would be worse off under this arrangement.

Of course, it is possible that the provinces/municipalities may fail, or claim to fail, to collect even the fixed amount due the central government. In practice, this applied mostly to the poorer provinces 19 out of the 35 provinces/municipalities were able to retain 100 percent of the revenues they collected at the margin.²⁷⁷

The 1994 tax reform introduced a nationwide Value-added tax, abolished the fiscal contracting system and replaced it by a fiscal federalism providing for revenue-sharing as well as a separation of the national and local tax bases. Again, the reform ensured that all provinces were not made worse off. The provincial governments were guaranteed revenue no less than that of their 1993 actual expenditures for the three years between 1994 and 1996. As might be expected, the provinces/municipalities had a major spending spree in the last quarter of 1993, which also attested to their confidence that the central government would in fact be able to carry out their part of the commitment.

4. Science & Technology in the Development of Defense Industry

Science and technology are cardinal forces in successful economic development, and scientific and technological capabilities, particularly high-tech strength, are among the most important indicators of comprehensive national strength. Both developed and some developing

²⁷⁷ Lawrence J. Lau: “Gain without Pain... p. 65.

countries attach importance to R&D* and its industrialization in the fields of microelectronics, computers, telecommunications, new manmade materials, biotechnology, space technology, nuclear energy technology, and so on. A number of countries have established a set of policies and measures to promote technological transfer and high-tech industrialization and to develop high-tech industries in accordance with their domestic particularities. In recent years, China has been one of them.

China's "domestic relative particularities" must be seen in the context of a developing economy carrying out the integration of a planned economy with market forces. In general, a comprehensive industrial system has been established. Traditional industries have made great progress, while new industries have made some progress. Many Chinese scientific and technological results have attained world levels, and high-tech industries, such as electronics, space, precision machinery, instruments and meters, have established reasonable standards.

4.1 Transfer of Science & Technology

Confronted with the challenge of the new technological revolution in the world, China is making an effort to catch up with world developments and narrow the gap between it and advanced foreign countries in certain areas that vitally affect future developments in science, technology, and the economy and make use of the advantages derived. China has drawn up two national plans: the High-tech Research and Development Program (simply called the 863 Program) in 1987 and the Torch Program in 1988. Both are nationwide and some of their research results have already been transferred into production. New high-tech enterprises have become the foundation for further development of high-tech industries. In introducing new technologies, China is relying on selective agreements with major foreign corporations as an element in its new policy of transferring know-how rather than importing equipment and products.²⁷⁹

In 1978, after more than ten years of turmoil (the so-called Cultural Revolution), the goal of modernizing agriculture, industry, national defense, and science and technology, first

* The phrase research and development (also R and D or R&D) has a special commercial significance apart from its conventional coupling of scientific research and technological development. For 2006, the world's three largest spenders of R&D are the United States (US\$330 billion), China (US\$136 billion) and Japan (US\$130 billion).

In general, R&D activities are conducted by specialized units or centers belonging to companies, universities and state agencies. In the context of commerce, "research and development" normally refers to future-oriented, longer-term activities in science or technology, using similar techniques to scientific research without predetermined outcomes and with broad forecasts of commercial yield. (<http://www.businessweek.com>)

²⁷⁹ State Science Technology Commission, "Guidelines on China's Science and Technology Policy" (Zhongguo kexue jishu zhinan), no. 3, 1988 (Beijing, 1989).

suggested by Premier Zhou Enlai in 1964, was reconfirmed by the Fifth National Congress. The National Congress Report asserted that the modernization of science and technology is the core of the four modernizations. The report also made clear that science and technology are necessary for production in both socialist and capitalist economies: they possess no class nature and are helpful to all nations and peoples in the world.

Because of this important policy statement, the attitude towards history of modern science and technology improved considerably. It was recognized that historical studies can influence the success of our scientific undertakings and promote the modernization of China. From the past we could learn the fundamental principles of how science and technology develop.

In 1977, when the Chinese Academy of Science formulated the projects for basic science, it made the study of history of modern science and technology one of eight focal points. In 1978, the national scientific program also made this item a major area of emphasis.²⁸⁰ In the same year, the division of history of modern science was established in the Institute for History of Natural Science of the Chinese Academy of Science. Though there were only a few research fellows, the research work started promptly and smoothly. At the same time a few universities for instance, Hua Zhong Institute of Technology at Wuhan, the University of Science and Technology of China at Hefei, Fudan University at Shanghai, Beijing University and Renmin University at Beijing, and Northeast University of Technology at Shenyang opened courses in history of modern science for both university students and graduate students.²⁸¹

In October 1980, the Chinese Society for History of Science and Technology was established. Once a stable environment was in place, historians of modern science made steady progress. The society, which contains divisions for the history of mathematics, physics, chemistry, astronomy, earth science, biology, and technology, now, has more than six hundred members; most are university graduates in science or technology. The society is governed by a committee, at the University of Science and Technology of China.

Academic communication has now become more frequent than before. In October 1982, a meeting held in Wuhan at Hua Zhong Institute of Technology and supported by the Ministry of Education of the State Council discussed problems of education and research in universities and further strengthened work in the history of modern science.²⁸² Now a few universities and

²⁸⁰ Li Peishan: "History of Modern Science and Technology in the People's Republic of China", *Isis*, Vol. 76, No. 3. (Sep., 1985), p. 366.

²⁸¹ Li Peishan: "Ibid."

²⁸² Li Peishan: "Ibid."

institutions have started graduate courses and degree programs. This development signifies the general acceptance in China of the history of science as an academic discipline.

In 1979 when the U.S. recognized China, the bilateral agreements on cooperation in the area of science and technology were restricted to the exchange of scholars and students. Emerging from the Cultural Revolution period, China experienced a severe shortage of educated personnel, and educational exchanges provided a mechanism for the PRC to prepare a cadre of people to assimilate modern technology. In May 1983, Dr. George Keyworth, President Reagan's science adviser, signed other significant agreements while visiting China, including agreements to cooperate in such fields as nuclear physics and controlled magnetic fusion, and aeronautical science and technology.²⁸³

The agreements on geologic and hydrologic cooperation, as well as those dealing with earthquake studies and environmental protection, make clear contributions to the economic development of China. Limits on the success of such cooperative agreements, however, may not be set by U.S. willingness to share the most advanced technologies or methods, but by the ability of the scientific and technical workers in China to absorb the knowledge.

In a report to the Congress, Denis F. Simon highlighted four factors that limit China's ability to absorb foreign technology: (1) uneven performance with respect to translating results into the serial production process; (2) poor management capabilities, particularly in such areas as project integration and industrial organization; (3) technical backwardness, particularly in precision instrumentation and testing equipment; and (4) insufficient numbers of qualified scientific and technical personnel to assist with the management and adaptation of imported technology.²⁸⁴ As one means to correct this deficiency, China sent as many as 40,000 students and scholars to the United States to study between 1979 and 1986, only a small portion of whom were government-sponsored. At the present time, about 14,000 Chinese students may be here. China's total program to upgrade the level of S&T by sending students abroad to study, places the number at about 33,000 Chinese students attending schools in more than 60 countries²⁸⁵ in the years 1978-1984.

²⁸³ Larry M. Wortzel: U.S. Technology Transfer Policies and the Modernization of China's Armed Forces, **Asian Survey**, Vol. 27, No. 6. (Jun., 1987), p. 623.

²⁸⁴ Denis F. Simon: "China's Capacity to Assimilate Technology: An Assessment," in Joint Committee Print, Joint Economic Committee, U.S. Congress, **China Under the Four Modernizations**, Part I (Washington, D.C.: U.S. Govt. Printing Office, 1982), p. 514.

²⁸⁵ Leo A. Orleans, "Chinese Students and Technology Transfer," a paper prepared for the U.S. National Defense University Mobilizations Concepts Development Center, Washington, D.C., May 1985, p. 23. Orleans cites 19,000 students in the U.S. between 1979 and 1983.

Notwithstanding China's lack of qualified S&T personnel and limited but developing ability to absorb new technology, the PRC has clearly demonstrated the capability to focus its S&T efforts successfully in certain areas critical to China's defense industries. Also, China has taken steps to export technology and weapons to other nations as a means to gain foreign exchange and to further its own foreign policy. In the aviation industry, for example, the Chinese have managed to produce an aircraft for civil transport (the Y-10) with military application in terms of deployment of men and materiel, which is often cited as an example of the PRC's acumen in combining foreign technology with domestic capabilities.²⁸⁶

Within the past five years (1978-1983), efforts to study the period from the late nineteenth century to the present have increased substantially.

In developing the history of science in China, it is imperative to exchange ideas and resources with scholars of Western countries. The open policy of China to the world is not only important for the economy; it is at least as important in science, technology, and culture.

The transfer of technology to China in the nineteenth century was carried out both by Chinese and foreigners. Given the half-hearted interest of the Chinese government in such activities, however, the role of direct foreign investment was enhanced. The profitability of such investments was determined not only by comparative costs and other conventional economic variables, but also by the interaction of each project with China's traditional system of political economy. The nature and importance of this interaction is examined by means of a number of case studies. The results emphasize the importance of cultural elements in the transfer of technology.

One of the most important sources of growth for a less developed economy is the technology imported from more advanced economies. The importance of such transfers of technology in the economic development of Europe, the United States, and Japan has already been the subject of a number of studies. In nineteenth-century China, however, as in many other poor countries, the transfer of technology did not lead to successful economic development. Among the reasons for this failure were China's system of political economy and the attitudes of its officials. How they combined to reduce the role of direct foreign investment in effecting the transfers of technology is the subject of this paper. Inevitably, this discussion touches upon the old and highly politicized question of what exactly was the foreign economic impact on China.

²⁸⁶ Larry M. Wortzel: "Ibid"

The transfer of technology is simply the transfer of knowledge, usually embodied in men or machines. Most successful transfers involve both. The men who embody such knowledge can be either foreigners who bring their expertise to the less developed economy or natives who have studied modern technology at home or abroad. In nineteenth-century China the latter were of no great significance.²⁸⁷ Only a small number of students studied abroad under missionary or other private auspices while officially sponsored programs foundered on the Chinese government's suspicions of the effects of foreign study—suspicions confirmed when it was learned that the first contingent of teenage boys sent to the U.S. to learn foreign languages and other useful things also learned to play baseball and cut off their queues. The program was soon aborted out of fears of deracination. Subsequent efforts in this direction were small and involved brief periods of postgraduate study abroad, mostly in England and France, by adults who were “suitably” Chinese.²⁸⁸

4.2 Defense Industry and Technology

Recent allegations concerning satellite exports and nuclear espionage, in particular, demonstrate the centrality of high technology to the debate about China's place in the world. This makes it especially important to explore links that may bind China's national technology and industrial policies to its approach to security and development. How has the Chinese understanding of this linkage changed as the past priority of militarized growth has given way to the rapid expansion of a commercial economy since the late 1970s?²⁸⁹ Who is responsible for making important technology decisions in China? How have Chinese technology leaders thought about the relationship between technology and national power during the past twenty years? Has political change affected this worldview? Finally, how has renewed contact with international technical circles since the 1970s affected the Chinese approach to national high-tech strategy and investment?

The formulation of national investment priorities are such high in areas that the central government and its technical advisers have deemed to be of strategic importance to China's national security and economic competitiveness. Such efforts by no means represent the only aspect of China's recent high-tech policy. Indeed, strategic technology programs are just one of

²⁸⁷ Shannon R. Brown: *The Transfer of Technology to China in the Nineteenth Century: The Role of Direct Foreign Investment*, **The Journal of Economic History**, Vol. 39, No. 1, *The Tasks of Economic History*. (Mar., 1979), p. 181.

²⁸⁸ Knight Biggerstaff: *The Earliest Modern Government Schools in China* (Ithaca, 1961), pp. 232-44.

²⁸⁹ On the past priority of military goals, as well as the impact of military elites, institutions, and ideas on China's Mao-era (1949-76) political economy, see Evan A. Feigenbaum, “Soldiers, Weapons, and Chinese Development Strategy: The Mao-Era Military in China's Economic and Institutional Debate” **China Quarterly**, No. 158 (June 1999).

five main pillars that together support China's twenty-first-century technology agenda.²⁹⁰ But strategic technology efforts are crucial for four reasons.

First, these programs represent perhaps the most explicit connection between national security and economic development issues in China's policymaking process. In addition, they constitute a critical link between purely domestic economic policy agendas and the international strategic concerns so central to Chinese decision makers.

Second, for much of the period since 1987, strategic technology programming has comprised the largest source of direct central government finance for research and development (R&D) in priority sectors such as space, lasers, and supercomputing. This brand of public investment is not channeled through the intermediary agency of ministry and state corporation budgets, or via the major government banks. It is organized around its own administrative system with a unique set of procedures. National programming is caught up with a wide-ranging debate about the proper role of publicly targeted, as opposed to risk and equity, finance in shaping national competitiveness.

Third, strategic programming focuses primarily on applied research and medium-term results. National high-tech programs thus lay bare the main military, civilian, and dual-use technical goals of the Chinese state for the early twenty-first century. For this reason, the contents and procedures of such programs are revealing of Chinese aims. Much of what we know about Chinese goals reflects the writings or statements of Chinese political leaders, generals, scientists, and businesspeople on technology issues. An understanding of recent strategic technology programming can supplement this discussion by shedding light on points at which concrete investment choices meet rhetorical bluster and wishful musing.

Finally, for most of the 1990s, strategic technologies programming has been the purview of China's most prominent technicians and industrial planners.

To understand the major changes in Chinese high-tech industrial policy since the late 1970s, one must first understand that militarization skewed priorities in national technology strategy away from comprehensive development during the 1950s and 1960s. Weaponization initially became the main focus of China's high-tech system because of Korean War logistics and equipment problems that dramatized China's comparative technological backwardness.

²⁹⁰ The other four pillars are (1) acquisition of foreign systems through technology transfer in joint venture, licensing, and co production arrangements; (2) promotion of commercial initiative in scientific laboratories; (3) creation of a budding venture capital industry to steer equity investment toward innovative technology start-ups; and (4) promotion of a greater role for industrial enterprises in research and development (R&D).

When China came under repeated threat of external attack during the 1950s, that sense of backwardness intertwined with a survival-state mentality to fuel the growth of a political constituency favoring massive, nationally directed strategic weapons and technology programs. Yet these programs required economic trade-offs, and by 1960-61, China's decision to pursue the most advanced retaliatory systems, not just a bare minimum nuclear deterrent, brought strategic weapons advocates into debates about national priorities. This agenda survived initial challenges from civilian and conventional weapons-oriented constituencies. But as the 1970s ended, the emphasis on strategic weapons as a basis for national high-tech efforts began to erode for three reasons.

First, China's overall strategic environment underwent a critical change. After rapprochement with the United States and Japan in the early 1970s, China cleared away two potential threats while checking Soviet pressure through new strategic partnerships. By 1978, the post-Mao leadership under Deng Xiaoping (1977-97) felt sufficiently confident to bet publicly on twenty to fifty years of comparative security after nearly thirty years in a survival-state posture. This newfound confidence would enable a focus on the economy.

Second, the shift to a focus on national economic development empowered civilian technology elites who now sought greater influence over the state's agenda after three decades of military dominance. Meanwhile, on the weapons-focused side of the R&D system, the Deng coalition decided in December 1977 to emphasize conventional weapons as the main focus of the People's Liberation Army's (PLA) acquisition agenda. This shift moved the locus of weapons decision-making much closer to its end users. It also increased the importance of what the Chinese term "equipment" (*shebei*)—which fell under the purview of uniformed service headquarters—at the expense of "technology" (*jishu*), which had become the formally mandated preserve of China's defense-technical elite. Not surprisingly, this shift empowered uniformed elites in the PLA's General Staff, navy, and air force at the expense of once-influential weapons air force at the expense of once-influential w scientists.²⁹¹

Third, China's defense R&D community began to confront mounting evidence that its Mao-era technical system had ossified. From the mid-1960s forward, a dramatic shift in the industrialized world reversed prevalent thinking about the relationship between defense and civilian sectors in spurring innovation. Where military innovation seemed firmly in the driver's

²⁹¹ The Central Military Commission made the shift official state policy in a formal decision taken jointly with the State Council in December 1977. On these meetings, see Xie Guang, ed., *Dangdai Zhongguo de Guofang Keji Shiye* (Contemporary China's national defense science and technology cause) (Beijing: Chinese Academy of Social Sciences Press, 1992), vol. 1, pp. 148-154.

seat in the period after World War II, by the late 1970s-80s, largely as a result of the microelectronics revolution that yielded semiconductors and integrated circuits, this flow of innovation appeared to have changed direction.²⁹²

The post-1960s Silicon Valley model reshaped innovation relationships in the West. China, however, missed this change almost entirely. Its technological infrastructure was a good fifteen years behind that of the places where this shift occurred. More important, the initial stirrings of this revolution in innovation coincided with the violent phase of China's Cultural Revolution (1966-71) and initial period of recovery (1971-77). Nineteen years behind the United States in their development of an atomic bomb, Chinese technicians could not confront fundamental innovation issues until tasks from the 1950s and 1960s, such as ICBM (intercontinental ballistic missile) and SLBM (submarine-launched ballistic missile) design projects, were set on the track to deployment. Yet even in the late 1970s, with some of these major tasks still unrealized, information about this change in approaches to innovation began to seep into China. An externally induced crisis of confidence thereby began to push Chinese defense technicians to reassess their approach to innovation. The proximate cause of this period of self-reflection was the renewal of international S&T exchange at the end of the 1970s. Foreign visitors offered new ideas about the role of high technology in society and economy writ large. Strategic weapons experts, or weaponeers, became the pivotal point of contact for these new approaches because they had dominated most high-end Chinese R&D and precision industry since the late 1950s.

For many Chinese technicians, the first stirrings of a post-Mao revolution in approaches to innovation can thus be traced to meetings that built on a series of important speeches given by China's new paramount leader, Deng Xiaoping, to the 1978 National Science Conference.²⁹³ Strategic weaponeers emerged at the forefront of Deng's effort to promote "scientific" decision analysis, in part because they had been among the only groups of Chinese technicians acquainted with these methodologies and techniques.²⁹⁴ Two of the most prominent players in the post-1978

²⁹² Jan P. Herring, "U.S. Electronics Industry: Military-Civilian Interdependence" unpublished manuscript, Motorola Corporation, 1985, cited in Richard J. Samuels, *Rich Nation, Strong Army: National Security and the Technological Transformation of Japan* (Ithaca, N.Y.: Cornell University Press, 1994), p. 30.

²⁹³ Deng Xiaoping, "Zai Quanguo Kexue Dahui Kaimoshi Shang de Jianghua" (Speech at the opening ceremony of the National Science Conference), March 18, 1978, in Deng Xiaoping Wenxuan, 1975-1982 (Selected works of Deng Xiaoping, 1975-1982) (Beijing: People's Press, 1983), pp. 83-84.

²⁹⁴ For instance, Qian Xuesen and Song Jian had experimented with cybernetic theories in the early missile programs. Song later sought to apply these to other problems, especially demography. On missileers and cybernetics during these early years, see Gu Mainan, "Cong Xiao Balu Dao Kexue-jia" (From a little eighth route armyman to a scientist), *Liaowang* (Outlook), January 5, 1987, pp. 13-16.

efforts, Zhang Jingfu and Song Jian, had been critical figures in the Mao-era strategic weapons programs.²⁹⁵

The basis of the weapons elite's search for new models was a creeping sense that China's R&D system had ossified even in areas where the foundations appeared strong. As strengths, many S&T planners highlighted areas that had been intimately connected to the privileged strategic weapons program, including space and materials science. Major weaknesses included energy technology and transportation systems.²⁹⁶

The opportunity to participate in international symposiums, to travel abroad, and to host overseas colleagues in China had immense shock effects. It served to demonstrate that China's technical infrastructure had fallen far behind global standards. More important, it drove home to technology policy leaders how anachronistic the simple spin-off conception underlying Mao-era strategic technology policy had become.

A first stream of that reassessment took place among scientists and engineers after a series of Sino-American and Sino-European S&T agreements led to working-level exchanges.²⁹⁷ In the late 1970s, for example, the U.S. National Academy of Sciences sponsored a series of delegations to China that jump-started the U.S.-China exchange process. Many of these groups met with key strategic weaponeers, including one of the men who would later propose the 863 program to Deng Xiaoping: the nuclear physicist Wang Ganchang. Wang's interlocutors, an American nuclear physics delegation, arrived in China in the late spring of 1979. It comprised both theorists and experimentalists and included some of the most prominent physicists in the United States. The group was led by Allan Bromley of Yale, who later became the science adviser to President George Bush.

²⁹⁵ Zhang Jingfu played a key role in charge of military liaison with the Chinese Academy of Sciences (CAS) in the late 1950s. Song Jian was deputy chief designer of China's SLBM program and later became a major figure in the missile and space administrative bureaucracy. On Zhang Jingfu, CAS, and defense technology, see Feigenbaum, "Soldiers, Weapons, and Chinese Development Strategy." See also Zhang Jingfu, "Zhongguo Kexueyuan yu Guofang Kexue Jishu" (**The Chinese Academy of Sciences and defense science and technology**), in Nie Li and Huai Guomo, eds., *Huigu yu Zhanwang: Xin Zhongguo de Guofang Keji Gongye (Retrospect and prospect: new China's defense science, technology, and industry!*) (Beijing: Defense Industry Press, 1989), p. 79.

²⁹⁶ Yang Lizhong, ed., *Gao Jishu Zhanli: Kua Shiji de Tiaozhan yu Jiyu (High-technology strategy: challenges and opportunities at the turn of the century)* (Beijing: Military Sciences Press, 1991), pp. 248-249.

²⁹⁷ The Sino-American process grew out of agreements signed during a July 1978 visit to China by the heads of U.S. technical agencies, led by President Jimmy Carter's science adviser, Frank Press. This led to a trip in the fall of 1978 by Energy Secretary James Schlesinger and to important defense-technical meetings with Undersecretary of Defense William Perry that I treat in greater detail below. For an account of the Press visit, as well as the overall importance of U.S.-China negotiations during this period, see Suttmeier, "Scientific Cooperation and Conflict Management in U.S.-China Relations."

These U.S. delegations proved crucial to the Chinese, first by providing benchmarks against which to assess relative progress and, second, as an introduction to the evolution of Western technical ideas.²⁹⁸

5- Foreign Affairs Retrospects & Prospects

Foreign affairs did not play a major role in the Cultural Revolution. Conversely the effect of the Cultural Revolution on foreign relations tended to be negative, its ideological line reinforcing China's isolation. In 1964 China was indeed isolated. The rift with the Soviet Union was publicly acknowledged. The People's Republic remained excluded from the United Nations and subject to boycott by the United States while US military involvement in Vietnam was escalating. China appeared liable to attack on two fronts. As the Cultural Revolution came under control in 1968-9 the leadership embarked on a new foreign policy initiative which reflected the national interests of China rather than ideology. By welcoming President Nixon in 1972 China made a significant move back into the community of nations.

5.1 Sino- Soviet Union Relations

This section tries to show the way of explaining the nature of Sino-Soviet relations, from 1966 to 1978. After defining its roots and nature, the evolution of Mao's Soviet policy within these parameters will be traced.

When the Cultural Revolution brought the return of more radical policies, beginning in 1969, however, the Sino-Soviet border conflicts made the Chinese leadership realize the necessity of ethnic minorities' support for national security.

The Cultural Revolution, of course, represented Mao's movement of the struggle against revisionism from the international stage onto the domestic scene. The struggle was with those who would seek to promote the 'restoration of capitalism' within China as had been the case in the Soviet Union.²⁹⁹ In the course of the next decade, the group which would become known as the "Gang of Four" took Mao's earlier concerns regarding the impact of relations with the Soviet

²⁹⁸ For example, on nuclear physics, see D. Allan Bromley and Pierre M. Perolle, **Nuclear Science in China**, CSCPRC Report no. 10 (Washington, D.C.: National Academy of Sciences Press, 1980). On solid state physics, see Anne Fitzgerald and Charles P. Slichter, *Solid State Physics in the People's Republic of China*, CSCPRC Report no. 1 (Washington, D.C.: National Academy of Sciences Press, 1976). On high-energy physics, see Wolfgang K.H. Panofsky, **Observations on High Energy Physics in China**: Report of a Visit to the People's Republic (October 5-22, 1976) (Stanford, Calif.: U.S.-China Relations Program, Stanford University, 1977). Panofsky is the founding father of the Stanford Linear Accelerator Center and was an important member of President Dwight Eisenhower's Scientific Advisory Committee.

²⁹⁹ J. Richard Walsh: China and the New Geopolitics of Central Asia, **Asian Survey**, Vol. 33, No. 3. (Mar., 1993), pp. 275.

Union on Chinese socialism and fashioned a foreign policy that saw the danger emanating from the Soviet Union—and the United States for that matter—to be more in the realm of ideological subversion than that of a conventional military or diplomatic nature. The proper foreign policy response, they argued, would emphasize domestic revolutionization and distance from the Soviet Union. Mao's radical supporters believed that 'confrontation was necessary to draw a clear line between China's revolutionary principles and the Soviet's decadent revisionism'—both for a domestic as well as an international audience.³⁰⁰

The Soviet leaders also knew that Mao and his faction strongly opposed rapprochement. As they observed the effects of the Cultural Revolution, they concluded that Mao was risking the continuation of Communist rule in China by destroying the Party and becoming ever more fanatical, while also building nuclear weapons and ballistic missiles. Starting in the 1950s, the Soviet Union had been concerned about the risks of nuclear war that might arise following China's acquisition of nuclear weapons. As discussed, Khrushchev had told Mao that China did not need the atomic bomb, since it was protected by the Soviet Union. But Mao persisted, stating that China, as a great power, should have its own atomic weapons. The Soviets judged that China, with its huge population also equipped with nuclear weapons, could become an extremely dangerous threat. They also feared that China could begin a war with the U.S. that would spread to the USSR.

The distrust was further magnified as the two powers negotiated about their border. In 1936, Mao told an American journalist, "It is the immediate task of China to regain all our lost territories," including Outer Mongolia, Central Asia, Siberia, Vietnam all of which Mao believed should again become part of China.³⁰¹ The discussions about China's claims on Soviet territory in the 1950s had been intense but inconclusive. As Mao moved away from cooperation with the Soviet Union, his determination to regain China's "lost territories," which included a significant part of the Russian Far East and some five hundred thousand square miles in Soviet central Asia, became stronger.

On March 8, 1963, the Chinese government published a list of "lost territories," which included considerable parts of the Soviet Union. At that time, China also demanded "the Soviets acknowledge, for the record, that the current Sino-Soviet frontier was a product of 'unequal' and

³⁰⁰ Steven M. Goldstein: "Nationalism and Internationalism: Sino-Soviet Relations" in Thomas W. Robinson and David Shambaugh, eds., **Chinese Foreign Policy: Theory and Practice** (Oxford, UK: Clarendon Press, 1994), p.250.

³⁰¹ John W. Garver: "The "New Type" of Sino-Soviet Relations", **Asian Survey**, Vol. 29, No. 12. (Dec., 1989), p. 1137.

therefore ‘illegal’ treaties. Moscow denied having territorial problems with any neighboring state and refused to admit the illegality of the old treaties with China.”³⁰²

The fall of Nikita Khrushchev in October 1964 momentarily offered the prospect of Sino-Soviet reconciliation. When Zhou Enlai led a delegation to Moscow for the anniversary of the 1917 Bolshevik Revolution, 7 November 1964, the Soviets raised the question of increasing aid to China (as well as North Korea and Vietnam) and in return the Chinese were expected to cooperate at least to the extent of ceasing public polemics.

It is notable that the question of supporting Vietnam became another bone of contention between the two communist powers. In April 1965 a Soviet proposal for a meeting with North Vietnamese and Chinese leaders to discuss cooperation was accepted by Hanoi and rejected by Beijing. Arrangements for the transport of Soviet supplies to North Vietnam via China led to bickering in which both sides accused the other of failing to support the struggle of the Vietnamese people.

Thus China and the USSR had a common interest in preferring not to be directly engaged in Vietnam. Both countries believed that limited involvement was essential to maintain a balance of power against American aggression in Asia. Such was the underlying reality of the anti-imperialist slogans at the time.

Negotiations regarding the border in 1964 made no progress, and early in 1969 and moving military units to the Russian border decided on an armed attack against Soviet troops.

The 1968 Soviet invasion of Czechoslovakia³⁰³ and the 1969 border clashes along the Chinese-Russian border raised the level of the Sino-Soviet conflict to new heights, where the Soviet Union constituted a threat to China’s national security. One consequence of the perceived threat was China’s reassessment of its foreign relations, including relations with the United States; others included the decision to further internationalize its anti-Soviet policy and to identify and secure its international role and status.

On March 14-15, 1969, the Soviet Union retaliated by attacking Chinese forces using tanks, artillery, and large numbers of soldiers, leading to about sixty Russian and eight hundred Chinese casualties. As described by Hsu, “Both sides made feverish propaganda out of the clashes, held exhibitions to illustrate the others’ atrocities, and organized vast demonstrations to stir up

³⁰² Steven M. Goldstein: “Nationalism and Internationalism: Sino-Soviet Relations” in Thomas W. Robinson and David Shambaugh, eds., **Chinese Foreign Policy: Theory and Practice** (Oxford, UK: Clarendon Press, 1994), p.264.

³⁰³ George T. Yu: “Africa in Chinese Foreign Policy, **Asian Survey**”, Vol. 28, No. 8. (Aug., 1988), p. 854

national sentiments and war scares. Battles were also fought on other border islands in the Amur River and along other parts of the Soviet-Chinese border. At the same time, China sought closer relations with Romania and Yugoslavia (countries which were also concerned about possible Soviet intervention) as a means of facing Moscow with the risk of a two-front war.

It was at this time that the Soviet Union increased preparations for a preemptive nuclear attack on China's nuclear facilities. Moscow's purpose was to assure that China could not further develop nuclear weapons capabilities, which could add to the threat it already posed to the Soviet Union. It is reported that the Soviet Union sent a high-level emissary to the United States, proposing to the recently inaugurated President Nixon (January 1969) that both countries undertake a joint military attack against China. President Nixon, however, gave "a sharply, angrily negative response."³⁰⁴ In the meantime, both the Soviet Union and China continued preparing for war.

Confrontational incidents on the long border between China and the Soviet Union had increased annually. In March 1969 military confrontation erupted into fighting over a disputed island in the Ussuri River. The Chinese attacked first. Why? The Soviet Union had been strengthening its border forces especially to the east of Lake Baikal. It was militarily appropriate to strike first and make the Soviets aware of the limits to their high-handed action as well as to make the political point that the Chinese people were threatened by the Soviet revisionists. The incident would draw attention away from internal problems and momentarily enhance the authority of Lin Biao.

After the Ussuri confrontation Moscow made proposals for talks which were ignored by Beijing. Meanwhile the Soviets increased their forces on the Soviet border, a Pravda article indicated that any Sino-Soviet conflict would inevitably be nuclear and the United States and other countries were asked how they would react in the event of a Soviet attack on China.³⁰⁵ If all this was designed to induce the Chinese to come to the conference table, it worked. On 11 September 1969 Kosygin and Zhou Enlai met at Beijing airport. Eventually Kosygin's proposal for talks on the border was accepted on 7 October. It was agreed that even if there was no settlement of the disputed borders, the status quo should be maintained and there should be no use of force.

³⁰⁴ P. R. Chari: China's Nuclear Posture: An Evaluation, *Asian Survey*, Vol. 18, No. 8. (Aug., 1978), p. 817

³⁰⁵ Lawrence, Allan: **China under Communism** (Making of the Contemporary World), Routledge; 1 edition (October 19, 1998) p. 85

This in itself was indicative of a new phase in Sino-Soviet relations. It also reflected the fact that the Cultural Revolution had calmed down.

5.2 Sino – Africa Relations

China and Africa are geographically far away from each other, separated by immense land mass with huge mountains and stretching deserts, as well as by vast Oceans. The distance covers several tens of thousands of miles either on sea or on land. In ancient times when there were no steamships, no railways, no airplanes, communications and contacts between the two continents were extremely difficult.

Africa increasingly assumed an important place in Chinese foreign policy. An intensive drive to win friends and gain influence ensued. Utilizing a vast variety of foreign policy instruments, China initiated a major program to penetrate the African states. The Chinese policy objectives over Africa are various but there are basic cornerstones of this policy during the Cultural Revolution.

Anti-imperialism has constituted a major theme in the foreign policy of the People's Republic of China. This must be understood in both the ideological and national interest (e.g., self-preservation) context. Marxism-Leninism, which divides the world into imperialist and socialist camps, serves as an important component of Chinese policy. The ideas relating to the struggle between the two camps and the unfolding of the world revolution against the imperialists are also influenced by China's ideological orientation. The recent statement by Lin Biao calling upon the "world countryside" of Asia, Africa and Latin America to surround and capture the "world cities" of North America and Western Europe can be accepted as a Chinese variation of the classical Marxist-Leninist thesis.³⁰⁶ It follows ideologically, therefore, that China perceives Africa as a stage in the world's unfolding revolutionary struggle against imperialism.

The anti-imperialism objective has also its more immediate aspects. In practice, anti-imperialism has been directed chiefly against the United States. In the view from Peking, the United States is not only the foremost "imperialist" power and the leader of the "world cities," but it is also the champion of the China containment policy, including the "occupation" of Taiwan. This has led the Chinese to certain "discoveries" in the history of imperialism in Asia and Africa, with the new version assigning a major role to the U.S. in both the past and present, thus linking these two periods. Within the context of China's African policy, anti-imperialism has served the primary function of "exposing" the imperialistic character of United States policy.

³⁰⁶ George T. Yu: "China's Failure in Africa, *Asian Survey*", Vol. 6, No. 8. (Aug., 1966), p. 462.

In the first place, China and Africa are held to be united because they belong to the same club. The club has been conceived of over the decades in a number of different ways. In the early 1950s, it appeared to be Islam, as Muslims from Xinjiang or Ningxia were sent to make contact with the North African states which at that time were virtually the only parts of the continent to have gained independence.³⁰⁷ The club was more broadly defined in the late 1950s and 1960s as Asia, Africa, and Latin America, and more recently the preferred terms have been the Third World and the South.

However much stress has been placed on the common ground in the Sino-African relationship, the differences have repeatedly made themselves felt. The most fundamental difference has consisted in the fact that the Chinese have looked upon Africa as an arena in which to campaign against a number of global opponents of their own. A campaign against the USSR was fought throughout the 1960s at the level of liberation movements and Communist-sponsored bodies such as the Afro-Asian People's Solidarity Organization (AAPSO): from the late 1960s onwards it was the principal factor determining China's relations with African governments, and it remained all-important right up to the mid-1980s. Chinese interest in Africa was the Sino-Soviet conflict. Following the open break with the Soviet Union in the early 1960s, Africa became a battlefield in the Sino-Soviet struggle. China sought to both exclude and oppose the Soviet Union, politically and otherwise, from and in Africa. In the former instance China campaigned to win African support to exclude Soviet participation at the abortive Afro-Asian conference of 1965; in the latter case, China supported one group of African liberation movements—e.g., the Uniao Nacional Para a Independencia Total de Angola (UNITA) and Zimbabwe African National Union (ZANU) while opposing other groups supported by the Soviet Union, such as the Movimento Popular de Libertacao de Angola (MPLA) and the Zimbabwe African People's Union (ZAPU).³⁰⁸

These campaigns have been launched for both strategic and political reasons. The Chinese have shown a constant tendency to look upon Africa in strategic terms.

The early 1970s, similar to the 1960-1965 periods, was an era of intense Chinese activism in Africa. Three areas of activity will suffice to provide examples of the extent of China's behavior. First, China undertook a major campaign to secure diplomatic recognition. Between January 1970 and December 1972, China established relations with eleven additional African

³⁰⁷ Philip Snow: "China and Africa: Consensus and Camouflage" in Thomas W. Robinson and David Shambaugh, eds., **Chinese Foreign Policy: Theory and Practice** (Oxford, UK: Clarendon Press, 1994), p.283.

³⁰⁸ George T. Yu: "Africa in Chinese Foreign Policy, **Asian Survey**", Vol. 28, No. 8. (Aug., 1988), p. 851

states and restored relations with four; by the end of 1975, 37 of the 48 African states recognized China. A major program was launched inviting African leaders to China. Between January 1970 and December 1975, no less than 16 African heads of government visited China, including President Nimeri of the Sudan (1970), Emperor Haile Selassie of Ethiopia (1971), and President Nyerere of Tanzania (1974).³⁰⁹

What was the successes of PRC in the mid- 1970s from its forward diplomacy in Africa? The answers are; first in 1971 the PRC secured China's U.N. seat with the support of 26 African states (34% of the General Assembly vote). Second, China won the battle against Taiwan in Africa; by 1975, 37 African states had recognized China as opposed to eight who continued to maintain relations with Taiwan. Less successful was China's attempt to organize an African anti-Soviet front based on the three world's theory, as the African states were unwilling to accept China's world view and rejected Beijing's anti-Soviet policy. There are several reasons that African states supported China in these years; according to the African goals: political independence, economic independence and the desire for membership in the community of nations.

China's relations with Africa have been closely interlinked with Sino-Soviet relations; China sought repeatedly to use Africa in the 1960s and 1970s as an area of confrontation in its struggles with the Soviet Union, albeit with very limited success. The reason of the poor policy of China was depending on the fact that, it was a developing nation with limited resources and high internal demands, but it was also an aspiring world power with global interests that required, in this instance, a foreign aid policy in accord with that role.

From the economic perspective, Communist China's trade and aid relations with the economically underdeveloped countries of the non-communist world would appear to be more purely political in inspiration than her economic contacts with the industrialized powers of the West. Seen from the standpoint of long-range Chinese objectives, trade with and credits from the West help in the development of China by providing urgently needed industrial equipment denied it by the U.S.S.R., while China's trade with and aid to the non-communist countries of Asia, Africa, and Latin America may in time help spread Chinese-type communism in vast and key strategic areas of the world. In China's present thin-cabbage soup era, such trade and aid are

³⁰⁹ George T. Yu: "Ibid" p. 855.

economic luxuries indulged in out of political necessity.³¹⁰ They are in the nature of political insurance for the future.

Diplomatically, the newly independent countries of Africa are vital to China's efforts to gain a seat in the United Nations and simultaneously to depose the Nationalists from their present position in that world body. The Chinese also believe that over the long run their strategy of economic development and socio-political transformation is more effective in dealing with the remnants of Western influence in Africa and more likely to lead to the emergence of socialist regimes than the methods proposed by the Soviet Union. For the time being, China's trade and aid contacts with the African countries are limited by her modest economic development, distance, and the absence of a sizable commercial fleet. Trade, however, is only one channel through which Chinese influence is exercised.

It is instructive by contrast to consider those parts of the continent where the Chinese have not been so active. The Chinese built the Tan-Zam railway, but they never went ahead with another railway line which they were asked at one stage to build between Guinea and Mali, and they never fell in with a request to construct the Manantali dam on the borders of Mali and Senegal.³¹¹ Most striking of all, they have given very little aid to Nigeria, the most populous country on the continent. This evidence supports the impression that for much of the last twenty years Chinese attention has largely been devoted to Southern Africa, the East African littoral, and the western Indian Ocean. West Africa and the hinterland north of the 'cone' have had lower priority. The obvious conclusion is that Chinese interest has focused on places where the Soviet navy has been expected to berth.³¹²

As a result of the Cultural Revolution years; Chinese foreign policy commitments toward Africa have represented key components of Chinese policy generally. Consider the legitimacy question, or the competition with the Republic of China on Taiwan for the right to be recognized as China, including representing China internationally. China's policy toward Africa during the 1960s and 1970s was clearly directed at winning African recognition, which in turn led to China's seating in the United Nations and other international organizations. Less successful was China's reactive policy in Africa in the context of the Sino-Soviet conflict, directed at discrediting and forming a united front against the Soviet Union.

³¹⁰ Jan S. Prybyla: "Communist China's Economic Relations with Africa 1960-1964" *Asian Survey*, Vol. 4, No. 11. (Nov., 1964), p. 1135.

³¹¹ George T. Yu: "China's Failure in Africa" *Asian Survey*, Vol. 6, No. 8. (Aug., 1966), p. 464.

³¹² George T. Yu: "Ibid"

In the 1980s, China's African policy has been a key component of its Third World policy and "independent foreign policy;" the goal of relations with Africa was to ensure China's Third World status and provide a balance with Washington and Moscow. These politics will be evaluated in the Deng's China, next Chapter.

5.3 Sino - United States Relations (Rapprochement)

As the Cultural Revolution came under control in 1968-9 the leadership embarked on a new foreign policy initiative which reflected the national interests of China rather than ideology. By welcoming President Nixon in 1972 China made a significant move back into the community of nations.

The main factors leading to diplomatic detente between China and the United States were:

1- The increase in the Soviet forces, both conventional and nuclear which were seen to constitute a threat to the security of China.

2- The difficult position of the United States in Vietnam. Attempts to get out began with President Johnson and became a keystone of incoming President Nixon's policy.

3- The prospect of US-Soviet collusion, exemplified by the US, USSR. UK Partial Test Ban Treaty in 1963 and further advanced in 1967 at a meeting between President Johnson and Alexei Kosygin in June which led to a draft nuclear non-proliferation treaty in August. Moves towards US-Soviet rapprochement came to a head in January 1969 when Nixon in his inaugural address announced his intention to cooperate further with the Soviet Union.

4- If the Americans were in an impasse over Vietnam, the Chinese were equally stymied over Taiwan. Detente with the US might lead the US to be less intransigent in its support for the nationalist regime on the island.

5- There could have been an economic rationale for detente with the USA, since it would lead to the opening-up of trade, particularly to China's advantage. But this reason does not appear in the Chinese materials sent out to party members in December 1971 to justify detente.³¹³

Auxiliary factors were the enthusiasm of the key players on both sides. Chairman Mao was happy as the prospect unfolded of China emerging from isolation to be recognized as a world power. Nixon relished the idea of winning a second term in office by an apparently daring and imaginative coup. Why did it take more than two years to set up the Nixon visit to Beijing?

³¹³ Constantine C. Menges: **China: The Gathering Threat**, Nelson Current (April 19, 2005).

5.3.1 Kissinger's Visit to China

In July 1971, Dr. Kissinger went to Beijing. The visit was kept secret by mutual agreement so that each country could explore whether a visit by President Nixon would be in their mutual interests. According to the account of a participant and of a declassified secret chronology of U.S.-China relations from 1971 to 1975, Kissinger, in his first meeting with Chinese Premier Zhou Enlai, preemptively gave China what it wanted most by stating that it was the U.S. position that there should be “No two Chinas; no one China, one Taiwan; no independent Taiwan.”³¹⁴

During Kissinger's first visit, the record shows that he also agreed that Communist China should replace Taiwan in holding the seat of China in the United Nations as a permanent member with a veto on the UN Security Council, and that the U.S. would confer formal diplomatic recognition on the government in Beijing during Nixon's second term in office. During his second visit in October 1971, Kissinger gave China important intelligence information, including photos of Soviet military deployments around China, intercepts, and other useful information. Former National Security Advisor Robert McFarlane, then working for Kissinger, has written that “extremely sensitive exchanges of information had begun by mutual agreement in late 1971,” including communications intercepts, high-resolution satellite photos, and other valuable information.³¹⁵

In return for these major U.S. concessions and helpful actions, Kissinger was told by Zhou that the United States should withdraw all its forces from Vietnam. After Kissinger left Beijing, Zhou “made a secret visit to Hanoi, assuring the North Vietnamese of China's continued support, yet also apparently urging some sort of compromise that would end the fighting. The result of Kissinger's missions to Beijing in 1971 was that President Richard Nixon received permission for a visit to China that would take place early the next year.

5.3.2. The Nixon Visit

It is widely recognized that strategic considerations were primary in stimulating the Sino-American rapprochement of 1971-2. On the Chinese side, Chairman Mao and Premier Zhou Enlai perceived an accentuated threat from the Soviet Union in the wake of the 1968 Soviet invasion of Czechoslovakia and the subsequent proclamation of the Brezhnev Doctrine, the 1969 Sino-Soviet border clashes, and ebbing of the American presence in Vietnam. Mao and Zhou perceived the balance of power between the superpowers to be shifting, with the Soviets on the

³¹⁴ Harvey Starr: *The Kissinger Years: Studying Individuals and Foreign Policy*, **International Studies Quarterly**, Vol. 24, No. 4. (Dec., 1980), pp. 465-496.

³¹⁵ Harvey Starr: “Ibid”

offensive and American power waning (Sugong, Meishou). Thus, from the perspective of Chinese national security, perceived shifts in the global balance of power warranted a strategic shift on China's part.

On the American side, President Nixon and National Security Adviser Henry Kissinger also perceived a heightened Soviet threat to Central Europe, North-east Asia, the Middle East, and Africa. Opening ties with Beijing not only had compelling logic in its own right, but helped shore up the American strategic position globally and in Asia in particular.

5.3.2.1 The expectations of China and U.S.A. by Each Other

With respect to Nixon's view of the Chinese intention to "build up their world credentials," the Nixon visit led to major benefits for the Beijing regime. First, it included the private promise that the U.S. would formally recognize China in the future, and the visit itself showed that the U.S. no longer contested the authority of the Beijing regime to rule the mainland. Second, the U.S. had already agreed that China should take Taiwan's seat in the United Nations; this occurred in the fall of 1971. Formally, the U.S. supported a two-China policy within the United Nations, but when this did not occur, Taiwan was effectively removed from its permanent seat on the UN Security Council and from the United Nations. Third, as soon as the United States announced President Nixon's visit, a number of other democratic countries moved to normalize relations with China, including Japan and West Germany among many others, so that within a few years, many governments had transferred their diplomatic recognition from Taiwan to Communist China.

Another Chinese purpose was to use the relationship with the United States as a means of reducing the probability of military attack by the Soviet Union. That purpose was clearly met. The handwritten notes of President Nixon show that in the private conversation with Zhou, he gave China assurances about the Soviet Union, including that the United States would "seek to maintain the balance of deals."³¹⁶ These assurances were accompanied by further U.S. promises of intelligence and other useful information about the Soviet Union.

Looking at U.S. purposes for the 1972 summit, we find that the United States accomplished the broad goal of opening up a new relationship with China, which has continued and which, in the U.S. view, provided an incentive for the Soviet Union to reach arms limitation agreements and to enter into detente with the United States. These were formalized at the U.S.-

³¹⁶ Andrew Porter; John Adams: "Nixon in China": John Adams in Conversation Tempo, *New Ser.*, No. 167. (Dec., 1988), pp. 25-30.

Soviet negotiations in May 1972. The goal of restraining the USSR and preventing it from attacking Communist China was met. Nixon's goal of a "more stable Asia"³¹⁷ was not met because Communist China and the USSR continued helping the Communist movements that took power in South Vietnam, Cambodia, and Laos in 1975. This was then followed by a long Soviet-Chinese proxy conflict in Cambodia, which included a punitive Chinese invasion in 1979 of the border region in Communist Vietnam.

This first U.S.-Chinese negotiation set a pattern that would continue over the next decades. In 1972, by any objective measure, the United States was in the far stronger negotiating position. It was China that was menaced directly by the Soviet buildup along its northern border; it was the United States which could and did help counter the effects of that buildup with intelligence information and later with some military assistance. It was Communist China which needed and received assurances that the United States would not agree to participate in or condone a Soviet nuclear attack on China and its nuclear military facilities. Nevertheless, the results of the encounter were that the United States made concessions on the issue of greatest importance to China—Taiwan—and then received virtually nothing on the issue which Nixon had originally defined as of greatest importance to the United States: Chinese help in bringing about a political settlement in Vietnam permitting the removal of U.S. forces without a Communist victory there.

5.3.2.2 The Results of Rapprochement

It facilitated an important realignment in the North-east Asian power balance by creating for the first time in the twentieth century a collaborative Washington-Tokyo-Beijing axis, thereby offering a counterweight to rapidly expanding Soviet power in East Asia. It also contributed significantly to the maintenance of stability on the Korean peninsula. The rapprochement further facilitated a gradual thaw between Beijing and the non-Communist nations in South-east Asia.

In general, the Sino-American opening reoriented China from being a destabilizing to a status-quo power in Asia. The rapprochement also enabled the People's Republic to be regarded as an actor of major international consequence whether or not the PRC actually exerted global influence, as indeed it did not China was perceived by many as having achieved global power

³¹⁷ Constantine C. Menges: China: The Gathering Threat, Nelson Current (April 19, 2005).

status.³¹⁸ Thus, the Sino-American rapprochement both contributed to global systemic change and became a beneficiary of it.³¹⁹

The Sino-American rapprochement proceeded simultaneously with US-Soviet detente. However, this bold American initiative to reduce tensions with both leading Communist powers raised Soviet fears of Sino-American collusion as well as resurrecting Chinese fears of a US-Soviet condominium of power over the world. All of this occurred when, in fact, there was no essential change in the overall bipolar structure of the international system. Despite detente, the world remained locked into the Cold War and the institutions of it. In other words, the 'loose bipolar' character of the international system that prevailed during the decade of the 1960s remained constant while the United States, China, and Soviet Union added a new dimension to the international system with the creation of the so-called 'strategic triangle'.³²⁰

Such had not always been the case. Sino-American relations had for two decades been beholden to a tighter bipolarity.³²¹ With the end of the Second World War and the division of Europe that emerged from the Yalta and Potsdam accords, the creation of NATO and the Warsaw Pact, and the installation of Soviet proxy regimes throughout Eastern Europe, the 'tight bipolar' world had taken root. With the signing of the Sino-Soviet Treaty of Peace and Friendship in February 1950, Sino-American relations became enmeshed in the broader international systemic properties of the day. No longer was the antagonism between Washington and Mao's Communists a primarily bilateral affair. 'Lost chance' or not, the Sino-American confrontation increasingly became a function of Moscow.³²²

The Sino-American estrangement during the decade of the 1960s can also be explained at the global systemic level of analysis, but the hostility endured for a different reason. Instead of the confrontation being sustained for reasons of tightening polarity, it was characterized during the 1960s by loosening polarity. The open Sino-Soviet rupture in 1960 and the subsequent struggles within the socialist camp, the defection of France from the military command structure of NATO, dissension within the Western alliance over the wisdom of the American involvement in Vietnam, decolonization and a series of popular uprisings in the developing world all

³¹⁸ See Jonathan D. Pollack: *China's Potential as a World Power* (Santa Monica, Calif.: Rand Paper p. 6524, 1980)

³¹⁹ Thomas W. Robinson: **Restructuring Chinese Foreign Policy, 1959-76: Three Episodes**, in Kal Holsti (ed.), *Why Nations Realign* (London: Allen & Unwin, 1982), p. 134

³²⁰ David Shambaugh: "Patterns of Interaction in Sino-American Relations" in Thomas W. Robinson and David Shambaugh, eds., **Chinese Foreign Policy: Theory and Practice** (Oxford, UK: Clarendon Press, 1994), p. 199.

³²¹ David Shambaugh: "Ibid"

³²² Steven M. Goldstein, "Sino-American Relations: 1948-1950: Lost Chance or No Chance?" in Harry Harding and Yuan Ming (eds.), **Sino-American Relations, 1945-1955** (Wilmington, Del: Scholarly Resources, 1989), 119-42.

contributed to the erosion of the tighter bipolarity of the 1950s. The ‘two camps’ and the ‘Chicom threat’ (particularly nuclear) thus remained the prevalent view in Foggy Bottom, precluding the new Kennedy administration from undertaking any new initiatives towards China.³²³ Although there were those in the Kennedy administration (particularly in the State Department) who recognized the geopolitical implications of the Sino-Soviet split and were pushing for an opening to China, the new President and Defense Secretary McNamara shared the view that China remained a pressing threat to US national security. Kennedy himself was particularly concerned about China’s nuclear potential which was realized in October 1964 with the Chinese detonation of an atomic device.

In this environment the US-China confrontation continued. The battlefield shifted from Korea and the Taiwan Straits to Vietnam. By 1965 the war was no longer fought only by proxy, as China deployed 320,000 People’s Liberation Army (PLA) regulars into North Vietnam between October 1965 and March 1968, when they were withdrawn.³²⁴ These forces manned anti-aircraft batteries, did logistical work, and engaged US aircraft in combat, although the two sides were careful to avoid direct engagement of forces.³²⁵ Because of the American military involvement on China’s southern periphery, the continued impasse over Taiwan’s status, and the stand-off in North-east Asia, Sino-American relations remained frozen in armed confrontation.

The 1968 Nixon Doctrine initiated the process of change. Henceforth resident regimes would have to carry the bulk of the burden for sustaining themselves against local insurgencies. ‘Vietnamization’ was the order of the day. As a result of this policy shift the United States began to disengage from Vietnam. This tactical change in American policy, coupled with escalating Sino-Soviet military tensions, led to the Sino-American breakthrough in 1971 (although the delicate signaling began as early as 1968). The Soviet invasion of Czechoslovakia in 1968 and the enunciation of the Brezhnev Doctrine of limited sovereignty for socialist states created great consternation in Beijing fears that were only reinforced by the 1969 Ussuri clashes and the real threat of a Soviet surgical strike against the Chinese nuclear establishment.³²⁶ All of these factors precipitated the formation of the ‘strategic triangle’.

When examining Sino-American relations during the two decades following rapprochement, system polarity continues to loom large as an explanatory variable. Despite the continued impasse over Taiwan and the inability to arrive at acceptable terms for the

³²³ David Shambaugh: “Ibid”

³²⁴ David Shambaugh: “Ibid”

³²⁵ John Garver: “**The Chinese Threat in the Vietnam War**”, *Parameters* (Spring 1992), 73-85

³²⁶ David Shambaugh: “Ibid”

normalization of diplomatic relations, the common strategic threat posed to both nations by the Soviet Union served to sustain the relationship throughout the 1970s and much of the 1980s. The Soviet-American detente of the late Brezhnev era did, however, inject a certain degree of caution into China's America policy. The Chinese were wary that the Americans were attempting to 'stand on their shoulders' to counter the Russians while making no concessions on Taiwan. Kissingerian strategy may well have been just that as the US played the 'China card'. This was somewhat less true of the Carter administration as it was more committed to establishing a broad-based, institutionalized relationship between the two governments and societies.³²⁷ The rationale of Carter's China advisers was that Sino-American relations would be forever vulnerable to fluctuation and potential confrontation if premised only on strategic alignment.³²⁸ For this reason the Carter administration made the decision that the Sino-American relationship had to be institutionalized at both public and private levels.

Despite the intent to root the relationship more broadly, the Soviet invasion of Afghanistan and the Vietnamese invasion of Cambodia further galvanized its strategic rationale. In fact, following these events and the official normalization of relations in 1979, the Sino-American relationship came close to being a de facto alliance. 'Tight alignment' is probably the best way to describe the strategic consultations and exchanges in the national security sphere during these years. The leaders and policy-makers in both nations held nearly identical perceptions of global strategic trends. Thus systemic changes (increased Soviet-American confrontation) again produced a shift in Sino-American relations during 1979-80.

5.4. U.S.-China Relations, 1993-2000

During the eight years of the Clinton presidency, the relationship between China and the U.S. was of enormous importance to both countries and received high-level attention. These were the years in which China's international trade grew enormously and more than 40 percent of its exports went to the United States. These were also the years when both powers began to adapt their international policies to the world after the unraveling of the Soviet Union. For both the United States and China, this meant a sharply diminished sense of risk from the former Soviet Union, and its main successor state, Russia.

As a candidate for the presidency, Clinton expressed three major concerns about China: its human-rights abuses; its selling of expertise and components for weapons of mass destruction to

³²⁷ Michel Oksenberg: "A Decade of Sino-American Relations", *Foreign Affairs* (Autumn 1982), p. 175

³²⁸ Michel Oksenberg: "The Dynamics of the Sino-American Relationship", in Richard H. Solomon (ed.), *The China Factor* (Englewood Cliffs, NJ: Prentice-Hall, 1981), 48-80

state sponsors of terrorism such as Iran, Syria, and North Korea; and, its strategic nuclear military buildup.

In the spring of 1993, President Clinton agreed to the unconditional renewal of Most Favored Nation trade with China. President Clinton persuaded the Democrats in Congress that he would seek these objectives through diplomatic means and that rather than legislation, a better approach would be for the administration to explicitly establish the conditions that China would have to meet in order to have its access to the U.S. market granted in the spring of 1994.³²⁹ This was done through an Executive Order issued by President Clinton on May 28, 1993, which specified the following conditions China would have to meet before its complete access to the U.S. market would be renewed:

- That China adheres to terms of the UN Universal Declaration on Human Rights;³³⁰
- That it releases from prison the thousands of individuals imprisoned as a result of peaceful free-speech activities in connection with the 1978 democracy wall movement and the Tiananmen Square events of 1989;
- That China comply with a U.S.-Chinese agreement signed in 1992 that no prison labor would be used for the production of products exported to the United States;
- That the treatment of the millions of prisoners in China's prisons and forced-labor camps would be certified as having improved;
- That Tibet's religious and cultural heritage be protected and safeguarded by the Chinese regime;
- That China permits international radio and television broadcasts to its territory.³³¹

Clearly, if adherence to these obligations became a condition for China's access to the United States market, a new political era would have begun there. However, after the Tiananmen massacre, the Chinese regime had made another decision: it decided to strengthen its political dictatorship and to use all means necessary to ensure the Communist regime would stay in power. China did not abide by the conditions set by President Clinton and immediately dismissed them as continuing the U.S. strategy of “peaceful evolution” and interference in its internal affairs.

³²⁹ Constantine C. Menges: **China: The Gathering Threat**, Nelson Current (April 19, 2005), p. 124.

³³⁰ <http://www.un.org/>

³³¹ Constantine C. Menges: *Ibid*, p. 124.

Although China made no improvements in its relevant international or domestic activities, in April 1993 the Clinton administration began lifting a number of post-Tiananmen restrictions on trade with China. For example, the administration permitted the U.S. Export-Import Bank to provide subsidized financing and loans for trade with China, and in the summer and fall of 1993 it waived various trade restrictions. As part of the administration's opening to high-technology trade with China, President Clinton agreed in July 1993 that the China Aerospace Corporation would be permitted to earn tens of millions of dollars by launching satellites made by two U.S. corporations, Motorola and Martin Marietta. Government documents revealed in 1998 that part of the reason underlying the approval was to provide incentives for China to stop selling missile technology.³³² This did not succeed, because only a month later, in August 1993, the Department of State imposed limited economic sanctions on Chinese entities that had sold ballistic missiles to Pakistan. Those sanctions were then lifted in 1994.³³³ These missiles and their technology would eventually be filtered out to various nations, including North Korea, Libya, and Iran through the Khan Network. This is, of course, in addition to the Chinese government's own cooperation with those nations in this area and is a perfect example of the effects of secondary proliferation.

In the fall of 1993, Clinton told electronics industry executives that he wanted to “tailor export controls to the realities of a post-Cold War world.”³³⁴ The electronics and computer industry wanted to increase exports to China. In December 1993, the administration ordered the loosening of restrictions on computer exports so that more advanced computers with a processing speed of up to 67 million theoretical operations per second (MTOPS) could be exported to China.³³⁵

5.4.1 China Reaffirms That the U.S. Is Its Main Enemy

Despite Clinton's many actions favoring China, the hardliners only saw the threat of - “peaceful evolution.” In April, 1993, 116 senior officers of the PLA wrote Deng and Party Secretary General Jiang Zemin, calling for an end to China's policy of “tolerance, forbearance, and compromise toward the United States.”³³⁶ This and a similar letter sent in May 1993 by other senior military officers expressed strong anti-US views at the senior levels of the military

³³² John Mintz, “NCS Papers Trace Concern on Export Waivers for China,” *Washington Post*, June 11, 1998, A10.

³³³ Mintz, “NSC Papers,” A10.

³³⁴ Aron L. Friedberg, “arming China Against Ourselves” *Commentary*, July-August 1999, p.29. <http://www.commentarymagazine.com/cm/main/viewArticle.aip?id=9048>

³³⁵ Constantine C. Menges: *Ibid*, p. 126.

³³⁶ Constantine C. Menges: *Ibid*, p. 126.

and, in particular, criticized the government for having failed to act more assertively against the decision by President Bush to sell Taiwan 150 jet fighters at the end of his term in 1992.

Communist Party of China regards the United States “as its international arch enemy” and that the final report said that in the next years the major target of American hegemonists and power politics is China. ... Its strategy toward China is through economic activities and trade, to control and sanction China and force China to change the course of its ideology and make it incline toward the West; to take advantage of exchanges and propaganda to infiltrate ideology into China's upper strata; to get financial assistance to hostile forces both inside and outside China's territory and wait for the opportune moment to stir up turbulence; to support and encourage Western groups to impose economic sanctions against China to fabricate the theory of a China threat to Northern Asian countries . . . And to manipulate Japan and Korea to follow American strategy toward China.³³⁷

That strategy meeting also concluded that China should seek to reestablish a close relationship with Russia. It is worth recalling that many in Chinese leadership had originally been trained in the Soviet Union, spoke Russian and had worked closely with Moscow from 1949 to 1959. The 1993 strategy meeting also proposed that China seek alliances with important Third World countries.³³⁸ The actions of China in the ensuing years have been consistent with these views.

In January 1994, despite these harsh criticisms by the Chinese Communist Party, the Clinton administration relaxed license requirements for the export of telecommunications equipment. In March 1994, at the initiative of the Clinton administration, the Coordinating Committee for Multilateral Export Controls (COCOM) was disbanded. COCOM had been established by all the industrial democracies to limit the export of militarily useful technology to Communist countries. In the ensuing years, this opened the way for a massive outflow of U.S. high-tech exports to Communist China. The Wisconsin Project on Nuclear Arms Control provided an overview of the nearly \$15 billion in permitted US. High-tech exports to China by the administration. It found that these legal exports could be used to “design nuclear weapons, process nuclear material, machine nuclear weapon components, improve missile designs, build missile components, and transmit data from missile tests.

³³⁷ Richard Bernstein and Ross H. Munro, **The Coming Conflict with China** (New York: Alfred A. Knopf, 1997) p.44.

³³⁸ Richard Bernstein and Ross H. Munro, *Ibid.*

While the Clinton administration was attempting to show goodwill to China in 1993-1994 by loosening export restrictions and other actions, the Beijing regime, for its part, began deployment of ballistic missiles opposite Taiwan.³³⁹ Government documents also reveal that the United States had information that China continued its sale of weapons of mass destruction in 1994, including the sale of ballistic missiles to Pakistan. This raised the risk of war between Pakistan and India.³⁴⁰

In 1994, China sharply devalued its currency. This made its exports much less expensive and much more competitive in comparison to those of South Korea, Thailand, Indonesia, and other Asian producers. This resulted in a sharp increase in China's export earnings and in its trade surplus with the U.S., because China continued to maintain tight restrictions on access to its market. The devaluation in - China reduced the export earnings of neighboring Asian countries friendly to the United States that competed in many of the same product areas in the markets of the industrial democracies. As their hard-currency export earnings declined in 1995 and 1996, China's devaluation set the stage for the very difficult and economically damaging Asian financial crisis of 1997-1999, which required about \$100 billion in emergency loans from the U.S.-supported International Monetary Fund.

5.4.2. The 1995-1996 Taiwan Missile Crisis

During the 1990s, the most visible and dramatic focus of China's international aggression and coercion was the Republic of China on Taiwan. This country had evolved over the years from an authoritarian, very poor country to a pluralist political democracy with a very good standard of living, far above that of mainland China, and with one of most equitable distributions of income in the world.

Yet Communist China has no more “right” to control Taiwan than North Korea does to control democratic South Korea or the former East Germany had to control West Germany. Taiwan has all the attributes of statehood, including a functioning government, a defined territory and population, the ability to enter into international agreements, and a long history of international diplomatic recognition. Taiwan, with a population approaching 23 million, is larger than two-thirds of UN member states.

³³⁹ Greg Gerardi and Richard Fisher, “China’s Missile Tests Show More Muscle,” *Jane’s Intelligence Review*, March 1, 1997.

³⁴⁰ Bill Gertz, **Betrayal: How The Clinton Administration Undermined American Security** , (Washington DC: regenery Publishers, 1999), 268.

On the Taiwan issue, the pattern of the Communist regime is to assert its “right” to what it has taken to calling “China's Taiwan” and then to attempt to coerce the Taiwanese and all other governments into acceding to China's demands. While the U.S. “acknowledged” that “it is China's view” that Taiwan is part of China and has said since 1971 that there should someday be reunification, all U.S. presidents, including President Clinton, repeated that China and Taiwan have to come to a mutual agreement and that the U.S. opposes the use of force by China to take control of Taiwan. This bipartisan consensus was given additional emphasis as U.S. policy by the Taiwan Relations Act of 1979, which was renewed in 1999.

In the summer of 1995, China took a new step in international coercion. To intimidate the people and leaders of Taiwan, China decided in the period July 21-26, 1995, to fire six of its short-range ballistic missiles into an area about forty miles from the capital of Taiwan. The advance notice of these “missile tests” closed the air and sea communication lanes around the island and caused fear in Taiwan.

The effects of China's intimidation against Taiwan were felt immediately on Taiwan. The stock market in Taiwan went down sharply by about 33 percent after the military exercises and missile firings began. At the same time, airlines serving Taiwan had to change the routes of scheduled flights and “Taiwan's fishermen kept their boats in port” for some weeks.³⁴¹

However, the Chinese threats may have played a role in the decision of the United States to send the aircraft carrier Nimitz through the Taiwan Straits in December 1995. This was an unusual route, ostensibly due to “bad weather.”³⁴² Most likely it was an attempt to send a message to the Chinese Communist leadership rather different than the one contained in Clinton's secret August 1995 letter. Neither Clinton's overtures to Jiang, nor commercial benefits, nor the aircraft carrier deployment had any effect on Chinese actions. China continued deploying ballistic missiles near Taiwan, scheduled large-scale military maneuvers for February-March 1996, and continued threats against Taiwan as the March 1996 presidential election approached.³⁴³

On Friday, March 8, 1996, China fired three ballistic missiles north and south of the Taiwan near two major ports and cities, and one directly over the capital, Taipei.

China deployed some 150,000 troops in Fujian Province bordering the strait, and conducted three consecutive military exercises in areas near Taiwan. These included missile tests

³⁴¹ James Mann, “Between China and U.S.,” **The Washington Post**, January 10, 1999.

³⁴² Constantine C. Menges: *Ibid*, p. 132.

³⁴³ *Ibid*, p. 132.

close to Keelun and Kaohsiung, Taiwan's two most important seaports; a live-ammunition military exercise, and a large-scale amphibious landing exercise. Taiwan was on high alert, declaring that it had made all necessary preparations to deal with “the communist invasion,” leading to the first military confrontation between the two sides since 1979. The United States became involved immediately, accusing China of being “reckless” and “provocative,” and sent two aircraft carrier battle groups to the area near Taiwan to “monitor Chinese military actions.” This was America's largest naval movement in the Asia-Pacific region since the Vietnam War. Beijing warned Washington not to send warships into the Taiwan Strait at that moment, and while the U.S. refused to make any promises, American warships did stay out of the strait. This constituted the first potential military confrontation between the two countries since the normalization of relations after Nixon's visit to China in 1972. Cross-strait tensions rose quickly and dramatically, and people feared that China's military exercises might turn into military.

After Taiwan's March 1996 presidential election, China ended its military exercises and stopped leveling criticism against President Lee Teng-hui. Both sides expressed willingness for reconciliation, and the U.S. moved its two carrier battle groups away from the area near Taiwan. The crisis was temporarily over but cross-strait disputes remain unsettled.

Taipei rejects the “one country two systems” formula, regarding it as a measure to relegate Taipei to the status of a local government under the PRC and an excuse to annex Taiwan eventually. Taipei's policy guideline on cross-strait relations can be summarized as “phased two Chinas,” or “two Chinas over a certain period of time with the orientation toward one China.” That means one China is a goal but not now. At the current stage there exist “two separate sovereign states: the ROC on Taiwan and the PRC on mainland.” This notion was put forth by Taipei's Foreign Ministry and first expressed by Economy Minister Chiang Pin-kung at the APEC Seattle conference in November 1993.³⁴⁴ It was widely criticized as a violation of the “one China” principle (which is Taipei's original official position) by Chinese both inside and outside Taiwan. Under fire, Taipei never recognized this notion as an official position but did not deny it either.

In reality, the “phased two Chinas” guideline reflects Taipei's current position. For example, in 1994 Lee Teng-hui said that “one China' is an American policy. Before national reunification, we will never accept a 'one China' policy; one China is a future, only after

³⁴⁴ Chen Qimao, The Taiwan Strait Crisis: Its Crux and Solutions, *Asian Survey*, Vol. 36, No. 11 (Nov., 1996), 1055-1066.

reunification will there is one China.”³⁴⁵ In his inaugural speech on May 20, 1996, he declared that he would like to make a peace journey to the mainland and meet the leaders in Beijing if necessary and if the people support him.³⁴⁶ But he did not mention the “one China” principle at all. In his interview with a CNN television news correspondent just three days before his inauguration, he reaffirmed his position that there is no “one China” at present, and that only after reunification will there be one; currently there are two separate sovereign states on the mainland and Taiwan.³⁴⁷

The “phased two Chinas” policy is also reflected in Taipei's diplomacy. Right now, Taipei pursues the “parallel representation model of pre-1989 Germany and Korea”³⁴⁸ in the international arena, and conducts “pragmatic diplomacy” including “head of state diplomacy” by sending its leaders to visit countries which have diplomatic relations with the PRC, using economic leverage to invite incumbent high ranking officials of these countries to visit Taiwan, and launching (since 1993) a campaign to reenter the United Nations. The highlight of the “pragmatic diplomacy” was Lee Teng-hui's visit to the United States which was described by Washington as a “private visit.” But in Taiwan it was acclaimed by the government and the news media as a big “diplomatic breakthrough” and the “biggest diplomatic victory since October 1971.”³⁴⁹ After Lee's visit, Lian Zhan, Taiwan's premier, made a trip to three East European countries and met their leaders. In euphoria Taipei even proposed to buy membership for Taiwan in the U.N. by donating \$1 billion to the world organization. Obviously, Taipei's “pragmatic diplomacy” is not only economic but political, seeking to raise Taiwan's international status and get international recognition.

China regards all these as efforts to create two Chinas serious steps toward Taiwan independence. Beijing holds that sovereignty is indivisible and inseparable and that adherence to the “one China” principle is the basis and premise for reconciliation and peaceful reunification. In Beijing's view, the international community since October 1971 has held a consensus that there is only one China; Taiwan is a part of China; and the PRC is the only legitimate representative of China. This “one China” formula has been reinforced by three Sino-American communiqués. Taipei does not agree that the PRC is the only representative of China and may reserve its own position over who represents China, but Beijing will never agree to its efforts to

³⁴⁵ Ibid.

³⁴⁶ **China Times**, May 20, 1996, p. 2.

³⁴⁷ Ibid. May 18, 1996, p. 2.

³⁴⁸ White Paper, Taipei, “The Statement on Cross-Straits Relations,” **Central Daily** (Zhong-yang ribao), July 6, 1994.

³⁴⁹ Chen Qimao, Ibid.

break the “one China” framework and to create “two Chinas” in the international arena. Taipei, however, maintains that China had already been divided into two political entities, and that the ROC was originally an independent sovereign state and has the right to pursue international recognition. Taipei accuses Beijing's opposition to its “pragmatic diplomacy” as efforts to “obstruct and kill Taiwan's living space” and vows to overcome the opposition. Hence, the crux of the cross-strait disputes is one China versus two Chinas (now).

Now the problem is that the respective Beijing and Taipei policy guidelines are strongly backed by the people on the mainland and on Taiwan. Ever since the Opium War, over 150 years of imperialist and colonialist aggression and oppression have made the Chinese people very sensitive to issues of sovereignty and territorial integrity. China recovered Taiwan from Japan after a bloody eight-year war in which more than 20 million Chinese lost their lives and China lost a huge amount of wealth. If Taiwan were allowed to achieve independence and separate from China permanently, this would amount to the cession of China's territory once again, which the Chinese people would never tolerate.

In 1988 Taiwan began constitutional reforms based on Western models. With political democratization, the transition of power to native Taiwanese has been completed. With economic development and overseas investment, Taiwan's people frequently travel abroad, and the demand for high international status has soared. Separatists use these developments to call for independence. As economic development and political democratization won acclaim in the West and as public opinion on the island showed support, Taiwan's pragmatic diplomacy gained strong momentum. Since both sides are backed by their people, a settlement on this issue one China or two Chinas is difficult to make. The insistence on the two opposing guidelines is bound to lead to a head-on collision.

5.4.3. Different Scenarios for Cross-Strait Relations

After Taiwan's March 1996 election, cross-strait relations entered into a crucial “buffer period.” Both sides made some conciliatory gestures, yet no substantial step toward reconciliation has been taken. It is still uncertain whether cross-strait relations will return to normal development or will deteriorate into a new crisis and even a military conflict. Given the current situation, there could be three scenarios.

First scenario: Both sides work together to normalize and improve bilateral relations and move it in a benign direction. No doubt fundamental differences, historical hatreds, long estrangement, and some international factors make it very difficult for both sides to achieve

reconciliation. But the highly complementary economies of the mainland and Taiwan badly need each other, and if a cross-strait war broke out it would be a serious disaster for the whole Chinese nation. In addition, the international community, including the United States, Japan, and other Asia-Pacific countries, do not want to see a war in the Taiwan Strait. Hence, both sides face pressure to ease tension and improve their relations.³⁵⁰

Taking its political and economic interests into account, Taipei may build up a consensus, adjust its policy, stop what the mainland regards as diplomatic efforts to create “two Chinas,” and take concrete measures to stabilize and improve bilateral relations. Beijing has reiterated time and again that Jiang's eight-point proposal is still in effect. If Taipei stops pursuing “two Chinas” and returns to the “one China” principle, cross-strait relations will stabilize and improve. Therefore, if Taipei really adjusts its policy and takes concrete steps, Beijing would make quick and positive responses. Thus cross-strait relations would undergo a gradual reconciliation.³⁵¹ After serious preparation, both sides would enter into political negotiation, attempt to end hostilities under the “one China” principle, and establish peaceful, stable, and mutually beneficial relations.

Second scenario: With some international support, Taipei could continue its diplomatic activities to create “two Chinas” and even do it more aggressively. This would make the mainland react so strongly that tensions would resurface and escalate into a new crisis, which in turn, may escalate into military conflict. This would be the most dangerous turn of events. The possibility of this scenario should not be underestimated for several reasons. (1) Lee Teng-hui's landslide victory in the March election might be interpreted as strong support by the Taiwan people for his “pragmatic diplomacy.” Accordingly, Lee may adopt a contemptuous and defiant attitude toward Beijing and press for more international space. (2) Lee's commanding victory in the election party resulted from the support of some Democratic Progressive Party (DPP) constituents.³⁵² Meanwhile, the KMT's weak majority in both the Legislative Yuan and National Assembly put the KMT in a difficult situation. In order to maintain power, the KMT is trying to co-opt some DPP elites into the government, but it is possible that the KMT will lose its majority in both legislative bodies in future elections, thereby forcing it to form a coalition government with its political opponents.

³⁵⁰ Suisheng Zhao, *Military Coercion and Peaceful Offense: Beijing's Strategy of National Reunification with Taiwan*, *Pacific Affairs*, Vol. 72, No. 4, Special Issue: Taiwan Strait. (Winter, 1999-2000), p. 510.

³⁵¹ Chen Qimao, *Ibid.*

³⁵² Suisheng Zhao, *Ibid.*

Among the two major opposition parties, a coalition government between the KMT and the New Party is unlikely because the New Party, which split from the KMT, firmly opposes Lee's policies and fiercely competes with the KMT for votes. By contrast the ideas of the mainstream KMT and DPP are relatively close. Both advocate Taiwan for Taiwanese, and after some tactical changes, the DPP's position on cross-strait relations has moved closer to that of the KMT. Hence, there is a higher possibility of cooperation between these two parties. In this case, the KMT has to meet the DPP half way, and thus continues to push the policy of creating "two Chinas" or "one China, one Taiwan." (3) Taiwan's democratization won acclaim in the West, and some pro-Taiwan foreign powers have offered support for Taiwan's effort to raise its international status, which will surely encourage Taipei to push forward its "pragmatic diplomacy."

Third scenario: Taipei will try to reduce cross-strait tensions and agree to hold peaceful negotiations on the one hand, but on the other will continue to work for more international recognition, raise its international status, and weave an "international security network" to constrain China. Or Taiwan will alternate between relaxing cross-strait tensions and pushing for more international space, so that Taipei may avoid the rupture of bilateral relations while gaining more international recognition. Beijing has stated time and again that as long as Taipei does not stop its efforts to create "two Chinas" or "one China, one Taiwan," Beijing will not stop its struggles against separatists. Although it will not resort to force easily, Beijing will take all "necessary" measures to deter Taiwan independence. Under these circumstances, there would be a situation of neither war nor peace but continuous tensions along the Strait, fluctuating sometimes higher, sometimes lower. Such a scenario, which is very possible, would be unfavorable to the economic development of both sides and would be especially detrimental to Taiwan's economy. And it would not be conducive to political stability and economic development in the Asia-Pacific region. This scenario would not be permanent; in the long run, it would either turn toward reconciliation or result in a military conflict.

China regards the Taiwan issue as its domestic affair and does not like to see intervention from foreign countries. The U.S. has said that what it cares about is peaceful settlement of the issue, and that it does not want to be a mediator between the two sides. However, the fact is the U.S. has been involved in the Taiwan issue since 1950 when the Korean War broke out, so the problem is not whether the U.S. is involved but rather how it plays its role.

To play a positive role in cross-strait issues, it seems that the most important thing for the United States to do is to stick to the "one China" policy and the framework of Sino-American

relations and American-Taiwanese relations established after President Nixon's visit to China in 1972 and the establishment of Sino-American relations in 1979, and avoid any actions on this issue that will disrupt the framework, infringe on China's sovereignty, and damage Sino-American relations as well as cross-strait relations. President Clinton has reaffirmed America's "one China" policy, and Secretary-of-State Christopher elaborated on the "one China" policy in his May 17, 1996, speech in which he emphasized that "this policy is good for the United States, the PRC, Taiwan and the entire region." He stressed that "America's 'one China' policy is predicated on the PRC's pursuit of a peaceful resolution of issues between Taipei and Beijing," and that "as Taiwan seeks an international role, it should pursue that objective in a way that is consistent with a 'one China' policy."³⁵³ While the Chinese leadership may not agree with him on all points, his reaffirmation of the "one China" policy and proposals to strengthen contacts and dialogues between the governments and leaders of the two countries are welcome in Beijing. This can be seen very clearly in U.S. National Security Advisor Anthony Lake's successful visit to China in July 1996.

Hence, one urgent matter in America's foreign affairs is to reach a bipartisan consensus on China policy as soon as possible. It is not easy to build consensus in an election year, but the recent Taiwan Strait crisis indicated that whether this issue can be handled appropriately or not has become a matter of war or peace. Given the sensitivity and explosive nature of the issue, the importance of relations with a rising China, and long-term American interests, it is better to take initiatives and overcome the difficulties in reaching consensus than to drift temporarily and passively and then reach consensus after paying a huge price.

China has shown its intention to improve relations with the United States. Its policy toward the U.S. is to increase trust, reduce troubles, strengthen cooperation, and avoid confrontation. And while China also wishes to solve its disputes with Taiwan peacefully under the "one China" principle, it will not retreat from preserving its sovereignty and territorial integrity. It is clear that if Taiwan becomes independent under the support of some foreign powers, China will use every means possible to reverse this, including the decisive use of military force, even at the risk of a military conflict with the United States. It is hoped that recent developments indicate that sober-minded and reasonable thinking regarding relations with China are getting the upper hand in the U.S. This will help defuse cross-strait tensions. If the United States can do something to help alleviate the cross-strait tensions, it will receive appreciation from Chinese on both sides of the strait, and its interests in the Asia-Pacific region, especially in China, will be better served.

³⁵³ Chen Qimao, *The Taiwan Strait Crisis*, p. 1059.

5.4.4. Conclusions and Implications

China cannot invade Taiwan, even under its most favorable assumptions about how a conflict would unfold. Nor will it be able to do so for more than a decade, if not much longer. Its best hope of pulling off a successful invasion would be to first mount a large-scale surprise attack with missiles, air power, and Special Forces. The PRC would follow up as quickly as possible with an airborne and amphibious assault. Even assuming a rather successful Chinese preemptive attack, however, Taiwan would be able to continue significant flight operations. Taiwan would also retain very effective anti-aircraft artillery, surface-to-air missiles, coastal defense guns, coastal patrol craft, and antiship missiles not to mention a mobilized and large ground army. Taiwan would be able to reinforce its defenses in sectors under intense PRC attack much faster than China could reinforce any initial positions it managed to establish on Taiwan. China is probably a factor of five to ten short of the material requirements for establishing and reinforcing a defensible beachhead on Taiwan and lacking in the necessary technology and military competence to boot.³⁵⁴ Even if China used chemical weapons in the attack, it would not have a credible chance of victory.

In broader political terms, attacking Taiwan would be extraordinarily risky for the ruling regime in Beijing. It would likely lose much of its elite military personnel and a large fraction of its strategic transport capabilities, combat aircraft, and navy in any such attack. A PRC government that attempted such an invasion could fall in its aftermath.

The message of this analysis should be reassuring and stabilizing. Beijing should recognize that it cannot seize Taiwan and thus be dissuaded from any disastrous attempt to try. The situation would be even more stable if the Pentagon would stop issuing poorly argued reports on the China-Taiwan military balance that could mislead Chinese leaders into thinking they have an invasion capability that they clearly do not.

Taipei should hardly be cavalier about moving toward a declaration of independence, however. Even if its military could hold off a full-bore Chinese assault, Taiwan would suffer substantial damage in the process. Blockade and missile-strike scenarios could also cause it great harm. In fact, even a limited blockade effort conducted by China's modest modern submarine force could stand a reasonable chance of dragging down Taiwan's economy and keeping it down for a prolonged period. U.S. military intervention might be needed to break the blockade quickly

³⁵⁴ Eric McVadon, "PRC Exercises, Doctrine, and Tactics toward Taiwan: the Naval Dimension," in James R. Lilley and Chuck Downs, **Crisis in the Taiwan Strait**. (Washington, D.C.: National Defense University Press, 1997), pp. 249-276

What are the policy implications of this assessment for Washington? The first is that there is no need to commit to Taiwan's defense in advance. For an invasion scenario the only one in which China could physically seize Taiwan and present the world community a *fait accompli* the United States would not need to participate militarily because Taiwan could defeat China on its own. For other scenarios, U.S. assistance might be required, but it would be less urgent. The United States would have time to react or to pressure the parties to a diplomatic solution before feeling the need to intervene militarily itself. In short, the United States should maintain its policy of strategic ambiguity. That desirable policy has helped restrain hard-liners on both sides of the strait historically, and continues to do so today without putting Taiwan at mortal peril.³⁵⁵

As for arms sales policy, the question is more complex, and the grounds for rethinking current U.S. policy more compelling. In early 2000, the Clinton administration announced a decision to sell Taiwan several types of precision-guided air-to-air and air-to-ground missiles, and to provide land-based radar for warning of any missile attacks by the PRC as well. These ideas make sense, as do further efforts to help Taiwan harden its airfields, fuel and ammunition storage facilities, and command-and-control infrastructure.³⁵⁶ The Clinton administration chose, however, not to sell Taiwan large naval weaponry including P-3 surveillance aircraft, attack submarines, and Aegis-class destroyer ships. Instead, the administration decided to allow time for further study of Taiwan's needs in these areas. Presumably it also wanted to keep leverage over Taiwan's President Chen to show restraint vis-à-vis Beijing during his first months in office and to test Beijing's willingness to pursue a more conciliatory policy as well.³⁵⁷

That cautious approach to arms sales makes sense as a matter of principle. The military benefit of possible arms sales to Taiwan must always be evaluated against the likely political fallout, including the chance that should Taipei ever feel either invulnerable or automatically assured of U.S. military aid in a crisis, it might be more inclined to act provocatively.³⁵⁸ Congressional Republicans tended to ignore this concern in crafting their Taiwan Security Enhancement Act, approved by the House in February of 2000.³⁵⁹ The act would formalize links between U.S. and Taiwanese militaries, state a U.S. predisposition to sell Taiwan any arms

³⁵⁵ Owen Harries, "A Year of Debating China," **National Interest**, Winter 1999/2000, pp. 145-147; Jonathan S. Landay, "How Far Would U.S. Go to Protect Taiwan?" **Christian Science Monitor**, September 3, 1999, p. 3

³⁵⁶ The comments of James Mulvenon, quoted in Steven Mufson, "Warship Sale Could Fuel China Tensions/" **Washington Post**, April 14, 2000, p. 1.

³⁵⁷ Thomas E. Ricks and Steven Mufson, "Taiwan Arms Deal Excludes Warships", **Washington Post**, April 18, 2000, p. 1.

³⁵⁸ Thomas J. Christensen, "Correspondence: Spirals, Security, and Stability in East Asia" **International Security**, Vol. 24, No. 4 (Spring 2000), p. 196.

³⁵⁹ Christopher Marquis, "GOP Criticizes White House on Taiwan Aid Plan," **New York Times**, April 19, 2000.

Taipei requested, and otherwise change the tone of American involvement in the Taiwan Strait problem. The proposal met with a negative reaction from the commander of U.S. forces in the Pacific, Adm. Dennis Blair. It also worried Chen Shui-bian, who in April asked the Senate to postpone consideration of the bill at least until he was inaugurated and had a chance to set up his cabinet.³⁶⁰

Nonetheless, congressional Republicans are correct to critique the Clinton administration's new arms sales package for Taiwan. Their argument is strongest not for the four Aegis destroyers Taipei has requested largely for missile defense, which have taken on a greater symbolic significance than their military capabilities warrant, but for dedicated antisubmarine warfare capabilities.³⁶¹

Given China's missile firings near Taiwan in 1995 and 1996, as well as its buildup of short-range missiles along its coast near Taiwan, Taipei's request for the Aegis vessels seems understandable. But Chinese ballistic missiles armed with conventional warheads are far too inaccurate to threaten Taiwan's military bases seriously. In addition, the Aegis technology is immature the U.S. military will not have advanced Aegis-based defenses against ballistic missiles until at least 2007 (a short-range defense may be available by 2003, but the broader coverage that would be needed to defend Taiwan will not).

Even if Taiwan had these ships and the antimissile systems worked perfectly, China has so many missiles that it could always overwhelm them with a large attack. An Aegis-class destroyer carries about 100 missiles of all kinds.³⁶² If every launch tube were devoted to missile interceptors, a single ship could plausibly intercept no more than a few dozen missiles in a best-case scenario (as a practical matter, two or even three interceptors would be fired at each incoming missile). Even if two ships were in position to defend a given region of Taiwan, China could saturate their defenses with fewer than 100 missiles, guaranteeing that subsequent missiles would not be intercepted.³⁶³ A sale of more advanced Patriot missile defense batteries to Taiwan is warranted, in light of China's major ballistic missile buildup. But Taiwan has better ways to

³⁶⁰ Thomas E. Ricks, "Admiral Takes Stand against Pro-Taiwan Legislation," **Washington Post**, March 8, 2000, p. A32; and Steven Mufson and Helen Dewar, "Taiwan Bill Tabled as Island's Leaders Urge Delay," **Washington Post**, April 27, 2000, p. 24.

³⁶¹ Steven Mufson, "Warship Sale Could Fuel China Tensions," **Washington Post**, April 14, 2000, p.12.

³⁶² David Mosher, "The Grand Plans," *IEEE Spectrum*, September 1997, pp. 34-35; and statement of Lt. Gen. Lester L. Lyles before the U.S. Senate, Committee on Armed Services, **Subcommittee on Strategic Forces**, 106th Cong., 1st session., March 24, 1999.

³⁶³ *Ibid.*

spend its defense resources than to buy four Aegis-class destroyers, which could be vulnerable to preemption and possess only limited antisubmarine warfare capabilities.³⁶⁴

Instead, the United States should grant Taiwan its request for the P-3 Orion aircraft, which can drop buoys with sonar devices and fire torpedoes at any submarines the buoys detect. They possess ultra-low-frequency sonar capable of detecting Kilo-class submarines that Taiwan cannot now easily find.³⁶⁵ Taiwan might replace its 31 S-2 aircraft with a comparable number of the more advanced, faster, and longer-range P-3s.¹²⁸ A P-3 fleet of that size would give Taiwan the capability to maintain about 10 to 12 planes in the sky continuously translating into 5 to 6 along a northern perimeter and another 5 to 6 along a southern perimeter of a protected shipping corridor beginning at Taiwan and extending some 1,000 miles to its east. Given the speed of the aircraft, that would allow each spot along the perimeter to be monitored every thirty minutes or so, making it tough for Chinese submarines to penetrate the barrier without being detected.³⁶⁶

The United States or better yet a country that makes diesel-electric submarines could also help Taiwan upgrade its decaying submarine fleet. Doing so would be more provocative to China, however, so this measure could be held in reserve for now. If China accelerates the modernization of its submarine fleet and other blockade-related assets, submarines could be sold to Taiwan in the future.

The Taiwan Strait problem merits careful political-military attention from U.S. policymakers. They need to base future policy on a sound understanding of the nature of the cross-strait military balance or more accurately, the various China-Taiwan military balances. It would be a major mistake for U.S. policymakers to keep emboldening China by telling its leaders that China can seize Taiwan. But it would also be a major mistake not to worry about other options that leaders in Beijing might consider and that the Chinese armed forces may be able to carry out.

5.5. Sino - European Union Relations & Prospects

5.5.1. Outlook

China has re-emerged as a major power in the last decade. It has become the world's fourth economy and third exporter, but also an increasingly important political power. China's

³⁶⁴ Erik Eckholm with Steven Lee Myers, "Taiwan Asks U.S. to Let It Obtain Top-Flight Arms," New York Times, March 1, 2000.

³⁶⁵ June Teufel Dreyer, "Taiwan's Military: A View from Afar," in Larry M. Wortzel, ed., *The Chinese Armed Forces in the Twenty-first Century* (Carlisle, Pa.: Strategic Studies Institute, Army War College, 1999), p. 307.

³⁶⁶ Erik Eckholm with Steven Lee Myers, *Ibid.*

economic growth has thrown weight behind a significantly more active and sophisticated Chinese foreign policy. China's desire to grow and seek a place in the world commensurate with its political and economic power is a central tenet of its policy. Given China's size and phenomenal growth, these changes have a profound impact on global politics and trade.

The EU offers the largest market in the world. It is home to a global reserve currency. It enjoys world leadership in key technologies and skills. The EU plays a central role in finding sustainable solutions to today's challenges, on the environment, on energy, on globalization. It has proved capable of exerting a progressive influence well beyond its borders and is the world's largest provider of development aid.

Europe needs to respond effectively to China's renewed strength. To tackle the key challenges facing Europe today – including climate change, employment, migration, security – we need to leverage the potential of a dynamic relationship with China based on our values. We also have an interest in supporting China's reform process. This means factoring the China dimension into the full range of EU policies, external and internal. It also means close coordination inside the EU to ensure an overall and coherent approach.

To better reflect the importance of their relations, the EU and China agreed a strategic partnership in 2003.³⁶⁷ Some differences remain, but are being managed effectively, and relations are increasingly mature and realistic. At the same time China is, with the EU, closely bound to the globalization process and becoming more integrated into the international system.

The EU's fundamental approach to China must remain one of engagement and partnership. But with a closer strategic partnership, mutual responsibilities increase. The partnership should meet both sides' interests and the EU and China need to work together as they assume more active and responsible international roles, supporting and contributing to a strong and effective multilateral system. The goal should be a situation where China and the EU can bring their respective strengths to bear to offer joint solutions to global problems.

Both the EU and China stand to gain from our trade and economic partnership. If we are to recognize its full potential, closing Europe's doors to Chinese competition is not the answer. But to build and maintain political support for openness towards China, the benefits of engagement must be fully realized in Europe. China should open its own markets and ensure conditions of fair market competition. Adjusting to the competitive challenge and driving a fair bargain with China will be the central challenge of EU trade policy in the decade to come. This key bilateral

³⁶⁷ Christopher M. Dent, **European Union and East Asia: Economic Relationship**, Routledge, 1999, p. 148.

challenge provides a litmus test for our partnership, and is set out in more detail in a trade policy paper entitled “Competition and Partnership” which accompanies the present Communication.

Europe and China can do more to promote their own interests together than they will ever achieve apart.

5.5.2. Rise of China

Internal stability remains the key driver for Chinese policy. Over recent decades, stability has been underpinned by delivery of strong economic growth. Since 1980 China has enjoyed 9% annual average growth and has seen its share of world GDP expand tenfold to reach 5% of global GDP.³⁶⁸ China’s growth has resulted in the steepest recorded drop in poverty in world history, and the emergence of a large middle class, better educated and with rising purchasing power and choices.

But the story of this phenomenal growth masks uncertainties and fragility. The Chinese leadership treads a complex daily path, facing a range of important challenges, primarily domestic, but which increasingly resonate beyond national boundaries:

- Disparities continue to grow. The wealth gap is significant and growing, as are social, regional and gender imbalances; there is huge stress on healthcare and education systems; and China is already facing significant demographic shifts and the challenges of a rapidly ageing population;

- China’s demand for energy and raw materials – China is already the world’s second largest energy consumer – is already significant and will continue to grow; and the environmental cost of untrammelled economic and industrial growth is becoming more and more apparent. At the same time growth patterns have not been balanced, with a focus on exports to the detriment of domestic demand.

Growth remains central to China’s reform agenda, but increasingly is tempered with measures to address social inequality and ensure more sustainable economic and political development. Paradoxically, in a number of areas, the conditions for stability improve as the Party and State relax control. A more independent judiciary, a stronger civil society, a freer press will ultimately encourage stability, providing necessary checks and balances. Recognition of the need for more balanced development, building a “harmonious society”, is encouraging. But further reform will be necessary.

³⁶⁸ Christopher M. Dent, *Ibid.*

China's regional and international policy also supports domestic imperatives: a secure and peaceful neighborhood is one conducive to economic growth; and China's wider international engagement remains characterized by pursuit of very specific objectives, including securing the natural resources needed to power growth. At the same time we have seen China's desire to build international respect and recognition. The 2008 Olympic Games in Beijing and the 2010 World Expo in Shanghai will focus the world's attention on China's progress.³⁶⁹

China has traditionally described its foreign policy as one of strict non-interference, but as it takes on a more active and assertive international role, this becomes increasingly untenable. The Chinese government is beginning to recognize this, and the international responsibilities commensurate to its economic importance and role as a permanent member of the UN Security Council as illustrated by its increasingly active diplomatic commitments.

The EU and China benefit from globalization and share common interests in its success. It presents challenges to both and brings further responsibilities. We also share a desire to see an effective multilateral system. But there remain divergences in values, on which dialogue must continue.

As the partnership strengthens, expectations and responsibilities on both sides increase. As China's biggest trading partner, EU trade policy has an important impact on China, as do China's policies on the EU. Increasingly, both sides expect that impact to be taken into account in their partner's policy formulation.

5.5.3. The way forward

The EU should continue support for China's internal political and economic reform process, for a strong and stable China which fully respects fundamental rights and freedoms, protects minorities and guarantees the rule of law. The EU will reinforce co-operation to ensure sustainable development, pursue a fair and robust trade policy and work to strengthen and add balance to bilateral relations. The EU and China should work together in support of peace and stability. The EU should increase co-ordination and joint action and improve co-operation with European industry and civil society.

Until now the legal basis for relations has been the 1985 Trade and Co-operation Agreement.³⁷⁰ This no longer reflects the breadth and scope of the relationship and at the 9th

³⁶⁹ Commission Of The European Communities, Report From The Commission To The Council And The European Parliament on the Implementation of the Communication "**Building a Comprehensive Partnership with China**", Brussels, 08.09.2000

³⁷⁰ Christopher M. Dent, *Ibid.*

EU-China Summit leaders agreed to launch negotiations on a new, extended Partnership and Cooperation Agreement (PCA) to update the basis for our co-operation. This new agreement presents an important opportunity. It will provide a single framework covering the full range and complexity of our relationship and at the same time should be forward-looking and reflect the priorities outlined in this Communication.

5.5.3.1. Supporting China's transition towards a more open and plural society

The Chinese leadership has repeatedly stated its support for reform, including on basic rights and freedoms. But in this area progress on the ground has been limited. The EU must consider how it can most effectively assist China's reform process, making the case that better protection of human rights, a more open society, and more accountable government would be beneficial to China, and essential for continued economic growth.

Democracy, human rights and the promotion of common values remain fundamental tenets of EU policy and of central importance to bilateral relations. The EU should support and encourage the development of a full, healthy and independent civil society in China. It should support efforts to strengthen the rule of law - an essential basis for all other reform.

At the same time, the EU will continue to encourage full respect of fundamental rights and freedoms in all regions of China; freedom of speech, religion and association, the right to a fair trial and the protection of minorities call for particular attention – in all regions of China. The EU will also encourage China to be an active and constructive partner in the Human Rights Council, holding China to the values which the UN embraces, including the International Covenant on Civil and Political Rights.

The twice-yearly human rights dialogue was conceived at an earlier stage in EU-China relations. It remains fit for purpose, but the EU's expectations – which have increased in line with the quality of our partnership – are increasingly not being met. The dialogue should be:

- More focused and results-oriented, with higher quality exchanges and concrete results;
- More flexible, taking on input from separate seminars and sub-groups;
- Better coordinated with Member State dialogues.

5.5.3.2. Trade and economic relations

China's integration into the global trading system has benefited both Europe and China. The EU is China's largest trading partner, representing more than 19% of China's external trade.

European companies trading with and investing in China have contributed to China's growth, bringing capital goods, knowledge and technology that have been instrumental to China's development.

An economically strong China is in Europe's interest. China, especially its rapidly increasing middle class, is a growing market for EU exports. EU exports to China increased by over 100% between 2000 and 2005, much faster than its exports to the rest of the world. EU exports of services to China expanded six-fold in the ten years to 2004. European companies and consumers benefit from competitively priced Chinese inputs and consumer goods. Openness brings benefits to both China and the EU.³⁷¹

Nevertheless, in Europe there is a growing perception that China's as yet incomplete implementation of WTO obligations and new barriers to market access are preventing a genuinely reciprocal trading relationship. Imports from China have added to pressure to adjust to globalization in Europe. This trend is likely to continue as China moves up the value chain.

For the relationship to be politically and economically sustainable in the long term, Europe should continue to offer open and fair access to China's exports and to adjust to the competitive challenge. The EU needs to develop and consolidate areas of comparative advantage in high-value and high-tech design and production and to help workers retrain. China for its part should reciprocate by strengthening its commitment to open markets and fair competition. Both sides should address concern over the impact of economic growth on natural resources and the environment. The EU will:

Insist on openness. The EU will continue working with China towards the full implementation of its WTO obligations and will urge China to move beyond its WTO commitments in further opening its market to create opportunities for EU companies. The EU will accept that it cannot demand openness from China from behind barriers of its own. The EU will urge China to honor its commitment to open accession negotiations on the Government Procurement Agreement in 2008 and work to bring them to a successful conclusion as rapidly as possible.

Level the playing field. Better protection of intellectual property rights in China and ending forced technology transfers are EU priorities, including through implementation by China of WTO obligations and will help create a better investment climate in China. The EU will press

³⁷¹ Commission of the European Communities, Communication from the Commission to the Council and the European Parliament **EU – China: Closer partners, growing responsibilities**, Brussels, 24.10.2006.

China to stop granting prohibited subsidies and reform its banking system, and encourage China to allow market forces to operate in its trade in raw materials.

Support European companies. The Commission will make a major effort to assist companies doing business with China, in particular small and medium sized enterprises while urging them to respect decent work standards. The EU will extend and strengthen the existing information, training and advice on protecting and defending IPR in China. A European Centre in Beijing should be opened. The EU-China Managers Exchange and Training Program should be extended.

Defend the EU's interests: dialogue first.³⁷² The EU has a clear preference for resolving trade irritants with China through dialogue and negotiation. The existing EU-China trade related dialogues should be strengthened at all levels, their focus should be sharpened on facilitating trade and improving market access and their scope extended. The EU and China also have an interest in joining their efforts in international rule making and global standard setting bodies. The EU will actively pursue global supervisory and regulatory solutions, promoting open markets and regulatory convergence, and build on co-operation with China through EU-China regulatory dialogues. This will also help to ensure compliance of Chinese imports with EU standards for food and non-food products.

But where other efforts have failed, the Commission will use the WTO dispute settlement system to ensure compliance with multilaterally agreed rules and obligations. Trade defense measures will remain an instrument to ensure fair conditions of trade. Recent progress has been made on some of the conditions. The Commission will continue to work with the Chinese authorities through the mechanisms we have established and will be ready to act quickly once all the conditions are met.

Build a stronger relationship.³⁷³ A key objective of the negotiations for a new Partnership and Cooperation Agreement, which will also update the 1985 Trade and Co-operation Agreement, will be better access to the Chinese market for European exporters and investors, going beyond WTO commitments, better protection of intellectual property and mutual recognition of geographical indications. China is already a major beneficiary of the international trading system and should assume a responsibility commensurate with those benefits, making a substantial contribution to reviving and completing the WTO Doha Round.

³⁷² Commission of the European Communities, Communication from the...

³⁷³ Ibid.

Many of these steps are not only in EU's interest. They are strongly in China's interest and an integral part of China's progress towards balanced and sustainable growth and development and global leadership and responsibility. The accompanying trade policy paper sets out a comprehensive approach to EU-China trade and investment relations for the medium term.

5.5.3.4. Conclusion

China is one the EU's most important partners. China's re-emergence is a welcome phenomenon. But to respond positively and effectively, the EU must improve policy coordination at all levels, and ensure a focused single European voice on key issues.

A closer, stronger strategic partnership is in the EU's and China's interests. But with this comes an increase in responsibilities, and a need for openness which will require concerted action by both sides.

6. Sino – ASEAN Relations

6.1. Introduction

Relations between China and the Association of Southeast Asian Nations (ASEAN) have undergone significant changes over the past 15 years. ASEAN's concerns over Beijing's drive for military modernization and its assertive posture in territorial disputes over the South China Sea of the early 1990s are replaced with growing economic ties and shared geo-political interests for building regional security through multilateral processes. Since the 1997 Asian financial crisis, Beijing has expanded its influence as a major political force in the region and a locomotive for economic recovery and future opportunity. What explains China's successful diplomatic offensive and what implications do closer China-ASEAN ties have for the United States?

Since the mid-1990s, China and the Association of Southeast Asian Nations (ASEAN) have developed a growing partnership in security cooperation, economic/ trade interdependence, and the development and sharing of "Asian values." Compared to the late 1980s and early 1990s when Beijing had yet to establish or normalize diplomatic relations with key ASEAN member states and when the concerns over the "China threat" both drove Southeast Asia's armament and military buildup and were the major rationale for initiating a regional security arrangement to keep the United States engaged, the current state of China-ASEAN relationship is truly remarkable. While a China and Southeast Asia living in harmony contributes to regional peace, stability, and prosperity and minimizes the potential for conflicts over unresolved territorial disputes, the future direction of this relationship nevertheless could have major implications for

long-term U.S. interests in the region, especially if it evolves into a competitive and even exclusive regional trading bloc and a geo-strategic arrangement under the shadow of a growing and more assertive China.

6.2. Perspectives, Prospects and Implications for U.S. Interests

During the 1980s, Chinese policy toward Southeast Asia began to undergo important changes in two critical areas. Beijing started to place state-to-state relationships in precedence over ideological ties by halting its support to communist insurgence movements in the region. In 1989, it also passed laws on Chinese citizenship requiring overseas Chinese to adopt citizenship of their countries of residence. By taking these two important measures, major irritants effectively were removed from China's bilateral relationships with a number of Southeast Asian countries. Beijing now seemed more than ever eager to court better relationships with its Southern neighbors, and this has paved the way for improvement of political ties.³⁷⁴

Beijing's official contact with ASEAN as a group began in July 1991 when Chinese Foreign Minister Qian Qichen was invited to attend the opening ceremony of the 24th ASEAN Foreign Ministers' Meeting. Since then China has attended each ASEAN Foreign Ministers' Meeting consecutively. In 1994, China participated in the ASEAN Regional Forum (ARF) and became a consultative dialogue partner of ASEAN. This status was elevated in 1996, when China became a full dialogue partner with ASEAN. In December 1997, Chinese President Jiang Zemin and ASEAN leaders held their first ever summit in Malaysia and issued a joint statement announcing their decision to establish a partnership of good neighborliness and mutual trust between China and ASEAN oriented toward the 21st century. In October 2003, China and ASEAN signed the "Joint Declaration of the PRC and ASEAN State Leaders A Strategic Partnership for Peace and Prosperity."³⁷⁵

The emerging China-ASEAN ties were influenced by a number of developments at the time. One was Beijing's efforts, in the wake of the Tiananmen incident, in particular in response to the sanctions imposed by the West, to break the isolation. Southeast Asian countries, given their relative reticence regarding the June 4 Incident, became targets of the Chinese diplomatic good neighborly policy. Beijing and Jakarta restored, and China and Singapore established, diplomatic relations in 1990. Chinese Premier Li Peng visited Indonesia, the Philippines,

³⁷⁴ N. Ganesan, "ASEAN's Relations with Major External Powers," *Contemporary Southeast Asia*, Vol. 22, No. 2, August 2000, p. 264.

³⁷⁵ Wang Gungwu, "China and Southeast Asia: The Context of a New Beginning," in David Shambaugh, ed., *Power Shift: China and Asia's New Dynamics*, Berkeley, CA: University of California Press, 2005, pp. 187-204

Malaysia, and Laos as part of that diplomatic endeavor. A second reason was to sustain the cooperation between the two in the wake of the Cambodian settlement, in which China played a constructive role in the resolution of the dispute and had been in close consultation with ASEAN in the 1980s. But most important of all was Beijing's changing perception of its security environment and the relative place of Southeast Asia in its post-Cold War security policy. This resulted in the successful management of the territorial disputes in the South China Sea, Beijing's reassurance to ASEAN of its benign intentions and its acceptance of multilateralism and cooperative security, and China's growing economic ties with ASEAN.³⁷⁶

On November 4, 2002, ASEAN and China signed the Declaration on the Conduct of Parties in the South China Sea, a major milestone in China-ASEAN relations, concerning how the claimant countries to the territorial disputes would resolve them. While ASEAN was not able to get Beijing committed to a code of conduct, which would be a more stringent measure, the declaration at least obliged China to pursue a multilateral approach to the issue, a shift from the bilateralism that it had preferred. It also was symbolic in that China had appeared to be accepting ASEAN's preference for norms and regulation of the dispute.³⁷⁷ Specifically, the Declaration commits the signatory parties:

“to exercise self-restraint in the conduct of activities that would complicate or escalate disputes and affect peace and stability including, among others, refraining from action of inhabiting on the presently uninhabited islands, reefs, shoals, cays, and other features and to handle their differences in a constructive manner”.

What motivated Beijing to adopt a more moderate approach to the territorial disputes was a growing concern over the Taiwan independence issue, and hence the need to secure ASEAN support for its unification policy; the risk of pushing the small Southeast Asian countries to the United States, resulting in greater ASEAN-U.S. military cooperation that could allow U.S. access to military facilities in the region, hence posing a greater threat to Chinese security interests, especially where the Taiwan contingency was concerned; and China's own lack of power projection capability that could help enforce its claims effectively.³⁷⁸ These considerations led to changes in managing territorial disputes, moving away from more confrontational and militaristic approaches to ones that emphasize dialogue and promote joint exploration and

³⁷⁶ Saw Swee-Hock, Sheng Lijun, and Chin Kin Wah, eds., *ASEAN-China Relations: Realities and Prospects*, Singapore: **Institute of Southeast Asian Studies**, 2005.

³⁷⁷ Leszek Buszynski, “ASEAN, The Declaration on Conduct, and the South China Sea,” **Contemporary Southeast Asia**, Vol. 25, No. 3, 2005, pp. 348-349.

³⁷⁸ Ralf Emmers, “Maritime Disputes in the South China Sea: Strategic and Diplomatic Status Quo,” **IDSS Working Paper** No. 87, Singapore: Institute of Defence and Strategic Studies, September 2005.

development, without in any way giving up its claim to sovereignty over the disputed territories in the South China Sea.³⁷⁹

The more moderate stance was meant to deflate growing alarm over Chinese aggressiveness, especially in the context of the 1995-96 Chinese missile exercises in the Taiwan Strait, rather than a fundamental change of the conception of sovereignty. Indeed, if anything, western analysts suggest that Beijing may be engaged in a slow-intensity conflict where it steadily strengthens its hold on, and extends its reach to, disputed maritime territories.³⁸⁰

Beijing also negotiated separate codes of conduct with Vietnam and the Philippines. Between 1992 and 2000, seven rounds of negotiation took place between China and Vietnam. In December 1999, Beijing and Hanoi signed a Land Border Treaty, which subsequently was ratified by the two countries' parliaments in 2000. On December 25, 2000, China and Vietnam signed the Agreement on the Delimitation of the Territorial Seas, Exclusive Economic Zones, and Continental Shelves in the Gulf of Tonkin and the Agreement on Fishery Cooperation in the Beibu Gulf. Both agreements subsequently were ratified by the two countries' legislatures in 2004.³⁸¹

In March 2005, national oil companies from China, the Philippines, and Vietnam signed a landmark agreement to conduct joint prospecting for oil and gas in the South China Sea. On the one hand, this is considered to be a major breakthrough, especially based on the idea of shelving territorial disputes and seeking joint exploitation and development. However, there also are concerns, from the ASEAN perspective, over China's "divide and rule" tactic that is establishing its dominance effectively in the region and undermining the organization's unity in dealing with the rising power.³⁸²

Furthermore, the territorial disputes continue to resurface from time to time, with occasional clashes resulting in casualties and detention, or otherwise property damages. A July 1999 run-in between a Chinese fishing boat and the Philippine Navy ended in the former's sinking. Similar incidents occurred in January 2000, when Philippine naval patrol personnel

³⁷⁹ Allen Carlson, **Unifying China, Integrating with the World: Securing Chinese Sovereignty in the Reform Era**, Stanford: Stanford University Press, 2005, especially chapter 3 and conclusion.

³⁸⁰ Andrew Scobell, "Slow-Intensity Conflict in the South China Sea," Foreign Policy Research Institute, August 16, 2000, accessed via **Taiwan Security Research** website, April 20, 2006.

³⁸¹ Zou Keyuan, "The Sino-Vietnamese Agreement on Maritime Boundary Delimitation in the Gulf of Tonkin," **Ocean Development & International Law**, Vol. 36, 2005, pp. 13-24.

³⁸² Christopher Roberts, "China and the South China Sea: What Happened to ASEAN's Solidarity?" **IDSS Commentaries**, April 26, 2005.

boarded Chinese fishing boats, touching off protests and warnings from Beijing.³⁸³ Chinese media also point out that Vietnam continues to encroach on Chinese territorial integrity in the South China Sea by setting up telephone networks on atolls and islets currently under Vietnamese occupation. These activities are seen as efforts to establish *fait accompli* to strengthen Hanoi's leverage in future negotiations.³⁸⁴

6.2.1. Defense and Security Cooperation

Over the years, China and ASEAN countries have developed defense and security ties in a number of areas, ranging from high-level visits by military and defense officials to port calls, small-scale joint military exercises, defense equipment transfers, military educational exchange programs, and multilateral dialogues by senior defense and military officers. In December 1999, General Fu Quanyou, Chief of the General Staff of the PLA, visited Thailand to observe ceremonies marking King Bhumibol Adulyadej's 75th birthday anniversary. Between 2002 and 2006, the Chinese defense minister, the PLA chief of general staff, service and military area commanders, and other high-ranking Chinese military leaders made visits to all 10 ASEAN member states; China also received defense ministers and ranking military officers from these countries. Meanwhile, Beijing has established security dialogues with six ASEAN member states Indonesia, Malaysia, Philippines, Singapore, Thailand, and Vietnam as well as ASEAN itself. Of these six, four have territorial disputes with China. China also has sold military equipment to six ASEAN member states (Cambodia, Indonesia, Malaysia, Philippines, Thailand, and Vietnam) over the past 5 years. In April 2006, China and Vietnam conducted joint maritime patrols in the Gulf of Tonkin.³⁸⁵

In October 2003, China acceded to the ASEAN Treaty of Amity and Cooperation and issued the China-ASEAN Joint Declaration on Strategic Partnership for Peace and Prosperity. In December 2004, a 5-year (2005-10) Plan of Action was adopted. The Plan focuses heavily on defense and security cooperation between the two, especially in the following areas:

- Confidence and trust in defense and military fields;
- Dialogue, consultation, and seminars on defense and security issues;

³⁸³ The incident is recorded in the "Chronology of China-ASEAN Relations, July-September 1999 and January-March 2000, in Comparative Connections, an online publication by the **Pacific Forum Center** for Strategic and International Studies (CSIS), www.csis.org/pacfor/ccejournal.html, accessed May 15, 2006.

³⁸⁴ Li Guo, et al., "Vietnam Sets up Telephone Networks in the Spratlys," **Global Times**, May 10, 2006, p. 16, paper.people.com.cn/hqsb/html/2006-05/10/content_5823628.htm.

³⁸⁵ Carlyle A. Thayer, "China's International Security Cooperation Diplomacy and Southeast Asia," paper presented at the **47th International Studies Association Annual Convention**, San Diego, and March 22-25, 2006.

- Cooperation on military personnel training;
- Joint military exercises; and,
- Peacekeeping operations.³⁸⁶

China also proposed and received endorsement from ASEAN, an Asian defense cooperation forum.³⁸⁷ The first ARF Security Policy Conference was held in Beijing on November 4-6, 2004. The Indonesian Vice Minister of Defense chaired the first meeting, which covered a whole panoply of issues including the Korean nuclear crisis and the Six-Party Talks, maritime security, and terrorist threats to the region. The second meeting was held in Vientiane, Laos, on May 19, 2005.³⁸⁸ China and ASEAN member states, especially those states adjacent to Yunnan Province, also cooperate in the areas of nontraditional security such as drug trafficking, piracy, and money laundering.³⁸⁹ Beijing has extended military assistance to Manila, including donations of \$1 million in equipment and \$3 million for setting up a Chinese-language training program for the Philippine armed forces. The PLA also invites the Philippine military personnel to receive educational training in China.³⁹⁰

6.2.2. China-ASEAN Free Trade Area

A major development in China-ASEAN relations since the end of the Cold War is perhaps the growing economic interdependence between the two. Indeed, two-way trade has been growing at a rate of 20 percent for the last decade and reached over U.S. \$100 billion in 2004, a year ahead of a previously set target. It further registered a 23 percent increase in 2005; reaching \$130.4 billion.³⁹¹ ASEAN member states have benefited from China's spectacular economic growth as the Asian giant's growing demands also generate economic benefits for the region as a whole. For instance, in 2004, ASEAN had a roughly \$20 billion trade surplus with China, while China's other major trading partners all sustained sizable deficits.³⁹²

³⁸⁶ **China Daily**, "China-ASEAN Move Forward," December, 2004, www.chinadaily.com.cn/english/doc/2004-12/09/content_398729.htm

³⁸⁷ Michael Vatikiotis, "A Diplomatic Offensive," **Far Eastern Economic Review**, August 5, 2004, pp. 28-30.

³⁸⁸ "Chairman's Summary of the First ASEAN Regional Forum Security Policy Conference, Beijing, November 4-6, 2004"; "Chairman's Summary of the Second ASEAN Regional Forum Security Policy Conference, Vientiane, May 19, 2005," ASEAN Secretariat website, accessed May 15, 2006.

³⁸⁹ Sheng Lijun, "China-ASEAN Cooperation against Illicit Drugs from the Golden Triangle," **Asian Perspective**, Vol. 30, No. 2, Summer 2006, forthcoming.

³⁹⁰ Dana Dillon and John J. Tkacik, Jr., "China's Quest for Asia," **Policy Review**, Vol. 134, December 2005/January 2006, p. 41.

³⁹¹ **Xinhua**, "China-ASEAN Trade Soaring," January 17, 2006, in the site: english.sina.com/business/1/2006/0117/62228.htm

³⁹² Wayne Arnold, "China Rise Not Doom for Others," **International Herald Tribune**, February 28, 2006. www.iht.com/articles/2006/02/28/business/asiaecon.php

Chinese analysts have divided the evolution of China-ASEAN economic relations into two phases. The first one, from 1991, when Chinese Foreign Minister Qian Qichen was invited to attend the 24th ASEAN Foreign Ministers meeting, to 2001 when Chinese Premier Zhu Rongji proposed a China-ASEAN free trade area, saw the two sides expand and deepen bilateral trade ties. The second phase began in November 2002, with the signing of the China-ASEAN Framework Agreement on Comprehensive Economic Cooperation moving toward regional economic integration. Over the years, China and ASEAN have institutionalized 48 regular mechanisms to facilitate closer economic cooperation. Prominent among them is the highest political mechanism ASEAN+1, launched in 1997. In addition, there are five working groups: the China-ASEAN Senior Officials meeting, the China-ASEAN Joint Cooperation Committee, ASEAN-China Joint Committee on Economic and Trade Cooperation, ASEAN-China Joint Committee on Science and Technology (July 1994), and the ASEAN Beijing Committee. The two sides also have identified five key areas for cooperation agriculture, information and communication technologies, human resource development, the Mekong River Development, and mutual investment.³⁹³

At the eighth ASEAN summit in Phnom Penh, Cambodia, in November 2002, China and ASEAN signed the Framework Agreement on Comprehensive Economic Cooperation. If and when implemented, it would constitute a common market of 1.7 billion people, with a combined gross domestic product (GDP) of U.S. \$1.5-2 trillion. The two sides sought to establish a free trade area (FTA) within 10 years, first with the original ASEAN-6 by 2010, followed by the entire ASEAN-10 by 2015.³⁹⁴ The initiative largely came from China, as it recognized ASEAN member states' concerns over China's growing economy and its crowding-out effect on investment flows into Southeast Asia and increasing economic competition. After Premier Zhu proposed the FTA idea, an ASEAN-China Expert Group on Economic Cooperation was established to study Zhu's proposal, as well as the impact of China's World Trade Organization (WTO) entry in 2001. It also is a response to the 1997 Asian financial crisis and hence the need for a more regional approach to future economic challenges. Cooperation also includes the Mekong River Basin development project that has been supported by the Asian Development

³⁹³ Zhang Haibing, "Zhongguo-dongmeng quyu jingji hezuo de xinjinzhan yu wenti" ("Progress and Problems in China-ASEAN Regional Economic Cooperation"), *Guoji wenti luntan (International Review)*, No. 38, Spring 2005. www.sisis.org.cn/gjwlt/2005/zhanghaibin.htm

³⁹⁴ John Wong and Sarah Chan, "China-ASEAN Free Trade Agreement: Shaping Future Economic Relations," *Asian Survey*, Vol. 43, No. 3, May/June 2003, pp. 507-526.

Bank and the endorsement by ASEAN of a U.S. \$2.5 billion Trans-Asian railway joining Kunming and Singapore.³⁹⁵

While there are many economic reasons for greater integration, some analysts also point to the strategic rationale for developing an FTA, especially from China's perspective. To begin with, such an arrangement could facilitate a more peaceful regional security environment critical to China's continued economic rise. Second, it addresses concerns in the region over China's growing power by more closely integrating itself with ASEAN, hence increasing the costs of conflicts. Chinese analysts suggest that the CAFTA should be viewed from a strategic perspective and as part of its peaceful rise. Geo-economics and greater economic interactions with ASEAN would support these objectives. To preempt Taiwan's strategy to buy its way into Southeast Asia, China should pay greater attention to the development of its southwestern region (Yunnan and Guangxi in particular) to develop and strengthen economic ties with the ASEAN countries.³⁹⁶

Third, by taking the lead in forming an FTA, China also hopes to play a more prominent role as the region's center of economic growth. Fourth, by investing more in the region and allowing a certain degree of self-discrimination as in the form of the so-called "Early Harvest Program," giving ASEAN states preferential treatment on agricultural products in terms of tariff reduction and market access Beijing seeks to address the perceived "China threat," not in the security area but in the context of economic competition. And finally, by entering a rules-based free trade arrangement, China also wants to demonstrate its acceptance of multilateralism and respect for norms and rules. ASEAN member states for their own reasons sought to partake in China's dynamic economic growth; at least not to be left behind. An FTA also could energize other external powers to seek similar arrangements, therefore opening up more opportunities in the areas of trade and foreign direct investment (FDI).³⁹⁷

While China-ASEAN trade has registered rapid growth over the last decade, both rank fifth as each other's trading partners, after intra-ASEAN, Japan, the United States, and the European Union (EU). Future developments will depend on how both could complement, rather than compete, in labor-intensive manufacturing sectors and increase investment in each other.

³⁹⁵ Joseph Yu-Shek Cheng, "The ASEAN-China Free Trade Area: Genesis and Implications," *Australian Journal of International Affairs*, Vol. 58, No. 2, June 2004, pp. 257-277.

³⁹⁶ Qiu Danyang, "Zhongguo-dongmeng ziyu maoyiqu: zhongguo heping jueqi de diyuan jingjixue sikao" ("China-ASEAN FTA: On the Geo-Economics of China's Peaceful Rise"), *Dangdai yatai (Contemporary Asia-Pacific Studies)*, No. 1, January 2005, pp. 8-13.

³⁹⁷ Busakorn Chantasawat, "Burgeoning Sino-Thai Relations: Heightening Cooperation, Sustaining Economic Security," *China: An International Journal*, Vol. 4, No. 1, March 2006, pp. 86-112.

ASEAN countries recognize the opportunities that a growing China provides, but they also are worried over the long-term impact of a stronger China competing with them for foreign direct investment and replacing them as the manufacturer of labor-intensive consumer products. There remain serious concerns that China may compete and crowd out ASEAN in terms of foreign direct investment, replace ASEAN states as a manufacturing base, and hence cause severe economic downturn in the ASEAN countries less capable of competition and with little room for adjustment.³⁹⁸

To address these concerns, China in particular needs to make a greater investment in ASEAN, potentially in the energy and resource-based sectors, to raise two-way trade volumes further, as well as to generate a larger market as is supposed to be provided by the CAFTA. However, investment negotiations between the two still face major hurdles. For instance, during 1995-2004, Chinese investment (\$1 billion) in ASEAN amounted to only 0.4 percent of the total. This compares poorly with EU-15 (\$68.5 billion, 28.3 percent), the United States (\$42.3 billion, 17.5 percent), and Japan (\$32 billion, 13.3 percent). It even is lower significantly than Taiwan's investment in the region (\$8.9 billion, 3.6 percent).³⁹⁹ At the same time, China has replaced Southeast Asia as the destination of FDI. Beijing also needs to manage potentially contentious issues such as the Mekong River project that has economic, ecological, and environmental impacts on downstream Southeast Asian countries.⁴⁰⁰

The CAFTA has generated much interest in other extra-regional powers that seek FTAs with ASEAN. The United States proposed the Enterprise for ASEAN Initiative (EAI) that would enable member states to establish FTAs along the line of the U.S.-Singapore FTA. Japan also issued the "Joint Declaration of the Leaders of ASEAN and Japan on the Comprehensive Economic Partnership" on November 5, 2002, in Phnom Penh. At the 2003 ASEAN+1 summit held in Tokyo, Japanese Prime Minister Junichiro Koizumi pledged \$3 billion in new aid.⁴⁰¹ With CAFTA, ASEAN+1, and other regional forums, including the East Asia Summit in December 2005, there is what some would call the trend toward regionalism with shared

³⁹⁸ Mari Pangestu, "China's Economic Rise and the Responses of ASEAN," in Kokubun Ryosei and Wang Jisi, eds., *The Rise of China and a Changing East Asian Order*, **Tokyo and New York: Japan Center for International Exchange**, 2004, pp. 241-263.

³⁹⁹ ASEAN Secretariat, **ASEAN Statistical Yearbook 2005**, Chapter VI, "Foreign Direct Investment," www.aseansec.org/SYB2005/Chapter-6.pdf; Chen Huiping, "China-ASEAN Free Trade Area: The Hurdles of Investment Negotiations," EAI Background Brief No. 271, Singapore: East Asian Institute, January 2006.

⁴⁰⁰ Alex Liebman, "Trickle-down Hegemony?, China's 'Peaceful Rise' and Dam Building on the Mekong," **Contemporary Southeast Asia**, Vol. 27, No. 2, 2005, pp. 281-304.

⁴⁰¹ Ho Khai Leong, "ASEAN+1 or China+1? Regionalism and Regime Interests in ASEAN-China Relations," in Leong and Ku, eds., **China and Southeast Asia**, pp. 198-199.

markets, growing economic interdependence, and even shared ideas on what a regional security architecture should look like.⁴⁰²

China-ASEAN relations have evolved from enmity and suspicion to amity and greater cooperation on a broad range of issues. Having established a strategic partnership for peace and prosperity, the two sides are working toward building a stable, long-term relationship for the future. In addition to the state-to-state security and economic ties since reform started in the late 1970s, the Chinese Communist Party (CCP) has sought to establish and expand ties with political parties in Southeast Asia. Today, the CCP has official relations with 39 political parties in the region, and the rationale and objectives are to promote mutual understanding, learning, economic success, and governance, regardless of ideologies. This is a far cry from the 1960s and 1970s when the CCP supported indigenous communist parties as part of a strategy to fan revolution in the region to topple ruling governments.⁴⁰³

Beijing's efforts to assure its neighbors through the so-called new diplomacy have paid off in winning confidence from its Southeast Asian neighbors, if not completely erasing disputes between them. The 1997 Asian financial crisis was a turning point. Chinese responses to the crisis, including its pledges of \$1 billion to help Thailand and not to devalue the Renminbi, won good will in ASEAN. Beijing also emerged more confident of its own potential leadership role in the region; although it remains deferential to ASEAN.⁴⁰⁴ China began to publish a defense white paper in 1998. Now published every 2 years, the document also has moved from mere exposition of general principles to some elementary explanations of defense budgets, modernization programs, and doctrinal issues. While still far from ideal, at least some modest steps have been made to enhance transparency. China also put forward the "New Security Concept" (NSC) at the ARF Inter-Sessional Support Group (ISG) on Confidence-Building Measures that it co-hosted with the Philippines in Beijing, March 1997. The NSC emphasizes cooperative security, confidence-building, peaceful resolution of disputes, and multilateral dialogue.⁴⁰⁵ In November 2004, China hosted the first ARF Security Policy Conference in Beijing. Within a decade, growing interdependence and skillful Chinese diplomacy have

⁴⁰² Mark Beeson, "ASEAN Plus Three and the Rise of Reactionary Regionalism," *Contemporary Southeast Asia*, Vol. 25, No. 2, August 2003, pp. 251-268; Leong, "ASEAN+1 or China+1?"

⁴⁰³ Jiang Shuxian and Sheng Lijun, "The Communist Party of China and Political Parties in Southeast Asia," *Trends in Southeast Asia Series*, Vol. 14, 2005, and *Singapore: Institute of Southeast Asian Studies*, December 2005.

⁴⁰⁴ Jürgen Haacke, "Seeking Influence: China's Diplomacy toward ASEAN after the Asian Crisis," *Asian Perspective*, Vol. 26, No. 4, 2002, pp. 13-52; Ba, "China and ASEAN," pp. 637-38.

⁴⁰⁵ "Summary Report of the ARF ISG on Confidence Building Measures, Beijing, 6-8 March 1997," www.aseansec.org/3605.htm

sustained a steady improvement and rising comfort level between China and ASEAN, allowing Beijing to exercise greater influence in the region.⁴⁰⁶

6.2.3. The Hedging Strategy

International Relations theories long have debated the policy options of states facing an emerging power or hegemony. They invariably would either choose to balance (internally and/or externally) against the dominant power or bandwagon with that power. The latter is divided further into bandwagoning because of fear or bandwagoning for profits. In recent discussions, a new concept of hedging has emerged as yet another policy option for states facing uncertain international security environments.⁴⁰⁷ Denny Roy has further characterized the ASEAN strategy of hedging as “low-intensity balancing” that both seeks U.S. support and works with China. They encourage the United States to maintain a military presence in the region and provide support and base access but decline to form formal military alliances with Washington.⁴⁰⁸

In Southeast Asia, hedging has been a particularly useful strategy for the region’s small powers to maneuver among major powers to secure their interests. According to Robert Ross, the continental ASEAN and maritime ASEAN member states would have different attitudes toward China.⁴⁰⁹ The new ASEAN, which consists of Vietnam, Laos, Cambodia, and Myanmar, for instance, has special relationships with China due to history, geographical proximity, as well as unsettled issues.⁴¹⁰ Wherever possible, ASEAN member states try not to be forced to choose sides, but opt for developing and maintaining good working relationships with as many major powers as possible.⁴¹¹ They all recognize the inevitability of China’s rise and see in it both opportunities and challenges. In a certain way, ASEAN states realize that they cannot by themselves form an effective alliance to check China’s rise; but neither do they want to ally themselves with external powers such as the United States for fear of provoking China. In addition to engagement with China, they therefore also seek to persuade the United States to stay

⁴⁰⁶ Brantly Womack, “China and Southeast Asia: Asymmetry, Leadership and Normalcy,” *Pacific Affairs*, Vol. 76, No. 3, Winter 2003-2004, pp. 529-548; Roy, “Southeast Asia and China,” p. 309.

⁴⁰⁷ Evan S. Medeiros, “Strategies of Hedging,” *The Washington Quarterly*, 2005.

⁴⁰⁸ Roy, “Southeast Asia and China”; see also Yuen Foong Khong, “Coping with Strategic Uncertainty: The Role of Institutions and Soft Balancing in Southeast Asia’s Post-Cold War Strategy,” in J. J. Suh, Peter Katzenstein and Allen Carlson, eds., *Rethinking Security in East Asia: Identity, Power and Efficiency*, Stanford: Stanford University Press, 2004.

⁴⁰⁹ Robert S. Ross, “The Geography of Peace: East Asia in the Twenty-first Century,” *International Security*, Vol. 23, No. 4, spring 1999, pp. 81-118.

⁴¹⁰ S. D. Muni, China’s Strategic Engagement with the New ASEAN: An Exploration Study on China’s Post-Cold War Political, Strategic and Economic Relations with Myanmar, Laos, Cambodia and Vietnam, IDSS Monograph No. 2, *Singapore: Institute of Defense and Strategic Studies*, 2002.

⁴¹¹ N. Ganesan, “ASEAN’s Relations with Major External Powers,” *Contemporary Southeast Asia*, Vol. 22, No. 2, August 2000, pp. 258-278.

engaged in the region to balance China's rise and to develop a network involving all major regional powers so they have stakes in regional order.⁴¹²

As pointed out above, since the end of the Cold War, ASEAN has pursued a dual-strategy of retaining U.S. security involvement in the region, including a military presence, and engaging China in diplomatic-political terms and expanding economic ties. While all member states recognize the importance of continued U.S. security involvement in the region, they also are concerned with Washington's penchant for unilateral use of force, in particular after the September 11, 2001 (9/11), terrorist attacks on the United States. Regarding China, ASEAN members have tried to refrain from identifying China as a threat; rather they talk about challenges and concerns, and their chosen strategy remains that of engagement rather than isolation, let alone containment. However, ASEAN also has reservations and appears uncertain about what a rising China will mean for them. If one could argue that ideology, overseas Chinese living in Southeast Asia, economic competition, and territorial disputes are the four key elements that could affect China-ASEAN relations, and then it is clear that the first two, by and large, have been addressed, with the latter two constituting the remaining major challenges. But even here, the implications may be different for ASEAN member states; the more developed may see less of economic competition in a rising China but more opportunities; countries that have territorial disputes with China may view Beijing's policies and activities more suspiciously. This may explain why ASEAN member states have adopted different approaches, and applied the hedging strategies with varying degrees, in their handling of China. For instance, some look for closer U.S. ties, while others seek greater engagement with China; still others, living in China's shadow, are making the best of their situations.⁴¹³

Although China has developed extensive ties with ASEAN on political and economic fronts, Beijing also has maintained close relationships with specific member states, which remain essential in China's regional diplomacy, especially where territorial disputes are concerned. At the same time, it should also be understood that ASEAN itself has yet to develop its own identity apart from agreements on general principles and processes. Each member state has unique historical experiences dealing with China, with varying threat perceptions regarding China's rise, and has adopted different strategies in its respective China policy.⁴¹⁴ ASEAN countries' threat

⁴¹² Evelyn Goh, *Meeting the China Challenge: The U.S. in Southeast Asian Regional Security Strategies*, **Policy Studies 16**, Washington, DC: East-West Center, 2005.

⁴¹³ *Ibid.*

⁴¹⁴ Interviews, East Asian Institute, National University of Singapore; Institute of Southeast Asian Studies, Singapore, March 9-10, 2006; Jüngen Haacke, "The Significance of Beijing's Bilateral Relations: Looking 'Below' the Regional Level in China-ASEAN Ties," in Leong and Ku, **China and Southeast Asia**, pp. 111-145.

perceptions of China vary depending on history, geography, and the extent and nature of unresolved disputes.

6.2.3.1 Malaysia

Malaysia established diplomatic relations with China in 1974. However, for a long time before and since normalization, Kuala Lumpur harbored serious misgivings about Chinese threats in the form of Beijing's support of (or refusal to sever ties with) the Communist Party of Malaysia (CPM) and the insurgence movement. Indeed, during the early years of the Mahathir administration, Malaysian officials often warned against Beijing's "dangerous ambitions . . . in the region" and the growing military threat to Malaysia's interests.

However, with the end of the Cold War and the initial uncertainty over long-term U.S. commitment to the region, Malaysia began to adopt a policy of engagement with China to mitigate any negative impact. Abdullah Badawi, then Malaysian Foreign Minister in the 1990s, made this observation on the importance of engaging China:

Close relations and cooperation between Malaysia and China would alleviate any attempt by China to resort to military action because that would also be detrimental to China. . . . If there is no cooperation, there is a possibility China may resort to military action (against Malaysia) or cause a conflict here because it will not lose anything. We want to create a choice (for China).⁴¹⁵

In fact, the end of the Cold War has opened up opportunities for improving Sino-Malaysian relations. Malaysia made a dramatic turn in its stance on China, shifting from the earlier suspicions and warning to a more accommodative, if not apologetic, tone of praising mutual confidence and trust and dispelling rhetoric about the so-called China threat. Indeed, Prime Minister Mahathir had become the most vocal defender of China, from security issues to human rights. Beijing and Kuala Lumpur have found mutual interests in defending the principles of sovereignty, noninterference in domestic affairs, aversion to Western/U.S. dominance in international affairs, and hence the need to develop a fairer and more equitable international political and economic order. Bilateral relations have been strengthened through regular visits by top leaders and high-ranking officials and such bilateral initiatives as the Malaysia-China Friendship Society, the Bilateral Meeting between Foreign Officials of Malaysia and China, and

⁴¹⁵ FBIS-EAS-93-159, August 19, 1993, BK1708110293, cited in Joseph Chinyong Liow, "Balancing, Bandwagoning, or Hedging? Strategic and Security Patterns in Malaysia's Relations with China, 1981-2003," in Ho Khai Leong and Samuel C. Y. Ku, eds., *China and Southeast Asia: Global Changes and Regional Challenges*, Singapore: Institute of Southeast Asian Studies, 2005, p. 287.

the Beijing Dialogue on Malaysia and China Partnership aimed at further strengthening mutual understanding and mutual benefits.⁴¹⁶

The area that has seen the most dramatic development of ties is bilateral trade, which grew from \$910 million in 1988 to over \$18 billion in 2003, and \$18.7 billion in 2004, making Malaysia one of ASEAN's largest trading partners with China, rivaling Singapore.⁴¹⁷ During the first 9 months in 2005, bilateral trade was at \$16.2 billion. Malaysian Prime Minister Abdullah Badawi told the visiting Chinese Premier Wen Jiabao in December 2005 after the first East Asian Summit that bilateral trade could reach \$50 billion by 2010.⁴¹⁸

Even in areas such as territorial disputes, as both China and Malaysia lay claims to the Spratly Islands in the South China Sea, Kuala Lumpur tends to view Chinese assertiveness as more targeted at Vietnam and less at Malaysia. This being the case, Malaysia on occasion has adopted a rather non-ASEAN stance on the issue of territorial disputes and even opposed the Philippine suggestion of adopting an ASEAN stance against China. Indeed, at both Track I and Track II forums, Malaysian officials and representatives reportedly have foiled attempts to make the South China Sea issue a multilateral one and instead preferred bilateral discussion and resolutions. Malaysian Foreign Minister Syed Hamid Albar once even rejected a Philippine request to discuss the issue at the ASEAN Regional Forum.⁴¹⁹ It also was Malaysia that effectively proposed the adoption of a political declaration rather than a more constraining code of conduct with regard to the South China Sea territorial disputes, hence winning Chinese acceptance and subsequently paving the way for Beijing to also accede to the ASEAN Treaty of Amity and Cooperation at the Phnom Penh Summit in November 2002, the first major power to do so.⁴²⁰

However, Kuala Lumpur hedges its China policy with its continued pursuit of ties with Washington, despite the occasional public rhetoric expressing differences of opinion. Indeed, Malaysian-U.S. military cooperation forms an important component of bilateral relations, even though Kuala Lumpur declined a U.S.-Japan proposal for the joint patrol of the Strait of Malacca. During his recent visit to Japan, Malaysian Prime Minister Abdullah Badawi tried to allay concerns that efforts at developing closer regional integration such the East Asia Summit held in December 2005 are aimed at excluding U.S. participation. At the same time, Malaysia,

⁴¹⁶ Liow, "Strategic and Security Patterns in Malaysia's Relations with China," p. 289.

⁴¹⁷ Ibid, p. 290.

⁴¹⁸ "PM Targets US\$50Bil Malaysia-China Trade by 2010," **The Star Online**, December 16, 2005, thestar.com.my/news.story.asp?fle=/2005/12/16/nation/12884965&sec=nation

⁴¹⁹ "Hamid: Spratlys Issue not for ARF discussion," **New Straits Times**, July 23, 1999.

⁴²⁰ Liow, "Strategic and Security Patterns in Malaysia's Relations with China, pp. 294-295.

while initially cool toward a 2004 Chinese proposal for a joint undertaking to maintain security in the Strait of Malacca, did later welcome Beijing's role in this regard in a joint communiqué issued after the China-Malaysia summit in December 2005.⁴²¹ Kuala Lumpur and Beijing also signed a memorandum of understanding on maritime cooperation in August 2006.

6.2.3.2. Vietnam

China and Vietnam have had a checkered relationship over the last 5 decades. Between the 1950s and 1970s, Beijing was a strong supporter of Hanoi's anti-French and anti-American causes, both providing significant amounts of materials (RMB ¥20 billion) and sending over 320,000 PLA air defense and engineering corps troops to the North. For years, Beijing and Hanoi touted the so-called Sino-Vietnamese relationship sealed in blood, camaraderie plus brotherhood. Ho Chi Minh himself visited China no less than 30 times between 1949 and 1969, the year when he died. Beginning in the late 1970s, relations began to sour, in large part driven by the two erstwhile allies' different perspectives on how Indochina should be run. China considered Vietnam's assertiveness as part of the Soviet Union's southern strategy as well as Hanoi's own aspiration for regional hegemony. A spat between the two was soon followed by Vietnam's expelling of hundreds of thousands of Chinese residents and Vietnam's 1978 invasion of Cambodia to unseat the Khmer Rouge regime in a direct challenge to Chinese interests. In early 1979, China launched an all-out military attack against Vietnam to teach the former client state "a lesson." The military clashes dragged on for years, causing tremendous damage to both sides. It was not until the early 1990s that the two countries normalized relations. The September 1990 Chengdu meeting, where top Chinese and Vietnamese leaders reached agreement on rapprochement, paved the way for bilateral normalization. The 1991 Paris settlement of the Cambodian issue further removed an obstacle to the normalization process.⁴²²

Bilateral ties have improved over the last decade. In recent years, the two countries have exchanged high-level visits between top party and state leaders. Bilateral trade also flourished, growing from U.S. \$32 million in 1991, to \$3.6 billion in 2002, and continued to grow, registering a record of \$8.2 billion in 2005.⁴²³ To facilitate border trade, the two sides also made great efforts in demining the areas. However, territorial disputes continue to cloud over the relationship. In 1988, the two countries clashed over the Spratlys, resulting in over 70

⁴²¹ Ronald Montaperto, "Smoothing the Wrinkles," *Comparative Connections: An E-Journal on East Asian Bilateral Relations*, Vol. 6, No. 2, **Honolulu: Pacific Forum-CSIS**, 2nd Quarter, April-June 2004.

⁴²² Li Hui, "Zhongyue: gaoceng hufang cuhezuo" ("China and Vietnam: High-Level Exchange Visits Promote Cooperation"), **Shejie zhishi (World Affairs)**, No. 22, November 16, 2005, pp. 28-30.

⁴²³ Amer, "Assessing Sino-Vietnamese Relations," p. 322; "China-Vietnam Trade Moves Up in 2005," Sina, February 8, 2006, english.sina.com/business/1/2006/0208/64696.html

Vietnamese killed.⁴²⁴ Beginning in 1992, the two countries engaged in extensive discussions and negotiation over land and maritime boundaries. On December 30, 1999, a land border treaty was signed. On December 25, 2000, the two sides signed the Agreement on the Delimitation of the Territorial Seas, Exclusive Economic Zones and Continental Shelves in the Beibu Gulf (hereinafter referred to as the Boundary Agreement), and the Agreement on Fishery Cooperation in the Beibu Gulf (hereinafter referred to as the Fishery Agreement).⁴²⁵ Although a protocol to the agreement of fishery cooperation was signed in December 2000, failure to define boundaries in the so-called Common Fishery Zone clearly has led to occasional clashes between the two, resulting in casualties. A shooting incident took place in January 2005, leading to the death of eight Vietnamese fishermen.⁴²⁶

Hanoi has sought to use its membership in ASEAN to strengthen its bargaining position vis-à-vis China. While to some extent, it has been able to apply multilateral pressure in dealing with China, it has not been able to rely completely on ASEAN and expect that ASEAN would always come to its assistance, since there are overlapping claims in territorial disputes even among member states and as ASEAN's own positions on the issue have undergone changes over the years.⁴²⁷ This reality has compelled Hanoi to try to balance its relationships with both the United States and China. U.S.-Vietnam military ties have grown in the last few years. But Hanoi's strategic calculation remains anchored on how to balance between the two major powers without becoming overly dependent on either. If Vietnam has learned anything at all in its experiences in dealing with major powers, including France, the Soviet Union, the United States, and China today, that lesson is if it ever gets embroiled in a major-power conflict as a junior, the assistance it expects rarely comes through.⁴²⁸ Chinese analysts suggest that Vietnam will continue to deepen ties with Washington as the United States remains the source of economic assistance, investment, and markets. For instance, American companies such as Nike are setting up manufacturing in Vietnam. On the other hand, as a close neighbor, China also is important to

⁴²⁴ Scott Snyder, Brad Glosserman, and Ralph A. Cossa, "Confidence Building Measures in the South China Sea," **Issues & Insights**, Vol 2, No. 1, Honolulu, HI, Pacific Forum-CSIS, August 2001, p. 8, http://www.csis.org/media/csis/pubs/issuesinsights_v01n02.pdf

⁴²⁵ Ramses Amer, "Assessing Sino-Vietnamese Relations through the Management of Contentious Issues," **Contemporary Southeast Asia**, Vol. 22, No. 2, August 2004, pp. 320-345; Stein Tennesson, "The Paracels: The 'Other' South China Sea Dispute, Asian Perspective, Vol. 26, No. 4, 2002, pp. 145-169.

⁴²⁶ Stein Tennesson, "Sino-Vietnamese Rapprochement and the South China Sea Irritant," **Security Dialogue** Vol. 34, No. 1, March 2003, pp. 55-70.

⁴²⁷ Ralf Emmers, "The Indochinese Enlargement of ASEAN: Security Expectations and Outcomes," **Australian Journal of International Affairs**, Vol. 59, No. 1, March 2005, pp. 71-88.

⁴²⁸ Institute of Southeast Asian Studies, Singapore, March 9, 2006. Simon Montlake, "Military Ties Warm between US, Vietnam," **Christian Science Monitor**, February 7, 2006, www.csmonitor.com/2006/0207/p07s02-woap.htm

Vietnam, not least because Chinese experiences in reform and opening up, while maintaining a socialist system, provide valuable lessons for Hanoi as it embarks on its own reform path.⁴²⁹

6.2.3.3. Singapore

Singapore practices a classic hedging strategy. The city-state both seeks greater opportunities in China and remains the strongest U.S. quasi-ally in the region, offering to host the American naval logistics command center (WESTPAC LOGCOM) and providing naval facilities (the Changi Naval Base) for the U.S. Navy. On the one hand, Singapore has developed extensive contacts and expanded ties with China on security, economic, and political issues. On the other, Singapore also is modernizing its military forces, and has systematically built up its security relationship with the United States. Indeed, Singapore has demonstrated a marked preference for a continued U.S. presence in the region to provide security guarantees.

Singapore has maintained a rather stable relationship with China since the establishment of diplomatic relations between the two in October 1990. Ever conscious of its own ethnic make-up and always careful of not being seen as too China-leaning, Singapore nonetheless has assisted China in industrial development, governance, and development of an efficient bureaucracy. It also has sought to act as a go-between in cross-Strait relations. Senior statesman Lee Kuan Yew has shuttled between Beijing and Taipei to facilitate cross-Strait contacts between Mainland China and Taiwan, sometimes offering Singapore as the neutral ground for dialogue. For instance, the first ever semi-official meeting between Beijing and Taipei was held in Singapore in 1993. However, Singapore's self-assigned role has been under increasing stress in recent years, not so much because Beijing does not appreciate the effort but more out of concern that Taipei, and in particular the Chen Shui-bian administration, will take advantage of any semblance of official contacts between Taiwan and the Southeast Asian governments to boost its independence drives. Indeed, Singapore's relationship with China took a dive when Prime Minister Lee Hsien Loong visited Taiwan before assuming his current position. Beijing was so upset that it strongly rebuffed Lee until the latter reaffirmed the "One China" policy.⁴³⁰

The two countries have developed and maintained a robust bilateral relationship, especially in the economic arena. Singapore's Prime Minister, Lee Hsien Loong, during his October 2005 visit to China, described the rise of China as the "single biggest event of our age."⁴³¹ The two

⁴²⁹ Zhai Kun, "Yuenan: zai zhongmei zhijian" ("Vietnam: In-between China and the United States"), **Shejie zhishi (World Affairs)**, No. 14, July 16, 2005, pp. 28-29.

⁴³⁰ Barry Wain, "Singapore: A David and Goliath Tussle," *Far Eastern Economic Review*, August 5, 2004.

⁴³¹ Chua Chin Hon, "China's Rise 'the Single Biggest Event of Our Age'," **Straits Times**, October 26, 2005.

countries enjoy booming trade, reaching \$33.15 billion in 2005, a 25.78 percent jump over the previous year. Investment, including that in the banking and service sector, also is growing.⁴³² At the same time, defense officials of the two countries also are seeking to foster closer military ties, although discussions so far have remained largely in principle and rhetorical in nature.⁴³³ Specific programs and activities such as functional-level exchanges, port calls, and joint military search and rescue operations, have yet to be developed. And there remains the Taiwan issue.

In fact, the China-Singapore tussle over the Taiwan issue may not be over. Singapore's military continues to undertake training in Taiwan (Operation STARLIGHT) and retains extensive military ties with Taipei. China has offered Singapore its Hainan Island as the training ground for Singapore, but the latter has declined, given the sensitivity the city state always has over its ethnic makeup and how too a relationship with the mainland cozy could stir apprehension in its Southeast Asian neighbors. Recent reports suggest that the Singaporean and Taiwanese militaries were involved in joint military exercises.

6.2.3.4. Myanmar

China and Myanmar have had a long history of a relatively close relationship since the two countries established diplomatic relations in June 1950. The two countries soon resolved their boundary issue and jointly endorsed the five principles of peaceful coexistence. The late Chinese Premier Zhou Enlai maintained close personal ties with Burma's leaders (Zhou visited Burma nine times).⁴³⁴ Beijing's current close ties with Rangoon began in the early 1990s as the military junta was shunned by the international community in the wake of its ruthless suppression of the country's democratic movement. Beijing provided up to U.S. \$1.4 billion in conventional weapons to the State Law and Order Restoration Council (SLORC). The package included ground-based radars, anti-aircraft guns, small arms, 24 F-6 and F-7 fighter aircraft, 100 T-69 II main battle tanks, 100 T-63 light tanks, 150 T-85 armored personnel carriers, 144 air-to-air missiles, and four patrol boats.⁴³⁵ In addition, China also reportedly was helping Burma build a naval base on Haingyi Island as well as setting up intelligence gathering posts on the Coco Islands. Presumably China may be expected to have access to these naval facilities and thus will

⁴³² "China-Singapore Trade Up in 2005," **People's Daily Online**, February 28, 2006, english.people.com.cn/200602/28/eng20060228_246749.html

⁴³³ **People's Daily**, "China, Singapore to Boost Military Cooperation," April 14, 2006, english.people.com.cn/200604/14/eng20060414_258288.html

⁴³⁴ Rui Wen, "Neighbors in Harmony," **Beijing Review**, June 10, 2004, [www.bjreview.com.cn/200423/Cover-200423\(C.htm](http://www.bjreview.com.cn/200423/Cover-200423(C.htm)

⁴³⁵ Bertil Lintner, "Chinese Arms Bolster Burmese Forces," **Jane's Defence Weekly**, November 27, 1993, p. 11.

have projected power capabilities into the Indian Sea.⁴³⁶ China also sees the importance of Myanmar as providing greater access to the Indian Ocean and through to the oil rich Middle East. While China's intentions might be to revitalize the wartime Burma Road and hence facilitate the country's southwestern region's (Develop the West) economic interactions with South Asian countries,⁴³⁷ its influence is bound to increase as China extends its reach through the newly developed road networks to South and Central Asia.⁴³⁸ New Delhi regards this as Beijing's intrusion into its traditional sphere of influence. Indeed, there are suggestions that the reason for India to cozy up relations with Vietnam and ASEAN, and even with Myanmar, was to counter Beijing's growing influence in the region.⁴³⁹

The China-Myanmar relationship goes beyond arms sales and military assistance. From ASEAN's perspective, Beijing's policy of noninterference in Myanmar's internal affairs is frustrating efforts to pressure Rangoon for change, which was the rationale in 1997 for accepting Myanmar into the organization. At the 2005 ASEAN Summit in Vientiane, Laos, Li Zhaoxing, the Chinese Foreign Minister, cut short his attendance to visit Myanmar instead, after the country received the strongest rebuke by the organization, a major sign of departure from its traditional noninterference position.⁴⁴⁰ From Beijing's perspective, noninterference as a principle aside, the Chinese government values stability in Myanmar over democratic processes, which could result in a period of uncertainty in that country and, worse still, large-scale unrest that could harm Chinese interests.⁴⁴¹

While Beijing maintains an amicable relationship with Rangoon, Myanmar's junta also has been seeking to broaden its external relationship so as not to rely solely on China. Indeed, over the last few years, India has been making great efforts in courting Myanmar after years of policies of isolating the military regime. Some analysts suggest that China and India are now competing for influence over Myanmar, even though Beijing may retain the lead in a wide range of areas. In October 2004, pro-Beijing Prime Minister Khin Nyunt was fired, followed by

⁴³⁶ Michael Richardson, "China-Burma Ties Upset Neighbors," **International Herald Tribune**, April 7, 1995, p. 4.

⁴³⁷ William Ashton, "Chinese Naval Base: Many Rumors, Few Facts," **Asia-Pacific Defence Reporter**, June-July 1993, p. 25.

⁴³⁸ John W. Garver, "Development of China's Overland Transportation Links with Central, South-west and South Asia," **The China Quarterly**, Vol. 185, March 2006, pp. 1-22

⁴³⁹ Mohan Malik, "Sino-Indian Rivalry in Myanmar: Implications for Regional Security," **Contemporary Southeast Asia**, Vol. 16, No. 2, September 1994, pp. 137-156; Bertil Lintner, ". . . But Stay on Guard," **Far Eastern Economic Review**, July 16, 1998.

⁴⁴⁰ Seth Mydans, "China Woos Myanmar as ASEAN Seeks Way to Deal with Its Leaders," **International Herald Tribune**, July 29, 2005.

⁴⁴¹ Zou Keyuan, "China's Possible Role in Myanmar's National Reconciliation," **The Copenhagen Journal of Asian Studies**, Vol. 17, 2003, pp. 59-77.

Myanmar's top leader General Than Shwe's visit to India. There was much media speculation that Beijing was losing ground. However, analysts point out that may not be the case, as China's influence remains deeply entrenched, as are the middle kingdom's strategic interests in the region.⁴⁴² During a 2004 visit to Myanmar, Chinese vice Premier Wu Yi pledged expanding bilateral trade from the current level of \$1 billion to \$1.5 billion in 2005. There have been proposals to build a pipeline running through Myanmar to connect Kunming, therefore providing China's southwestern region a more direct access to Middle Eastern oil.⁴⁴³

6.2.3.5. Philippines

The Philippines is confronted directly with the territorial dispute with China. After the Mischief Reef incident, Manila sought support from ASEAN, which expressed its concern and urged Beijing to abide by the 1992 ASEAN Declaration on the South China Sea. The two countries subsequently signed a code of conduct to ease tension and seek maritime cooperation. While Manila continues to complain of Chinese violation of the code, by and large the two countries have kept their dispute under control.⁴⁴⁴

The Philippines signed a Visiting Forces Agreement with the United States in 1999 and requested that Washington provide military assistance. The Arroyo government also has been quite forthcoming in supporting the U.S. global war on terrorism, with the Bush administration expressing its appreciation by identifying the Philippines as a major non-NATO ally. Military assistance increased from \$1.9 million in 2001 to over \$400 million in 2004. Manila also has allowed U.S. Special Forces troops to be sent to advise the Philippine military in its fight against the Abu Sayyaf group.⁴⁴⁵

When Chinese NPC Chairman Wu Bangguo visited the Philippines in September 2003, he proposed that the two countries jointly explore for oil in the South China Sea. Beijing and Manila have strengthened their economic ties over the last few years, with bilateral trade reaching \$13.3 billion in 2004, up further to \$17.5 billion in 2005. Bilateral trade may well reach \$20 billion in the next few years. During Chinese President Hu Jintao's visit to Manila in April 2005, the two governments signed 14 trade and investment agreements and targeted annual bilateral trade of

⁴⁴² Robert Sutter, "China-Southeast Asia Relations: Progress with Limitation," *Comparative Connections*, January-March 2006.

⁴⁴³ Bruce Vaughn and Wayne M. Morrison, **China-Southeast Asia Relations: Trends, Issues, and Implications for the United States**, CRS Report for Congress. Updated April 4, 2006, pp. 23-24.

⁴⁴⁴ Ian James Storey, "Creeping Assertiveness: China, the Philippines and the South China Sea Dispute," **Contemporary Southeast Asia**, Vol. 21, No. 1, April 1999, pp. 95-118.

⁴⁴⁵ Carl Baker, "China-Philippines Relations: Cautious Cooperation," in Satu Limaye, ed., *Asia's Bilateral Relations*, Honolulu: Asia Pacific Center for Security Studies, October 2004; Ba, "China and ASEAN," p. 644.

\$30 billion by 2010. Other bilateral economic cooperation included agreement on a \$400 million railway project.⁴⁴⁶

6.2.3.6. Indonesia

As the largest member state and an initial leader of ASEAN, Indonesia has had a complex relationship with China. In the 1950s, Jakarta and Beijing forged close ties in promoting Asian-African emergence and solidarity, via the famous Bandung Conference of 1955, at which the Five Principles of Peaceful Coexistence were promulgated. However, bilateral relations entered a period of stagnation and hostility after the failed 1965 coup and the subsequent purge and prosecution of members of the Indonesian Communist Party and large-scale prosecution of the ethnic Chinese. Over 500,000 Chinese reportedly were killed. The two countries severed diplomatic relations, and it was not until 1990 that diplomatic ties were restored when Indonesian Foreign Minister Ali Alatas and his Chinese counterpart, Qian Qichen, signed a Memorandum of Understanding on the Resumption of Diplomatic Relations between Indonesia and China.

Growth in bilateral trade represents the most significant achievement since Jakarta and Beijing mended fences in 1990. China now ranks as the fifth largest trading partner of Indonesia, which in turn ranks as China's 17th. In 2005, bilateral trade totaled \$16.7 billion. The two countries are seeking to forge closer economic relations and increase bilateral trade to \$20 billion in the next few years. In 2002, a Memorandum of Understanding (MOU) was signed that set up the Indonesia-China Energy Forum. The Chinese national oil company has invested in Indonesia's energy sector, while the latter won a contract to supply liquid natural gas to China's Fujian Province. In April 2005, China and Indonesia signed an agreement of "strategic partnership" when Chinese President Hu Jintao visited Jakarta after observing the 50th anniversary of the Bandung Conference. During Hu's visit, the Chinese side pledged \$300 million in preferential loans, promised to facilitate a \$10 billion investment in Indonesia's private sectors, and expanded cooperation in joint efforts to combat smuggling and maritime piracy.⁴⁴⁷

While bilateral relations are stable and have continued to grow in recent years, problems remain. One is the Taiwan issue. The other relates to Jakarta's concern over Beijing's long-term intentions in the region. Yet a third is the potential conflict over exclusive economic rights in the South China Sea, where overlapping claims over areas with identified natural gas deposits could

⁴⁴⁶ "China, Philippines Sign 14 Agreements," *Xinhuanet*, April 28, 2005. news.xinhuanet.com/english/2005-04/28/content_288710.htm; Baker, "China-Philippines Relations."

⁴⁴⁷ C. S. Kuppuswamy, "Indonesia: Relations with China on the Rise," *South Asia Analysis Group*, Paper No. 1354, April 29, 2005, www.saag.org, accessed on May 4, 2006.

lead to conflict. Indonesia has maintained close economic ties with Taiwan, even after Jakarta and Beijing officially restored diplomatic ties. In 2000, bilateral trade amounted to \$4.7 billion. Taiwan's President Lee Teng-hui made a historical visit to Indonesia in 1994, even though the visit was termed private. Many high-ranking Indonesian officials, including cabinet members, continue to visit Taiwan. Indeed, Taipei has targeted Indonesia in its southward policy and "golf diplomacy," or "tourist diplomacy," which clearly irritates Beijing.⁴⁴⁸

Analysts suggest that, despite improvement in bilateral relations, elite perceptions in Indonesia remain suspicious of China's long-term intentions. Jakarta also remains vigilant for signs of potential Chinese encroachment on what it considers as its oil and natural gas fields near the Natuna Islands.⁴⁴⁹ Indonesia continues to look to the United States for future military assistance, including the lifting of the arms embargo currently in place. The Bush administration has partially lifted the sanctions by allowing the provision of spare parts for Indonesian military transport planes in the post-tsunami relief operations. In addition, Washington has restored the International Military Education Training (IMET) program for Indonesia.⁴⁵⁰

6.2.3.7. Thailand

Of all the ASEAN member states, Thailand maintains the most cordial relationship with China, matched perhaps with only that between China and Malaysia. Bangkok recognized Beijing in 1975 and in the 1980s formed a close alignment with China in their common objectives of seeking to oust Vietnam's occupation of Cambodia. China began to provide arms to Thailand, including 500 T-69 tanks, some 1,160 T-531 armored personnel carriers (APCs), and Jianghu-class frigates. Beijing also made "friendship"-priced offers to Bangkok for the transfer of anti-aircraft missiles, diesel-electric Romeo-class submarines, and F-7 fighter jets. In 1989-90, it transferred 200 T-69 main battle tanks (MBTs) to Thailand and in 1991, began delivery of the four 1,800-ton Jianghu-class frigates ordered by the Royal Thai Navy.⁴⁵¹ Chinese arms sales to Thailand during this period represented an important aspect of this special relationship. Unlike some of the other ASEAN member states, Thailand does not have any territorial disputes with China, and most of the ethnic Chinese in the country are well-integrated into Thai society.

⁴⁴⁸ Samuel C. Y. Ku, "Indonesia's Relations with China and Taiwan: From Politics to Economics," *Asian Perspective* Vol. 26, No. 4, 2002, pp. 227-256.

⁴⁴⁹ Ian Storey, "Indonesia's China Policy in the New Order and Beyond: Problems and Prospects," *Contemporary Southeast Asia*, Vol. 22, No. 1, April 2000, pp. 145-174.

⁴⁵⁰ Storey, "Progress and Remaining Obstacles"; Catharin Dalpino and David Steinberg, eds., *Georgetown Southeast Asia Survey 2004-2005*, Washington, DC: Georgetown University, 2005, pp. 61-62.

⁴⁵¹ R. Bates Gill, "China Looks to Thailand: Exporting Arms, Exporting Influence," *Asian Survey*, Vol. 31, No. 6, June 1991, pp. 526-539.

Relations continued to grow with the end of the Cold War and after the Cambodian settlement. This is particularly the case in bilateral trade, which grew from \$24.6 million when the two countries established diplomatic ties in 1975 to \$15 billion in 2004, with China now becoming the third largest trading partner of Thailand after Japan and the United States. Bilateral trade reached close to \$22 billion in 2005, 5 years ahead of the originally set target.⁴⁵² China contributed \$1 billion to the International Monetary Fund (IMF) for rescue efforts during the 1997 financial crisis and extends the Early Harvest Program to Thailand in the China-Thailand Free Trade Agreement, where Thai agricultural produce is given preferential tariff treatment.

The two countries also have formed strong political ties, signing a Joint Statement on a Plan of Action for the 21st century in February 1999. Thai Prime Minister Thaksin Shinawatra visited China eight times between 2001 and 2005. All top Chinese leaders, including President Hu Jintao, also have made visits to Thailand. Bangkok adheres firmly to the One China principle and has carefully handled issues sensitive to Beijing. For instance, the Thai government has denied entry into the country by the Dalai Lama and has expelled members of the Falungong. Thailand has managed its relationship with China skillfully despite its alliance with the United States.

In sum, due to historical and geo-strategic reasons, the seven ASEAN member states listed above have adopted various approaches in their dealing with China. While none has chosen confrontation with China, some, such as Indonesia, the Philippines, and Vietnam, obviously have the greatest concerns over China's growing military and economic power since all three have had conflicts with China in the past and continue to have territorial disputes. But they have sought to face these challenges through a combination of alignments with external powers and bilateral negotiations with Beijing to arrive at mutually acceptable codes of conduct to restrain China's use of force, while at the same time pushing for expanded ties in the economic field.

At the other end of the spectrum are countries such as Thailand and Myanmar, both of which maintain cordial relationships with China, although for different reasons. Bangkok's ties with Beijing have been longstanding, and the absence of territorial disputes and the better integration of Chinese in Thailand have helped the two countries to focus on areas of mutual interest and gain bilateral trade and investment. While small agricultural businesses in Thailand do face competition from China, the current Early Harvest Program at least provides some time albeit rather short for the Thai agricultural sector to make the adjustment. Beijing's comfort level with Bangkok allows it to be rather tolerant of Thailand's close military ties with the United

⁴⁵² Chinese Ministry of Commerce, "Country Trade Report: Thailand," accessed on March 29, 2006.

States, including frequent joint military exercises. Myanmar, on the other hand, has developed a close relationship with China over the past decade out of necessity as the military regime in Rangoon seeks to hold on to power and maintain domestic order. In the face of international condemnation and isolation, Beijing's assistance and moral support provide the necessary breathing space for the government. However, that does not mean that Rangoon is not concerned over its overwhelming dependence on China's good will and pocket book, nor is it blind to the growing Chinese influence in the country, especially in the Northeastern areas bordering Yunnan Province. For that reason, Myanmar's authority also has turned to other external powers to reduce its dependence on China. This explains Rangoon's turn to New Delhi and the purge of the pro-China faction in the government.

Singapore and Malaysia stand in between the cordial and suspicious in their relationships with China. Territorial disputes do not constitute a major schism in bilateral relations. Both have played an active role in promoting engagement with China, although Singapore maintains extensive security ties with the United States. Malaysia, on the other hand, has found an ideological bedfellow in China in that both share such Asian values as sovereignty, noninterference in internal affairs, and moreover, a vision of greater East Asian community wherein Asian powers play a dominant role.

6.3. Implications for U.S. Interests

Southeast Asia has emerged as an area of increasing strategic interest to the United States. It straddles critical sea lanes of communication (SLOCs), and the United States has an interest in maintaining freedom of navigation; it has one of the world's major seaports and transit points that create opportunities for terrorist groups to transport weapons of mass destruction (WMD) materials or sneak bombs to U.S. ports. In recent years, the region also has been the focal point of potentially deadly diseases such as Avian Flu and Pandemic Influenza. It contains a large Muslim population, and the region's secular governments for years have had to deal with ethnic and religious extremist and terrorist groups. And it also is a vast market, as well as production base, for U.S. multinationals. Perceived growing Chinese influences have refocused Washington's attention.⁴⁵³

⁴⁵³ Bruce Vaughn and Wayne M. Morrison, *China-Southeast Asia Relations: Trends, Issues, and Implications for the United States*, **CRS Report for Congress**, updated April 4, 2006.

The U.S. strategy for Asia remains that of maintaining its primacy and preventing the rise of a regional power that would challenge the U.S. position.⁴⁵⁴ And that power is unquestionably China. Specifically, the United States is highly aware of the consequences of Chinese domination of Southeast Asia. China's naval ambitions, its territorial disputes with a number of Southeast Asian states, its threatened and actual use of force to prevent Taiwan independence, and its growing interest in guarding against piracy on the high seas mean that Beijing increasingly will seek to project its power, and hence could threaten SLOCs and therefore gravely affect U.S. interests in the region.⁴⁵⁵

Since the 1997 Asian financial crisis, ASEAN's own ability to mediate the Sino-U.S. relationship has continued to depend on the nature of that relationship. Indeed, in a way, conflict and rivalry have provided the opportunity for the regional organization to continue to play the hedging strategy. This has allowed the smaller states of Southeast Asia to retain their autonomy, while at the same time exploring the opportunities provided by this geo-strategic structure. In general, Southeast Asians have sought to hedge against a potential Chinese threat in the future by aligning themselves with the United States in various security and military arrangements short of formal alliances, but continue to develop stable political and economic ties with China through engagement, exchanges, and exploration of economic opportunities. This way, they retain their strategic value to both great powers without either becoming subservient to one or having to choose between the two.⁴⁵⁶

Washington is seeking to reinsert itself in Southeast Asia's geo-politics and to regain lost ground. Secretary of State Condoleezza Rice made her first visit to Indonesia as America's top diplomat in March 2006, where she sought to expand a "strategic partnership" with the important Southeast Asian country in an effort to regain U.S. influence in the region in response to China's perceived inroads of the last few years.⁴⁵⁷ Indeed, since 9/11, U.S. policy has seemed to be less focused on winning political support in the region, but too much focused on the military dimension of its global war on terrorism. Washington's occasional display of indifference to the region also helps diminish its influence; one example is the absence of Secretary Rice at the

⁴⁵⁴ Robert Sutter, "The United States and Asia in 2005: Managing Troubles, Sustaining Leadership," *Asian Survey*, Vol. XLVI, No. 1, January/February 2006, pp. 10-21.

⁴⁵⁵ Joshua P. Rowan, "The U.S.-Japan Security Alliance, ASEAN, and the South China Sea Dispute," *Asian Survey*, Vol. 45, No. 3, May/June 2005, pp. 414-436.

⁴⁵⁶ Shannon Tow, "Southeast Asia in the Sino-U.S. Strategic Balance," *Contemporary Southeast Asia*, Vol. 26, No. 3, 2004, pp. 434-459.

⁴⁵⁷ Steven R. Weisman, "Rice Seeks to Expand Indonesian Partnership," *International Herald Tribune*, March 14, 2006.

annual ASEAN Regional Forum (ARF) foreign ministers' meeting in July 2005.⁴⁵⁸ At other times, American leaders' moralizing irks Southeast Asian politicians, losing them as friends, if not creating enemies.

The conventional wisdom is that ever since the 1997 Asian financial crisis, Beijing has made significant gains in a region that only years before had harbored strong suspicion of Chinese intentions and ambitions, which had been amply displayed in the construction on the Mischief Reef in the South China Sea and the PLA missile exercises adjacent to Taiwan. The "China threat" was then a popular selling point and had a more receptive audience. But Beijing's leadership since has modified its tactics dramatically, if not the essence of its policy objectives; has put forward a New Security Concept that appeals to and is compatible with the ASEAN Way of working on security issues; and has become an active participant in the region's only multilateral security arrangement the ARF something that it had shunned in the early 1990s, considering it a thinly veiled attempt by the region's states to gang up against China.⁴⁵⁹

Not only has China embraced multilateralism with ASEAN characteristics, of course but Beijing actively now has promoted its virtues as a preferred alternative for a regional security architecture to what it considers the Cold War relics, i.e., the hub-and-spokes type of U.S.-led bilateral military alliances. Beijing also has moderated its approaches to territorial disputes significantly by signing a Declaration of Conduct in the South China Sea that commits it in principle at least to peaceful solutions of the issue. It also has acceded to the ASEAN Treaty of Amity and Cooperation, the first major power to do so, effectively accepting the organization's principles of respect for sovereignty, noninterference in domestic affairs, and the code of consensus in reaching decisions.⁴⁶⁰

However, the most important gains that China has struck over the past decade are the increasing economic ties between it and its Southeast Asian neighbors. Bilateral trade has been growing at 20 percent per year over the last decade, with China-ASEAN two-way trade reaching \$130.4 billion in 2005. There also is growing economic interdependence and major initiatives such as the Greater Mekong Sub region (GMS) that further promote economic cooperation. Even greater economic integration is projected with the signing of the China-ASEAN FTA targeted at 2010-15. Analysts predict that by then China could well surpass the United States as the

⁴⁵⁸ Simon Montlake, "Rice's No-Show Irks Southeast Asia," **The Christian Science Monitor**, July 26, 2005, www.csmonitor.com/2005/0726/p06s01-wosc.html

⁴⁵⁹ On China's growing influence, see David Shambaugh, ed., **Power Shift: China and Asia's New Dynamics**, Berkeley, California: University of California Press, 2005.

⁴⁶⁰ Dana R. Dillon and John J. Tkacik, Jr., "China and ASEAN: Endangered American Primacy in Southeast Asia," **Background**, No. 1886, October 19, 2005, Washington DC: The Heritage Foundation.

organization's largest trading partner. What also is significant is China's growing interest in developing energy cooperation with such ASEAN member states as Indonesia to secure oil and natural gas. Chinese companies have acquired stakes in oil and natural gas fields, and in 2004 Indonesian exports to China increased by 232 percent over the previous year.⁴⁶¹

These are all significant achievements that greatly extend China's reach and influence in the region. While not directly engaged in a contest with the United States, China does have different interests in the region's development in terms of security architecture, economic interdependence and integration, and the political systems. Beijing promotes ARF and multilateral security dialogues as alternatives to what it considers as the Cold War relics military alliances.⁴⁶² China puts a high premium on sovereignty and noninterference in domestic affairs while the United States seeks to promote democracy and challenge the legitimacy and hold on power of authoritarian and repressive regimes such as the military junta in Myanmar.

These differences aside, Beijing and Washington do not harbor open animosity, and U.S. influences are palpable. Indeed, the suggestion that China has made large gains in Southeast Asia and is wielding significant influence may be as misleading as it is exaggerated. Measured in trade, investment, and diplomacy, Beijing's perceived inroads into Southeast Asia are less than what is usually portrayed by the media. China's growing trade with the region largely is accounted for by intra-firm activities of the world's largest multinational corporations. Chinese companies have yet to penetrate Southeast Asian markets. Nor is China's investment in the region significant. As was noted earlier, it compares poorly with that by the EU, Japan, the United States, and even Taiwan. Chinese success in diplomacy has been achieved through moderation of its own stance rather than by imposing its will on ASEAN, hence the questionable influence.⁴⁶³

China's growing political, economic, and security ties with ASEAN are the results of a combination of factors. Beijing's post-Tiananmen diplomacy has focused its attention on Asia, including Southeast Asia, as it seeks to promote a stable regional security environment for its economic development. It also has reflected a change in its approaches to regional issues from confrontation and assertiveness to moderation and restraint in tactics without giving in on principles on issues it still holds dear Taiwan, sovereignty, and maritime territorial integrity for

⁴⁶¹ Jane Perlez, "As Rice Visits Asia, a China Subtext Looms," **International Herald Tribune**, March 13, 2006.

⁴⁶² Catharin E. Dalpino, "China's Emergence in Asia and Implications for U.S. Relations with Southeast Asia," statement before the United States Senate Foreign Relations Committee, June 7, 2005.

⁴⁶³ Sheng Lijun, "China's Influence in Southeast Asia," in Trends in Southeast Asia Series: 4, 2006, **Singapore: Institute of Southeast Asian Studies**, 2006.

economic security reasons. ASEAN's own efforts at engaging China in ways that assured Beijing provide another impetus for the fostering of bilateral relationships, especially in the security area once Taiwan and maritime territorial disputes are taken off the agenda. The 1997 financial crisis in Asia has found ASEAN member states increasingly turning to China, partly as a result of their rejection by the United States and West-dominated international financial institutions. While many ASEAN states realize the long-term challenges of facing and retaining the ability to compete with China in manufacturing and attracting foreign investment, they also want to explore the opportunities that an expanding Chinese economy offers.

But ASEAN remains wary of China's growing power and uncertain about Beijing's future intentions. History, territorial disputes, and the ethnic Chinese issue continue to be important considerations for the foreign policies of some member states. They adopt the strategy of hedging as an insurance policy but choose not to alienate and alarm China by formally forming alliances with the United States. At the same time, Beijing's influence remains limited, as is its capability to affect regional developments. The 2004 tsunami and the recent earthquake in Indonesia have displayed U.S. capacities in both the amounts of disaster relief it is able to provide and the speed with which it can deliver it.

If anything, the United States remains the major market and the source of investment and technology transfers for both China and ASEAN. Indeed, in all economic indicators, the United States remains unsurpassed, while China and ASEAN, respectively, rank fifth as each other's major trading partners. Even in the politico-diplomatic arena, Washington's lost ground may be more apparent than real. Indeed, American influence remains strong and deep-rooted, as are its institutional arrangements with the region in terms of alliances, base access, and visiting forces agreements. The post-9/11 security environment has provided the opportunity for the United States and a number of ASEAN member states to work out specific military cooperation arrangements that facilitate American military operations in the region in both supporting the global war on terrorism and positioning itself for future contingencies. Such ties are as much historical as the deliberate hedging strategies that ASEAN member states have adopted in securing their own vital interests in a region that is drawing growing attention from major powers, both because of its strategic location in the path of vital SLOCs and due to its rising importance in the global war on terrorism and WMD nonproliferation.⁴⁶⁴

But Washington does need to be more proactive and go beyond rhetoric in truly recognizing ASEAN's critical place in American foreign policy. Specifically, it needs to change

⁴⁶⁴ Reuters, "US, Japan to Help Malaysia Boost Strait Security," February 27, 2006.

its current approach. First, it should treat ASEAN as an important multilateral organization and deemphasize its distinctly bilateral approach. This requires a positive attitude toward multilateralism and greater patience in accepting the ASEAN Way of gradualism, consensus, and non confrontational ways of settling disputes. The multilateral approach is applicable in equally developing and expanding U.S.-ASEAN economic ties.

Second, Washington should avoid a China-prism in its ASEAN policy. This is not, and should not be, framed as a zero-sum game in which Beijing's gains must be seen as Washington's loss. China itself certainly does not have the grand strategy of developing its own Monroe Doctrine in Southeast Asia. It is therefore particularly unhelpful, and indeed could be highly counterproductive, to present ASEAN member states a choice that they find most difficult to make. Most of all, it can be quite an embarrassment for Southeast Asian countries when American officials publicly chastise China on their turf.

Third, America needs to learn to apply nonmilitary, non confrontational means to address the challenges that the region is facing: fragile democracy, need for good governance and accountability, uneven distribution of wealth and poverty, and other social problems that could provide fertile grounds for ethnic and religious intolerance and terrorist activities. Indeed, U.S. responses to the tsunami disaster last year have won wide-spread good will in the region. On the other hand, too much emphasis on preemption, a penchant for unilateralism, and threats of force only heighten concerns among Southeast Asian states and could fan anti-American sentiments. ASEAN states' shifting stances on the U.S. global war on terrorism are a good example.⁴⁶⁵ Most ASEAN member states, with the exception of Singapore and the Philippines, publicly oppose unilateralism and unipolarity, a clear reference to the United States. Perhaps a good way to start is to take a page from Beijing's book of charm diplomacy. And this should be something easy to achieve and at relatively low costs. Washington should make better use of what it is supposed to do best: soft power.

6.4. Conclusion

China-ASEAN relations have undergone significant changes over the past 15 years. Moving away from enmity and suspicion, bilateral ties have grown and strengthened in political, economic, and security areas. While ASEAN may still be apprehensive about China's growing power and how it will use that power in the future relationship that ranges from the economic to the territorial, at least for the time being, China is recognized in the region as an economic

⁴⁶⁵ David Capie, "Between a Hegemon and a Hard Place: The 'War on Terror' and Southeast Asian-U.S. Relations," *The Pacific Review*, Vol. 17, No. 2, June 2004, pp. 223-248.

opportunity, a political heavy weight, but not necessarily a military bully, even as Beijing continues to modernize its armed forces.

But ASEAN states, given their place in the international pecking order and their strong sense of protecting national sovereignty and independence and recognizing the geo-strategic realities, have resorted to various stratagems of power balancing and hedging, as well as engagement of major powers. The United States remains a key power that is welcomed to continue playing a stabilizing and reassuring role in the region, but that may not be taken for granted, especially given the large Muslim communities and ASEAN's political sensitivity to external interference in internal affairs, coercion and/or use of force, and unilateralism and blatant display of arrogance and domineering.

The United States retains strong political influence, economic clout, and military prowess in the region. Southeast Asia remains a key battleground for the global war on terrorism and U.S. efforts to prevent WMD proliferation. While China may have gained influence in Southeast Asia over the last decade, it may not be at America's expense. On a number of fronts, closer China-ASEAN relations actually could advance American interests in the region. China's agreement to be bound by restraint on the territorial issue lowers the risk of military conflicts and hence major disruption of key SLOCs vital to the economic security of both the United States and its important allies in the region, such as Japan, which depend on secure and stable supplies of raw materials and energy resources. Multilateralism and cooperative security also have led to gradual improvement in Chinese military transparency which, in turn, can address anxieties in the region's capitals, as well as in Washington and Tokyo, about the scope and intensity of the PRC's defense modernization programs.

What may constitute the biggest threat to long-term U.S. interests' lies in the economic field as China replaces America as ASEAN's number one trading partner and as the CAFTA fully launches in the coming years and expands to the East Asian region to form the largest trading bloc in the world. But even here, the United States still holds some important cards technology, market, and investment. But Washington's approach must be strategic, comprehensive, and proactive rather than piecemeal, passive, and reactive. It is important to maintain solid bilateral relationships with its key allies and friends in the region, but the United States should also begin to recognize the value of the growing role and importance of ASEAN and treat the regional grouping as such.

III. CHINESE ECONOMIC AND POLITICAL ROLE IN THE INTERNATIONAL SYSTEM AND FUTURE PROSPECTS OF CHINA'S POLITICAL ECONOMY

Introduction

The energy sector in China is growing rapidly to match the country's economic transformation. With the exception of oil, China has now taken the lead position (surpassing the United States) in the consumption of virtually all major commodity categories.

The rapid rise in production and consumption of energy has taken place largely as a consequence of the economic reforms introduced in the late 1970s and 1980s which ushered in the rapid industrialization and urbanization of the country.

This process has triggered a high demand for energy both to feed growing industry and business, and to meet growing consumer demand, having far-reaching consequences for China, the Far East and the global energy market. It is shaping Chinese foreign policy and presents both challenges and opportunities for governments and energy players the world over.

This was borne out by a recent research study by Accenture in Asia that revealed that China is considered by far to be the most attractive country for investors in the region, with 94 per cent of respondents citing it as having the biggest growth opportunities in Asia. Yet at the same time, the survey revealed that businesses see a large amount of risk in China, the biggest of which is the continuing increase in the price of oil and other raw materials.

The national demand for electrical power during the first years of the new century, which had been forecast to grow at about 6 per cent per year, has in fact grown from 2001 onwards at a rate exceeding 10 per cent per year, reaching 15 per cent in 2003.⁴⁶⁶

This in turn has led to a mismatch between supply and demand. In 2005 a power supply deficit exists, resulting in the emergence of power shortages across the country. Households and industries continue to experience planned power outages on a regular basis. This appears to be a direct result of the drive for economic growth being pursued without sufficient regard for the energy requirements involved or enough lead-time to build the necessary generation, transmission and distribution infrastructure.

In addition to solving the issues around supply and demand, China is faced with a separate challenge of reducing its reliance on coal. China's government has just passed a law which seeks

⁴⁶⁶ Huaichuan Rui, "Development, Transition and Globalization in China's Coal Industry": Judge Business School, University of Cambridge.

to increase the usage of solar and wind power to 10 per cent of China's total energy consumption within five years, a target most sees as overly optimistic. The country still relies on coal for two thirds of its power, mining 1.8 billion tonnes in 2004, and the equivalent of 700 million tonnes of oil.

The price for this dependence on coal is high, and not just in environmental and emissions terms. Digging the coal costs the lives of 15 miners a day, or nearly 6,000 fatalities a year. The biggest culprits are small private mines, despite the Beijing government's attempt to consolidate the mining industry.

Though use of hydro and nuclear (using 'pebble bed' technology) is growing, coal will still be providing the majority of China's energy needs in 2030. Whatever the fuel mix, if economic growth in China stays on course, China is likely to account for 25 per cent of the world's increase in energy generation in the next 30 years.

Indeed, this FPC paper suggests that the domestic regulatory framework for China's power sector may be a more urgent and important subject for foreign policy specialists than China's growing oil imports from the Middle East. Regulation must be a tool to quickly bring China's energy process in line with the market value of energy.

Regulation must also be an engine for energy efficiency. Energy consumption per unit of GDP in China is five times greater than in the United States and 12 times greater than Japan. This lack of efficiency may cause shortages which could slow down China's economy.

Beyond China itself, untrammelled energy growth without effective controls could have wider geopolitical implications. How China resolves its energy challenges will be felt not just within the country but will reverberate around the world. China's growing presence on the international stage could ultimately create issues with the world's largest energy consumer, the United States, with both economies potentially in competition for energy resources in Russia, the Caspian region, the Middle East, the Americas, and Africa.

So for economic, social, environmental and geopolitical reasons, effective energy regulation is needed. China's rising demand for energy goods and services is putting pressure on global energy markets. According to the International Energy Agency, China will account for 20 percent of world incremental energy demand and for half of the increase in coal use over the next three decades.

Some prominent international commentary has painted this emerging situation in classic 'resource security' terms. The main suggestion has been that China's gargantuan energy

consumption in coming decades will position it as a rival to other major energy importers and that the consequent rivalry will have a destabilizing effect on international security, either globally or at least in key oil producing regions, like the Middle East.

This section starts from a different vantage point. It suggests that the most important international impact of China's growing energy use may not be strategic in classic 'hard security' terms that emphasize great power rivalry. The paper suggests that the most important international impacts of China's energy use in the coming decade will lie in the changing patterns of domestic energy use, and the efficiency of China's power sector – especially the generation, pricing and transmission of electric power.

The domestic regulatory framework for China's power sector may be a more urgent and important subject for foreign policy specialists than China's growing oil imports from the Middle East. The efficiency of China's industrial sector is also an issue, as industrial processes in China continue to require large amounts of fuel relative to output. For example, energy consumption per unit of GDP of China is five times greater than in the US and twelve times greater than in Japan.

For 25 years China's government has been promoting new approaches to energy efficiency and more recently to environmental protection. International actors can help China in this field in various ways, but most directly through investment in energy-efficient technologies, including development of Chinese specialist expertise. The goal of promoting energy efficiency in China is about reducing future demand.

A. THE ENERGY RESOURCES AND THE FUTURE OF ENERGY IN CHINA

In this section, we are going to explore the future vision for energy demand, production, supply based on energy resource availability, environment constraints, and in the meantime to promote economy activities to reach government aim. Recent energy development in China was presented, and future energy and emission scenarios were developed by giving three different pathways. Together with the energy scenario and emission scenario, energy resource and possibility for energy import was presented. The results from quantitative analysis show that energy demand in China could be as high as 2.9 billion toes in 2030, which could exceed the available energy supply.

China is the largest energy user in Asia and the second largest in the world after the US. This paper documents substantial changes of the structure of China's energy use over the past decades. It explores the puzzling phenomena of China's low gross domestic product elasticity of energy consumption. China is currently the largest energy user in Asia and the second largest in the world after the USA. In 2004, China used 27 million barrels of oil equivalent per day (boe/d) of primary commercial energy, as compared to 47 million boe/d for the USA, 13 million boe/d for Russia (the third largest), 10 million boe/d in Japan (the fourth largest), and 7 million boe/d in India (the fifth largest).⁴⁶⁷ China also uses over 4 million boe/d of combustible renewable energy and waste, which is included mainly non-commercial biomass energy.

The structure of China's energy use has gone through some significant changes over the past five decades.

1. Coal Industry in China: Recent Years and Prospects

Coal accounts for about 70% of China's total energy consumption. The development and production of the coal industry provides stability in China's economic growth. The coal resources in China have been exploited since 476 BC, and it is estimated that even with all the years of coal exploration, China has total coal deposits of 4, 490 billion tons which are as deep as 2,000 vertical metres. Eventually China will exploit its coal resources until they are eliminated. Despite these two problems of quality and location, China's coal industry remains abundant and prosperous. Coal resources in the pre-war era were more than sufficient to support the industry in China. The growth in coal production continued more rapidly in the 1950s. By the 1970s, two of the eight mining bureau produced over 10 million tons per year. Today, the coal enterprise is

⁴⁶⁷ BP, **BP Statistical Review of World Energy**, (2005). London: BP.

the main contributor to China's "economic miracle". In 1990s coal accounted for 76% of China's energy supply.⁴⁶⁸

In China, coal provides 70 per cent of the country's primary energy source and generates 80 per cent of the electricity. However, this strategically important industry has also been one of the most problematic: with fluctuating market surpluses and shortages, it was the leading loss-maker among all industries until 2001, with over three million people being made redundant since the mid-1990s; it has also suffered from high accident rates and been subject to frequent demonstrations by coal workers.

As a result, the industry has been the object of large-scale restructuring since the late-1990s, involving three major categories of coal producers: tens of thousands of small township and village owned (TVE) or private mines have been closed down; dozens of loss-making state-owned (SOE) coal companies have been declared bankrupt; and large modern coal corporations have been built. Despite significant progress, however, huge difficulties remain. TVE coalmines have been reopened; more than 90 per cent of SOE coal companies are still loss-makers; and the building-up of large coal corporations has been handicapped by the coal surplus and state obligations to look after loss-making SOEs.

The coal industry has long been at the centre of China's economic and social development. It has been responsible for fuelling China's economy, from the period of severe shortage before the 1990s, through to the demands of the present high-GDP growth, and for ensuring sustainable development in the future. As a major channel for developing the non-agricultural business sector and for increasing income, coal also plays a significant role in absorbing the surplus labor force, in improving living standards, and in promoting local development in many coal-rich areas. Therefore, the coal industry will still play a dominant role in national economy and social development in a quite long period in the future.

China is relatively rich in coal, but poor in oil and gas. Table below shows that coal accounted for 95 per cent of the country's primary energy consumption from 1952 to 1960; 80 per cent from 1961 to 1970; about 70 per cent from the 1970s to the 1990s (the drop being mainly due to expanded oil use after the discovery of the Daqing oilfield), and still accounted for 69 per cent by 2002. Coal is used to generate around 80 per cent of the country's electricity at all times.

⁴⁶⁸ <http://www.american.edu/TED/chincoal.htm>

Table 4: China's Energy Production and Consumption Structure 1949–2002⁴⁶⁹

Year	Energy	Structure (total energy output = 100)				Energy	Structure (total energy output = 100)			
	Output (Mtoc)	Coal	Oil	Gas	Hydro-electricity	Consumption (Mtoc)	Coal	Oil	Gas	Hydro-electricity
1949	23.74	96.3	0.72	0.04	2.99	–	–	–	–	–
1959	271.61	97.0	1.96	0.14	0.89	239.26	94.7	4.1	0.14	1.1
1969	231.04	82.2	13.1	1.1	3.2	227.30	81.9	13.8	0.8	3.5
1978	627.70	70.3	23.7	2.9	3.1	571.44	70.7	22.7	3.2	3.4
1985	855.46	72.8	20.9	2.0	4.3	766.82	75.8	17.1	2.2	4.9
1990	1,039.22	74.2	19.0	2.0	4.8	987.03	76.2	16.6	2.1	5.1
1995	1,290.34	75.3	16.6	1.9	6.2	1,311.76	74.6	17.5	1.8	6.1
1996	1,326.16	75.2	17.0	2.0	5.8	1,389.48	74.7	18.0	1.8	5.5
1997	1,324.10	74.1	17.3	2.1	6.5	1,381.73	71.5	20.4	1.7	6.2
1998	1,242.50	71.9	18.5	2.5	7.1	1,322.14	69.6	21.5	2.2	6.7
1999	1,100.00	68.2	20.9	3.1	7.8	1,301.19	68.0	23.2	2.2	6.6
2000	1,069.88	66.6	21.8	3.4	8.2	1,302.97	66.1	24.6	2.5	6.8
2001	1,209	68.6	19.4	3.3	8.7	1,349	65.3	24.3	2.7	7.7
2002	1,390	70.7	17.2	3.2	8.9	1,480	66.1	23.4	2.7	7.8

Note: Mtoc ¼ million tons of coal equivalent.

Although the coal industry has, since the mid-1990s, been able to meet the country's demands for coal, and although the development of TVE mines has had many negative effects on the economy and the environment, this does not mean that China does not need its TVE mines. Coal demand is likely to increase further, and SOE mines alone may not be able to meet the demand. The growth of the economy, population and per capita energy consumptions are fundamental factors in determining the long-term demand for energy: it is estimated that China's energy demand will increase from 1,280 million tons of coal equivalent (Mtoc) in 2000, to around 2,700 Mtoc by 2020, and 4,100 Mtoc by 2050, which could make China the largest energy consuming country in the world by that time.⁴⁷⁰ Given China's limited ability to substitute other sources of energy, such high demand will transfer most pressure onto coal. Estimates suggest that coal will account for approximately 60 per cent of the country's primary energy consumption by 2010 and 50 per cent by 2050. At the same time, it is generally believed that supply may already have started to fall behind demand. While capacity from SOEs is not expected to increase significantly, TVE mines will be expected to maintain their supply (author's interviews).

⁴⁶⁹ CSA (2003) China's Statistical Digest. Beijing: China Statistical Press. DTI (Department of Trade and Industry, UK) (1999) 'Summary of Energy Paper 67 Cleaner

⁴⁷⁰ Horii, N. and S. Gu (eds.), Transformation of China's Energy Industries in Market Transition and Its Prospects. China, Japan: Institute of Developing Economies, Japan External Trade Organisation, (2001) p. 215.

The other major role for TVE mines is in improving living standards and absorbing surplus labor in coal-rich areas. China’s labor force accounts for 26 per cent of the world total. By the end of 2002, the total rural and urban labor force stood at 737 million, up 7 million from 2001.⁴⁷¹ Significant levels of unemployment persist in both rural and urban areas, but the absorption of the labor force by TVEs has been stagnating and even decreasing since 1999. This will add to the already enormous numbers of labor migrants moving from rural to urban areas. While rural migrants pour into urban areas, an official report⁴⁷² shows that the registered unemployment in urban areas increased from 5.2 million in 1995 to 7.95 million in 2003. Taking 3.5 million laid off SOE workers and graduates into account, the current unemployment rate in urban areas is estimated at 7 per cent.

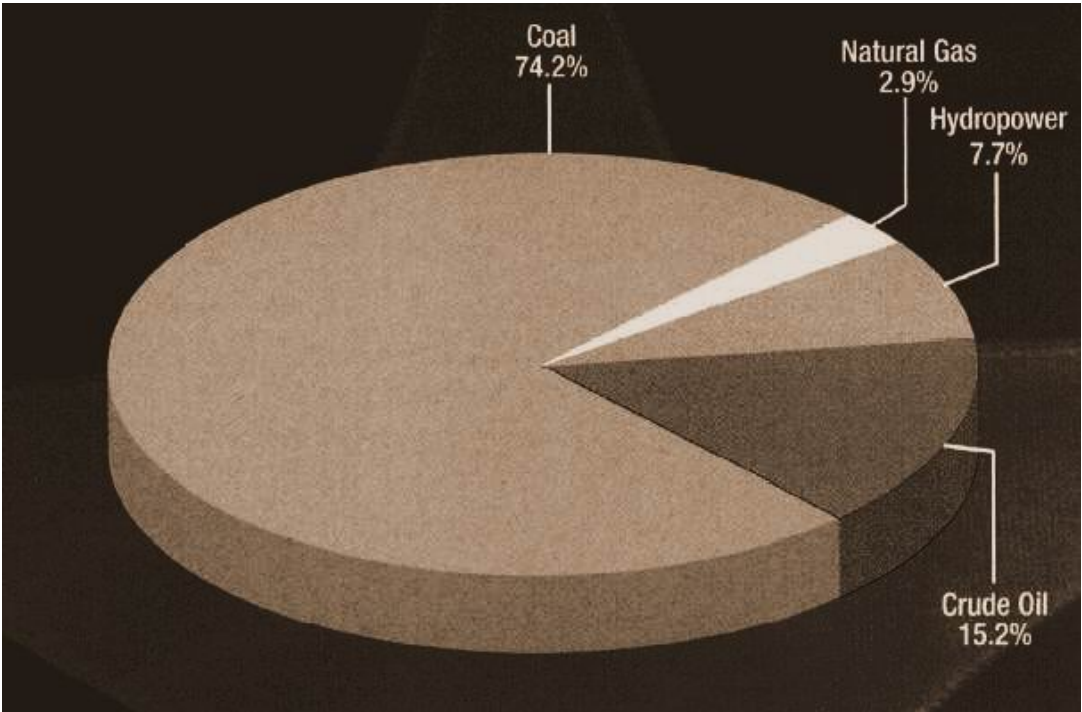


Figure 6: China’s Energy Portfolio & Importance of Coal

More importantly, after more than two decades of development, the gaps between urban and rural and between west and east China have widened. This poses a potential threat to social stability. TVE mines, as an important channel for absorbing the surplus rural labor force and improving rural living standards, have become an important option for filling the gap between urban and rural areas and easing social instability. At the same time, the rapid development of TVEs has given many poor people their first taste of wealth: taking it away from them again may not be the best course of action for the government, even though it has the capacity to do so.

⁴⁷¹ SSB (State Statistical Bureau): China Statistical Yearbook. (2003) **Beijing: China Statistical Press**, p.42.
⁴⁷² Outlook (2003) ‘China Faces Huge Pressure of Employment’. Available online: <http://www1.cei.gov.cn/hottopic/doc/zjzt2002101/200309050669.htm>

Nevertheless, closing at least some of the TVE mines is starting to appear increasingly inevitable, given the other challenges facing the industry, from transition and globalization.

Despite large oil discoveries in the Middle East in this century, coal remains one of the most important sources of primary energy in the world. In 2002, coal still accounted for 23 per cent of the world's primary energy consumption, while 38 per cent of electricity and 66 per cent of steel production depend on coal feedstock.⁴⁷³ Known coal reserves worldwide are thought likely to last for 250 years at current levels of consumption, much longer than the life expectancy of oil reserves. Because of the lack of alternative sources, coal is more important for China than for almost any other country.

Compared with the institutional changes under way in most other industries, the coal industry still lags behind in terms of global consolidation, although the process has been speeding up in recent years. In the late 1990s, mergers and acquisitions in the coal sector grew to record levels, reaching US\$ 17 bn in 1995, and US\$ 26 bn in 1998. In 2001, the BHP/Billion merger alone was valued at US\$ 31.1 bn. The key players in the market are a small number of powerful international mining companies such as Rio Tinto, Anglo American and BHP/Billiton, which together controlled over 62 per cent of total international trade in coal by 2002. The competitive advantage of these global coal giants lies primarily in their size, capital, brand name and management skills.⁴⁷⁴ These mining giants have all entered China within a relatively short period, resulting in more coal imports into China, but also threatening domestic companies as with their advanced equipment and management skills they may be able to produce cheaper and higher quality coal in the domestic market.

The challenge represented by globalization is reflected in the widening gap between China's coal companies and their counterparts in the rest of the world. Most Chinese coal firms do not have any of the elements which comprise competitive advantage in the global coal industry, such as size, management skills, superior technology and brand name. A mass of evidence testifies to the fragmented nature of China's coal industry. In 1998, China produced 1,232 million tons of coal (the world's largest output); this was produced by over 72,042 firms, giving an average output per company of only about 17,101 tons. As a result of the closure policy which started in 1998, the number of coal companies reportedly dropped to 27,266 by

⁴⁷³ WCI (World Coal Institute), (2005) 'Coal Uses, overview'. Available online: http://www.wci-coal.com/web/list.php?menu_id=2.7.1

⁴⁷⁴ Nolan, P., China and the Global Economy: National Champions, **Industrial Policy and the Big Business Revolution**, (2001) New York Basingstoke: Palgrave.

2002⁴⁷⁵ and average output increased to approximately 50,000 tons. The market share of China's ten largest coal producers increased from 13 per cent in 1997 to 21 per cent in 2001, but by comparison, the top five US coal producers accounted for 51 per cent of total coal production in 2001.⁴⁷⁶ Shenhua, the largest coal company in China, accounted for just 5 per cent of the national total. There is no economy of scale in China's coal industry.

Shenhua currently represents the long-term hope for China's coal industry, but the extent to which more Shenhua-style coal corporations can be built will largely depend on China's development and its transitional progress. The factors which will play a key role include the government's financial capacity to build more such corporations; the establishment of an effective social security system to resettle redundant workers so that more labor can be replaced in SOE mines; and the real number of 'closed' TVE coalmines. Obviously, these will all require extensive government involvement.

China has proven, recoverable coal reserves estimated (as of January 2005) at about 125 billion short tons, and potential reserves of as much as 4 trillion short tons. More than half of this is bituminous and anthracite, and most of the reserves, including almost all of the highest-quality coal, is located in the northeastern part of the country.

China is presently the world's greatest coal producer and accounts for about 30% of the world's total annual coal production. China is also the world's greatest coal consumer, accounting for more than 28% of the world's total annual coal consumption. China's consumption is sufficiently less than its production that China is now a major coal exporter. Domestically, coal currently accounts for about two-thirds of China's total energy usage and is responsible for fueling 70-80% of power generation, 75% of energy used in industry, and even 80% of household energy.⁴⁷⁷ While coal's share of China's energy consumption will decline in the coming years, the demand for coal is expected to increase by 20 million short tons annually over the next five years, and China plans to increase coal production by about 17% within five years. Much of this coal will be used for generation of electricity. An historical summary of coal production and consumption in China is shown in Table below.⁴⁷⁸

⁴⁷⁵ SCA (State Coal Administration), **Coal Economy Operation Report**, Beijing: (2003) State Coal Administration.

⁴⁷⁶ NMA (National Mining Associates, USA) (2003) 'US Coal Producers 2001', Available online: <http://www.nma.org>

⁴⁷⁷ Chinese Academy of Science Staff, **Cooperation in the Energy Futures of China and the United States: National Academies Press**, 2000.

⁴⁷⁸ <http://www.cslforum.org/china.htm>

Table 5: Coal Production and Consumption in China, 1993-2003 (in millions of short tons)

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Production	1,304	1,404	1,537	1,545	1,507	1,429	1,365	1,314	1,459	1,521	1,635
Anthracite	251	271	297	321	275	267	238	237	262	312	335
Bituminous	989	1,066	1,170	1,163	1,167	1,103	1,068	1,025	1,138	1,140	1,225
Lignite	63	67	70	61	65	59	60	53	58	69	75
Consumption	1,276	1,390	1,495	1,509	1,450	1,392	1,343	1,282	1,357	1,413	1,531

Finally, at present, China's energy use is still dominated by coal. In 2004, China used approximately 1.9 billion metric tons (tones) of coal, up from 610 million tones in 1980, 1.1 billion tones in 1990, and 1.2 billion tones in 2000. As such, coal accounted for 68.7% of the PCEC. China has long been a coal exporter, exporting 88 million tones in 2004. In the meantime, however, the imports have also been on the rise, reaching 22 million tones, up from 2 million tones in 2000 and 11 million tones in 2002.⁴⁷⁹

Today, China is moving to rationalize its coal industry by limiting production from inefficient mines and banning the use of lower quality coal, as well changing the way it uses coal, with a particular effort addressed to lowering consumption of coal in areas in which harmful effects can be minimized or mitigated, such as in electric power generation. Smaller, inefficient coal-fired plants (less than 100 MW) are targets for early retirement to minimize pollution. Mine-mouth plants (so-called coal by wire projects) will take on new importance in the 2020 time frame, as will foreign participation in the coal sector in general. China has been actively pursuing a variety of advanced coal technologies, including coal gasification and liquefaction, coalbed methane production, and coal slurry projects. Approximately 25,000 small coal mines in China, mostly in towns and villages, are scheduled to close in 1999 due to concerns over mine safety and small mine inefficiencies.⁴⁸⁰ In the short term, these closures will act as a means of cutting excess production and stockpiles and are also representative of China's desire to rationalize the coal industry over the longer term.

Prospects for Chinese Coal Industry

⁴⁷⁹ Tianshu CHU, Fereidun FESHARAKI and Kang WU, China Energy in Transition: Regional and Global Implications, *Asian Economic Policy Review* (2006) 1, 134-152

⁴⁸⁰ Chinese Academy of Science Staff, "Cooperation in the Energy Futures of China and the United States", p. 24

In the predicted future, coal is still the main energy source in China, but its importance will relatively descend. It is newly predicted by experts that national coal demand in 2010 will be about 140 Mt, equivalent with the original planned output in 2000, which is completely unexpected. The coal proportion in primary energy demand will come down to about 60% in 2010. The demand for coal will be about 1800-2000 Mt in 2020, and the proportion in primary energy demand will fall to below 60%.⁴⁸¹

From a long view, the upper limits of coal supply in China will be 2700 Mt in 2050, and coal will become the clean and highly efficient energy source. 70% of coal can be provided for power generation, and the compound liquid fuels produced by coal will probably exceed 100 Mt.⁴⁸²

Simply expanding the use of coal to meet this growing demand is not an option. Already 40% of China's railroad capacity is dedicated to hauling more than 1 billion tons of coal per year (two-thirds of China's energy is produced from burning coal).⁴⁸³ Chinese primary coal demand will grow from 1,308 Mt in 2002 to 2,402 Mt in 2030, an increase of 2.2% per year. China will thus extend its position as the world's largest coal consumer. Although coal will remain the dominant fuel in China's energy mix, its share of total primary energy consumption will drop from 57% in 2002 to 53% in 2030, owing to the growing use of natural gas in electricity generation and of oil in transportation.⁴⁸⁴

The power sector will account for more than 73% of total Chinese coal consumption in 2030, compared with 52% in 2002, as coal remains the backbone of China's generating capacity. Industrial uses, mainly of coking coal in steel production, will rise at a more modest 0.7% per year. In response to rising incomes and urbanization, coal use in the residential sector will decline as it loses out to more convenient and cleaner sources of energy.

China has an estimated 114 billion tons of proven coal reserves.⁴⁸⁵ The majority of these are found in northern China, particularly in the provinces of Hebei, Shaanxi, and Inner Mongolia. Hard coal accounts for 84% of total proven reserves. The remainder consists of lower-quality coals, including lignite. China will remain the world's biggest producer of both steam and coking

⁴⁸¹ Thomson Elspeth, **Chinese Coal Industry: An Economic History**, Curzon Press Limited, (2002), p. 305.

⁴⁸² Coal Information Research Institute, Coal Information, No.11 April 6, 2000

⁴⁸³ Marsha Freeman, China's 21st-Century Nuclear Energy Plan, February 25, 2005 issue of **Executive Intelligence Review**. http://www.larouchepub.com/other/2005/3208china_htr.html

⁴⁸⁴ http://www.coalleader.com/2004/dec04cover_story.htm

⁴⁸⁵ Wang Qingyi, Coal Industry in China: Evolvement and Prospects

coal in 2030. In 2002, production totaled 1,398 Mt, around 29% of the world total. It is projected to increase to 2,490 Mt in 2030, or 35% of the world total.⁴⁸⁶

The Chinese coal industry has undergone a major rationalization involving the closure thousands of small mines, as well as, the expansion of large mines operated by the central government. This program has helped raise productivity levels, improved safety standards and given the government more control over production. Nonetheless, further reforms are needed. Illegal small-scale mining operations continue to pose problems; safety standards remain low and regulations are poorly applied. In addition, large state-owned mines are burdened with a wide range of social responsibilities, such as providing schools and hospitals, which distract management and undermine efficiency. The sector requires more investment, not only to expand capacity but also to modernize existing mines. Priorities include mechanizing underground mines, building coal-preparation plants and improving rail transport, water supply and water-disposal facilities.

China is an important, yet unpredictable, supplier of coal to world markets. China's exports totaled 97 Mt in 2002, making it the world's second-largest exporter after Australia. Exports are expected to increase steadily to 130 Mt in 2030.⁴⁸⁷ Currently, however, exports are being restricted by the government to alleviate local shortages of coal for electricity generation and steel production. Restrictions include a reduction in export price rebates and lowered export quotas. The export cap for 2004 was 80 Mt. These moves have disrupted world markets and raise prices, hitting European steel manufacturers particularly hard. Over the long term, however, China is expected to exploit its vast reserve base and its proximity to rapidly growing Asian markets to wind market share away from more distant suppliers. Export prospects will depend to a large extent on whether the government continues to support coal producers. Other factors will be the development of rail and port infrastructure and the rate of growth in domestic demand.

2. Natural Gas

Natural gas, unlike oil, has played an insignificant role in China's energy mix, accounting for just 2% of primary energy consumption. This is set to change as China tries to make better use of its own gas resources as well as examine the opportunities for tapping into the vast reserves in Russia and Central Asia Domestic reserves of natural gas are estimated at 1.4 trillion cubic meters. Current production of 22 billion cubic meters per year gives a reserves/production

⁴⁸⁶ Tianshu Chu, Fereidun Fesharaki and Kang Wu: Ibid.

⁴⁸⁷ Thomson Elspeth: Ibid.

ratio of 60 years.⁴⁸⁸ However, any substantial increase in demand will require both an ongoing effort to discover and develop new gas reserves within China (both onshore and offshore) and the construction of new infrastructure for gas importation. The volume of annual natural gas imports could be as high as 60 billion cubic meters by the year 2020,⁴⁸⁹ which is equivalent to the current level of gas imports to Japan, the world's third largest gas importer after the U.S. and Germany.

2.1. Current Natural Gas Policies of China

In 1997, natural gas accounted for 2.2 percent of China's primary energy consumption, very little of which was used in power generation. Of the 18.5 billion m³ (0.7 EJ) that entered the domestic market in 1996, about 40 percent was used as feed stocks for producing fertilizers and chemical fibers. 12 percent was used by households, and most of the rest was used as fuel by manufacturing industries. Natural gas production is likely to be about 25 billion to 30 billion m³ (1-1.2 EJ) by 2000 and 90 billion m³ (3.6 EJ) in 2020. If total gas consumption reaches an anticipated 190 billion m³ (7.5 EJ) in 2020, China will have to increase natural gas imports to 100 billion m³ (4 EJ).⁴⁹⁰

About 3,700 km of major natural gas pipelines are in operation in China, most of which are found in Sichuan Province. A few major gas pipeline projects have recently been completed or are nearing completion, including pipelines to Beijing, Shanghai, Xi'an, and other major urban centers not located in areas rich in gas resources. These are promising signs that the Chinese energy sector is moving toward the use of higher quality, cleaner gas to replace destructive coal burning, particularly in urban areas. Given the potency of methane as a greenhouse gas, an important requirement in the installation of new gas facilities is minimal leakage design.

One intriguing aspect of China's natural gas future is the potential for coalbed methane (CBM)* development and use. Having one of the largest endowments of coal resources in the world, China's CBM deposits are believed to be huge: Initial assessments put coalbed methane resources at around 33 trillion m³ (about 1.300 EJ), comparable to the holdings of natural gas resources (38 trillion m³ or about 1.500 EJ). In comparison, U.S. CBM resources are estimated to

⁴⁸⁸ BP, BP Review of World Energy 1999.

⁴⁸⁹ Keun-Woon Paik, "China Moves on Gas for Supplies and Environment," *Petroleum Economist*, February 1999, pp. 23-24.

⁴⁹⁰ SETC (State Economic and Trade Commission), 1997, *China Energy Annual Review*, Beijing, China: State Economic and Trade Commission. Also; EIA (Energy Information Administration): (1997) *Natural Gas Annual*. Washington, D.C.: U.S. Department of Energy.

* The process that converts plant material to coal produces large quantities of methane-rich gas, which is stored within the coal. This coalbed methane has only recently been treated as an energy resource, through its utilization poses some new technical difficulties.

be about 700 tcf (788 EJ), with technically recoverable resources at around 100 tcf (112 EJ).⁴⁹¹ U.S. reserves are 11.5 tcf (13 EJ).⁴⁹² Coal mining activities in China currently release about 19 billion m³ (0.75 EJ) of CBM per year, a much more potent greenhouse gas than carbon dioxide.* Currently coal mines withdraw about 500 million m³ (0.02 EJ) for local use.

In March 1998 the National People's Congress approved reform measures that, among other things, allowed for the first time the integration of upstream and downstream activities in independent national corporations, each with a regional base of operations. Since then, China's oil and gas industry has seen the largest restructuring in its history. The full ramifications of this move remain to be seen, but it is hoped that the restructuring will improve productivity, increase competition, and ultimately reenergize China's oil and gas sector to meet future demand. China also took a major step in oil price reform in June 1998 by pegging domestic oil prices to international standards, moving further ahead in integrating domestic oil industry with that of the world.

The China United Coalbed Methane Corporation (CUCBM) established in 1996 is solely responsible for the exploration and development of CBM, and for foreign participation in this field. The government plans to raise the output of CBM from 0.5 billion m³ in 1997 to 1 billion m³ (0.04 EJ) by 2000, and to 10 billion m³ (0.4 EJ) by 2010. In comparison, the United States currently produces about 1.1 trillion cubic feet (1.2 EJ) of CBM annually, about 6 percent of total U.S. natural gas production. CBM reserves in the United States are estimated at about 11.5 tcf (13 EJ).⁴⁹³

Liquefied natural gas (LNG) is authorized for trial in Guangdong Province: this represents a significant opportunity for sale of equipment, technology, and services necessary to build and operate an LNG facility, as well as the long-term import of LNG from Alaska to China.

2.2. Prospects for Chinese Natural Gas Resources

According to the International Energy Agency the average annual growth rate in primary demand for natural gas in China is expected to increase by 5.4 percent per year between 2002

⁴⁹¹ Gas Research Institute. 1999. U.S. Coalbed Methane Resources, Chicago. IL: Gas Research Institute.

⁴⁹² EIA (Energy Information Administration), 1998a. Natural Gas 1998: Issues and Trends, Office of Oil and Gas, Energy Information Administration. U.S. Department of Energy, Washington D.C.: U.S. Department of Energy.

* Coalbed methane is a greenhouse gas with a potency of about 50 times that of CO₂ in a 20-year time frame and about 20 times as potent on a 100-year horizon.

⁴⁹³ EIA (Energy Information Administration), 1998a.

and 2030, from 36 bcm in 2002 to a projected 157 bcm in 2030.⁴⁹⁴ China will become more reliant on gas imports, projected to account for 27 percent of primary gas supply by 2030. According to the WETO report for the European Commission, the share of electricity generated from Natural Gas is expected to increase from the 1990 level of 5 percent to 17 percent by 2030 in Asia. The Table below shows the percentage share of electricity generated from natural gas globally by region.

Table 6: Share of Electricity Generated From Natural Gas⁴⁹⁵

	1990	2000	2010	2020	2030
European Union	12	22	27	29	27
CIS, CEEC	35	30	36	44	49
North America	15	14	22	24	20
Japan, Pacific	24	31	40	37	35
Africa	25	34	39	47	49
Latin America	10	15	29	38	40
Asia	5	12	13	16	17
World	18	19	25	28	28

China’s installed LNG processing capacity will account for approximately one-fifth of installed capacity in the Asia Pacific by 2011. Owners⁴⁹⁶ of Australia’s Northwest Shelf project agreed to sell LNG to China at an approximate 20 percent discount to existing contracts. It has also been reported that contracts renegotiated by buyers located in Malaysia have also been discounted by approximately 5 percent relative to existing contracts. Importing countries are seeking increased flexibility and better contract terms. Typically LNG contracts are long term often 20-25 years to guarantee supply and have destination clauses that prevent buyers from reselling the cargos to third parties. Short term contracts (under one year) approximately account for 8 per cent of the market. In Asia, prices are linked to the imported crude oil price. The pricing formula typically includes a base price indexed to crude oil prices, a constant, and perhaps a mechanism for the review/adjustment of the formula. LNG import prices in Asia are typically

⁴⁹⁴ Global consumption of natural gas is expected to increase more in absolute terms than that of any other primary energy source almost doubling over the projection period 2002 to 2030.

⁴⁹⁵ European Commission, **World energy, technology and climate policy outlook 2030**, (2003), p.87.

⁴⁹⁶ Woodside operate the LNG project on behalf of the joint venture partners BHP Billiton, BP, Chevron Texaco, Japan Australia LNG (consortium of Mitsui and Mitsubishi), Shell, and CNOOC Limited which had become a partner from 2005/06.

higher than Europe and the United States. Costs related to the processing and transporting of LNG have fallen significantly over the past twenty years.

While LNG projects are currently one of the most expensive energy projects, LNG industry costs are declining.⁴⁹⁷ Costs vary widely depending on the location and whether the project is Greenfield, i.e. built in a new location, or an expansion of an existing plant. Generally the trend in the production and the shipping of LNG is declining. There is increasing demand for natural gas as it is considered to be a cleaner alternative to coal. This has led to increasing investment in LNG processing capacity. It is considered as one of the higher growth areas of the energy sector in China.

China's natural gas prospecting and exploitation efforts have found major gas producing sediments in the nation's offshore and west areas. With a low proven gas reserve but large potentials for new reserves, prospecting has become increasingly difficult with higher demand for technical capabilities. Acceleration of natural gas prospecting and exploitation will not only call for huge investment, but will also need an accelerated pace in introducing advanced foreign techniques and management experience.

According to experts' estimation, China will need an investment as much as RMB 220 billion for its natural gas infrastructures' construction during the period of 2002-2020. The money will mainly be consumed in laying 50,000 km long natural gas pipelines, and building up a liquidified natural gas capacity over 10 million tons and a shipping capacity at million ton level for the same fossil fuel.⁴⁹⁸

Along with the vigorous construction of natural gas transmission pipelines, natural gas terminals will expect a new round of investment fever.

China's electricity generation has taken 14% of the nation's current natural gas consumption, though the proportion may further go up to 30% or above. Expansion and transformation of old power plants, or simply upgrading existing gas burning generators may create lucrative commercial opportunities.

3. Petroleum & Oil (CNPC and Sinopec)

Under the post-Mao economic reforms China's oil and petrochemical industry was mainly organized into two separate entities, upstream and downstream respectively. On the upstream

⁴⁹⁷ There are four main cost components of LNG (gas production at 15 to 20 per cent; LNG plant at 30 to 45 percent; LNG shipping at 10 to 30 per cent; and receiving terminal at 15 to 25 per cent).

⁴⁹⁸ <http://www.chinaembassy.org/rom/kjwh/t154825.htm>

side, prior to the 1980s, the country's entire oil and gas exploration and production had been controlled by the Ministry of Petroleum Industry (MPI). In 1988, the Ministry was reorganized into the China National key entity on the downstream side was Sinopec, established in 1983 as a state holding company. Sinopec spanned the full range of petrochemical industry production including crude oil refining, oil products, the manufacture of petrochemicals, chemical fertilizers, synthetic resins, fibres and rubbers, and the marketing of these products.⁴⁹⁹

Almost the entire national oil and petrochemical industry was included in these two giant holding companies.

Under the Chinese enterprise reform, individual production enterprises within CNPC and Sinopec were granted the status of incorporated legal persons, able to sign contracts, responsible for their own profits and losses, and able to retain profits. Many of them established large-scale joint ventures with multinational companies, and floated on international stock markets. In the case of the key large-scale enterprises within both Sinopec and CNPC, the enhanced autonomy of the reform period built upon already strong traditions of enterprise identity. It was far from clear where the 'enterprise' that constituted the heart of China's 'enterprise' reform would finally be located in the oil and gas sector. Individual large enterprises under Sinopec and CNPC had reason to believe that they might indeed end up as autonomous firms, which would form the key entities around which China's industrial strategy for this sector would be organized. Many of the key enterprises began to develop a real sense of 'corporate identity', striving to increase their autonomy from the holding company.

The establishment of CNPC and Sinopec as state holding companies signaled an important transition from the purely administrative control functions of the Ministry towards a market-oriented method of functioning. However, it was still unclear where the 'firm' would be located. Would CNPC and Sinopec become truly independent companies, owning and managing the subordinate production units under its control, or would they simply act as quasi-Ministries with declining ownership and management rights over the subordinate entities? The period from the early 1980s until 1998 was one of experimentation, groping towards the correct business structure for the industry. Not until the 1998 restructuring was it finally decided by the central policymakers that CNPC and Sinopec would each indeed become a truly integrated company, casting off its old 'ministerial' functions.⁵⁰⁰

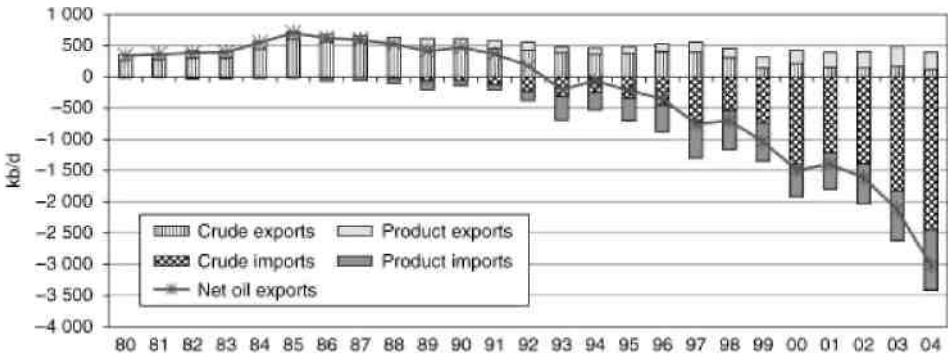
⁴⁹⁹ Peter Nolan, **China and The Global Economy, National Champions, Industrial Policy and the Big Business Revolution**, Palgrave, (2001), New York.

⁵⁰⁰ Peter Nolan, *China and The Global Economy*.

Oil is important for the Chinese economy, particularly for transportation, the petrochemical industry, and residential and other sectors. Since the early 1990s, China's petroleum product consumption has been rapidly increasing. China is currently the largest oil consumer in Asia and the second largest in the world, although its oil consumption is far behind that of the USA. In 2004, China consumed 6.1 million barrels per day (b/d) of petroleum products (including direct use of crude oil for power generation and other purposes), up from 1.6 million b/d in 1980, 2.2 million b/d in 1990, and 2.6 million b/d in 2000. For individual products, the share of fuel oil has declined substantially while the share of light products has increased significantly. In 2004, the share of oil in China's total PCEC was 22.3%. China became a net oil importer in 1993 and the net imports have since been growing substantially. China's growing dependence on imported oil has become a new and growing concern to the Chinese government since the new millennium, prompting the government to formulate its own energy security strategies after decades of not focusing on this issue.

Oil represents less than 17 percent of China's total primary energy consumption,⁵⁰¹ and China's crude oil production capacity of 160.7 million tons (7.1 EJ) in 1997 tanks fifth in the world. Nonetheless, China became a net oil importer in 1993 and a net crude oil importer in 1996 and by 2000 likely will import 50 million tons (2.1 EJ) of crude and oil products. By 2020 China is projected to produce about 220 million tons (9.2 EJ) of oil and import about 130 million tons (6 EJ).⁵⁰²

Over 19,000 km of pipeline systems (about 70 percent of which carry crude oil) are in place in eastern China, mostly along the coast or on rivers near China's refineries. Oil fields in western China are not yet connected via pipeline, instead relying on railway systems. Refined oil products are currently moved by rail (60 percent), water (30 percent), and pipeline (10 percent).



⁵⁰¹ This includes all forms of global energy consumption, including renewables, but does not include traditional energy use.

⁵⁰² Chinese Academy of Science Staff, **Cooperation in the Energy Futures of China and the United States**, National Academies Press

Figure 7: China's oil exports and imports, 1980–2004⁵⁰³

China would very much like to decrease its dependence on imports of petroleum and petroleum products. The possible options range from increasing domestic production, decreasing dependence on petroleum, and development of alternative liquid fuels: all of which hinge on major increases in investment and deployment of technology. The refining industry in China also will play a significant role in alternative trajectories as demand increases for higher quality products transportation fuels with reduced lead and sulfur while quality of crude oil decreases. Other estimates of China's oil import balance are more severe: EIA projects that China's petroleum capacity in 2020 will only deliver less than 4 mbd of the over 10 mbd estimated to be consumed in 2020.⁵⁰⁴

Through development of the petroleum industry over the last 40 years, China has a relatively complete portfolio of science and technology available, many of which are at world levels. Much of this science and technology has been developed around the on-shore oil industry which only represents a fraction of China's total reserves.

Although China is the world's sixth-largest producer of petroleum, it now imports one-third of its oil.⁵⁰⁵ With China's rising oil imports and projected rise in overall imports of energy, which will also include natural gas, energy security has emerged as one of the top priorities for the Chinese government and energy planners since the start of the new millennium. In China's 10th Five-Year plan, which was finalized in 2000 and covered the period 2001–2005, ensuring energy security has become one of the policy goals for the first time. For the past five years, various elements of energy security policy and strategies were discussed and considered by the government. To date, China has not yet had a clear and final energy security policy but various elements have been identified and are being included.⁵⁰⁶ Among these items, two are worth further examination here. One is the establishment of strategic petroleum stockpiling, and the other is the push to expand global energy, and particularly oil and gas, investment by Chinese state energy companies.

⁵⁰³ US Department of Energy, FACTS (2005), FACTS Fall 2005 Databooks. Honolulu: FACTS

⁵⁰⁴ Chinese Academy of Science Staff: Ibid.

⁵⁰⁵ Marsha Freeman, China's 21st-Century Nuclear Energy Plan, February 25, **2005 issue of Executive Intelligence Review**. http://www.larouchepub.com/other/2005/3208china_htr.html

⁵⁰⁶ Gao S. (2003). Securing Energy China's Policy and Its Wider Strategic Implications, Berlin: German. Also see, Wu K. (2004). Energy security in East Asia with a special focus on China and Japan. Presented at the Workshop on Shifting Economic Power in East Asia, Bureau of Intelligence and Research, US Department of State, Washington, DC.

After considering the decision for years, China formally put the target of establishing strategic petroleum stockpiling into the 10th Five-Year plan. Under Phase I of the strategic petroleum stockpiling, a total of 100 million barrels of crude storage capacity will be built, with the following breakdowns: (i) Zhenhai (Zhejiang) with Sinopec, 5 million m³ (31 million barrels); (ii) Aoshan (Zhejiang) with Sinochem, 5 million m³ (31 million barrels); (iii) Huangdao (Shandong) with Sinopec, 3 million m³ (13 million barrels); and (iv) Dalian (Liaoning) with PetroChina, 3 million m³ (13 million barrels).

Construction started on the site at Zhenhai in late 2004 and was completed in early 2006, but the filling of crude has not yet begun. The other three sites are still under construction. These three projects will be completed by 2006. China is likely to fill these strategic petroleum tanks between the end 2005/early 2006 and early 2007. Under Phase II, another 100 million barrels of capacity may be established by 2010.⁵⁰⁷

National Development and Reform Commission (NDRC) of China is in charge of the work. The Energy Bureau of NDRC is the home of the National Office of Strategic Petroleum Stockpiling. The government is expected to pass a law soon to regulate the strategic petroleum stockpiling and may require oil companies to also establish a minimum level of storage as a supplement to the national storage. If handled properly, the move to establish strategic stockpiling will help secure China's oil supply for a time of emergency or crisis, and is thus an effective way of addressing the issue of energy security.

4. Nuclear Reactors and Power Prospects

China's nuclear power program began in the 1980s with their first commercial plant Qinshan, a 300-MW pressurized water reactor (PWR^{*}) going online in 1991. In 1994, Daya Bay (two French 900-MW PWRs went online providing 2.1 GW of nuclear capacity. 1.3 percent of total electric power generation. An additional 6.4 GW of capacity is under construction, including Qinshan phase two (two Chinese-design 600-MW PWRs) were been online in 2002 and 2003. Daya Bay phase two (two additional French 900-MW units) in 2002 and 2003. Qinshan phase three (two Canadian 700-MW (CANDC reactors) were also been online in 2003,

⁵⁰⁷ Chinese Academy of Science Staf: Ibid.

* **PWR**= Pressurized Light Water Reactor. This is the most common type of commercial reactor and is found in nuclear industries throughout the world. Two thirds of the commercial nuclear reactors in the United States are of this type. A diagram (provided by the U.S. Nuclear Regulatory Commission) appears elsewhere on this site.

PHWR= Pressurized Heavy Water Reactor.

VVER= Soviet (and now, Russian Federation) acronym applied to their versions of light water pressurized reactors, whether domestically built or exported. For light water pressurized reactors designed by countries outside the former Soviet Union, the acronym PWR is used instead of VVER.

and Tian Wan (Lianyungang, two Russian 1000-MW PWRs) have been online in 2004 and 2005.⁵⁰⁸ The list of China's Commercial Nuclear Reactors is indicated below⁵⁰⁹:

Daya Bay 1 is located near Shenzhen in Guangdong province. Daya Bay 1 is operated by the Guangdong Nuclear Power Joint Venture Company, Ltd. The reactor was designed and built (with Chinese participation) by the French National Company, Framatome.

Daya Bay 2 is the twin of Daya Bay 1, and the details that follow are identical. Unit 2 is located near Shenzhen in Guangdong province. Daya Bay 2 is operated by the Guangdong Nuclear Power Joint Venture Company, Ltd. The reactor was designed and built (with Chinese participation) by the French National Company, Framatome.⁵¹⁰

Ling'ao 1, like the two Daya Bay reactors, is located in Guangdong province. It is less than a mile from the Daya Bay nuclear power plant. This is not the only similarity. Like Daya Bay 1 and 2, the reactor was designed by Framatome, the French national company that builds reactors for both the domestic market and for export. A total of four reactors are planned for the Ling'ao nuclear power plant. According to the People's Daily, the first unit went on stream "48 days ahead of schedule."

Ling'ao 2 is the companion to Ling'ao 1. This reactor was originally scheduled to go on line in March 2003, but China is consistently bringing its new units in ahead of schedule. Another characteristic of the Chinese nuclear program is to build reactors in pairs. This leads to much repetition in written summaries such as this.

Qinshan 1 is the sole exception to the Chinese practice of building units in pairs. When the reactor was first proposed in 1981, no other reactors were planned. At that time, the reactor was simply known as Qinshan. The number was added after the appearance of a second proposed reactor (Qinshan 2, now known as Qinshan 2-A) for the region. It is a matter of national pride that, although there is substantial foreign participation in China's nuclear program, the first Chinese reactor was designed, built, and maintained by China. Construction began in 1985, two months prior to the start of Daya Bay 1 (Guangdong 1). But Qinshan 1 was connected to the grid 20 months before Daya Bay 1. The reactor was shut down for a year for fueling and repairs beginning in August 1998. It returned to service in September 1999 and appears to have

⁵⁰⁸ Chinese Academy of Science Staf: Ibid.p. 33.

⁵⁰⁹ Reactor Summaries, The Energy Information Administration (EIA).

http://www.eia.doe.gov/cneaf/nuclear/page/nuc_reactors/china/reactors.html#pwr – also available in; By Xu Yuming (Vice Chairman, China Atomic Energy Authority) Nuclear Energy Development in China, 31July,2002. <http://www.caea.gov.cn/n602670/n621902/32228.html>

⁵¹⁰ Xu Yuanhui; Policies of Nuclear Energy Development in China Institute of Nuclear Energy Technology Tsinghua University: China. http://taou.nuc.berkeley.edu/asia/1997/97ILP_Xu.pdf

operated without substantive problems since then. The reactor served as the model for Pakistan's Chasnupp 1, the first Chinese commercial reactor constructed on foreign soil.

Qinshan 2-A, is the first reactor of the two reactors constructed under phase 2 of the Qinshan project, it is of Chinese design and manufacture. According to the International Atomic Energy Agency, although it is locally designed and constructed, some heavy equipment was imported. Unit 2-A came online on February 2, 2002. Originally known as Qinshan 2, it was changed to 2-A when China decided to construct reactors in pairs. As of March 31, 2004, Qinshan 1 is the only commercial reactor in China to not have a twin. Unit 2-A has also been identified as 2-1 (with its two sometimes identified as 2-2) and appears as such in some EIA features, such as the Nuclear Timeline.

Qinshan 2-B began operation on March 4, 2004, a month ahead of its scheduled on-line date (April 1, 2004). Like its companion unit, 2-A, this light water pressurized reactor is of Chinese design and construction. During the final decade of the 20th century and the first few years of this century, new reactor designs in the United States and Europe usually have capacities of about 1,000 net MW(e) or greater. Indeed, the French have built several giants that are 1,200 net MW (e), the largest ever built according to EIA's Unique Reactors feature. The philosophy is that more capacity means more electricity for the consumer, and lower costs and more profits for the producer. The two leading commercial nuclear power producers in Asia, Japan and South Korea, have been bringing units on line that are about this size. While China has a pair of Russian-built reactors in this range under construction, Tianwan 1 and 2, the Chinese seem quite comfortable with their design's more modest capacity. In fact, they are comfortable enough with the design to use it as the basis for their first exported unit (in Pakistan).

Qinshan 3-A, is the first Canada Deuterium Uranium Reactor CANDU constructed in China. Unit 3-A and its twin, 3-B, are China's first heavy water pressurized reactors (PHWR). China was able to bring this reactor on line months ahead of schedule.

Qinshan 3-B went on line a few months after its companion, Qinshan 3-A. Like 3-A, it is a CANDU unit and was also brought on line ahead of schedule.

Tianwan-1 is scheduled to begin commercial operation in 2004. About a quarter of the world's commercial nuclear reactors have capacities of 1,000 MW(e) or more, but this reactor and its twin (Tianwan-2) will be the largest reactors ever built in China. Construction of this reactor began in October 2000 and should be completed in January 2004. The reactor is being built by Russia but Russia and China are not the only countries with a stake in the future of this

plant. The German-based company, Siemens, reports that this power plant will be the first to incorporate its newly-designed digital instrumentation and safety control systems.

Table 7: China's Commercial Nuclear Reactors⁵¹¹

Operational Units: Reactors fully licensed to operate and that are either in service or are shutdown but expected to return to service				
Unit Name (Alternative Names)	Type	Capacity MW(e)		Status (as of March 31, 2004)
		Net	Gross	
Daya Bay 1 (Guangdong 1)	PWR	944	984	Connected to the grid on August 31, 1993
Daya Bay 2 (Guangdong 2)	PWR	944	984	Connected to the grid on February 2, 1994
Ling'ao 1 (Lingao A)	PWR	938	990	Connected to the grid on February 26, 2002
Ling'ao 2 (Lingao B)	PWR	938	990	Connected to the grid on December 15, 2002
Qinshan 1 (formerly, Qinshan)	PWR	279	300	Connected to the grid on December 15, 1991
Qinshan 2-A (formerly, Qinshan 2, of Qinshan 2-A)	PWR	610	642	Connected to the grid on February 2, 2002
Qinshan 2-B (formerly, Qinshan 3)	PWR	610	642	Connected to the grid on March 4, 2004
Qinshan 3-A	PHWR	665	728	Connected to the grid in April 2003
Qinshan 3-B	PHWR	665	728	Connected to the grid in July 2003
Total Capacity		6,593	6,988	
Units in the Construction Pipeline				
Tianwan-1 (Lianyungang)	VVER	1,000	1,060	Under Construction
Tianwan-2 (Lianyungang)	VVER	1,000	1,060	Under Construction
Total Capacity		2,000	2,120	

China's multi-pronged nuclear strategy follows the same strategy as its program in space exploration. First, rather than reinventing the wheel, China has imported commercial power plants from Russia, France, and Canada, to have the immediate benefit of nuclear energy, and to train its own cadre of engineers and operators. Today, China has nine reactors operating and two under construction, with nuclear energy accounting for about 2% of its total electricity output.

In the late 1990s, as the large-scale construction of nuclear plants was under way, Chinese officials were already planning for the 21st Century. China plans to choose one reactor design (and supplier) for its next group of nuclear plants, to enable it to standardize its nuclear operations, rather than continue with the widely varying designs now in place, from different suppliers. The goal is to have an increase of nearly sixfold in nuclear capacity, up to 40,000 MW by 2020, from 8,700 MW today. Due to the size of China's electric system, even this aggressive effort will bring nuclear's share up to only 6% of installed electric-generating capacity. This

⁵¹¹ http://www.eia.doe.gov/cneaf/nuclear/page/nuc_reactors/china/reactors.html

program requires that at least two new reactors come online each year, over the next 16 years. By 2050, China plans to have 150,000 MW of nuclear capacity, equivalent to 150 large power plants. There are about 440 nuclear reactors today, worldwide, and 103 in the United States.

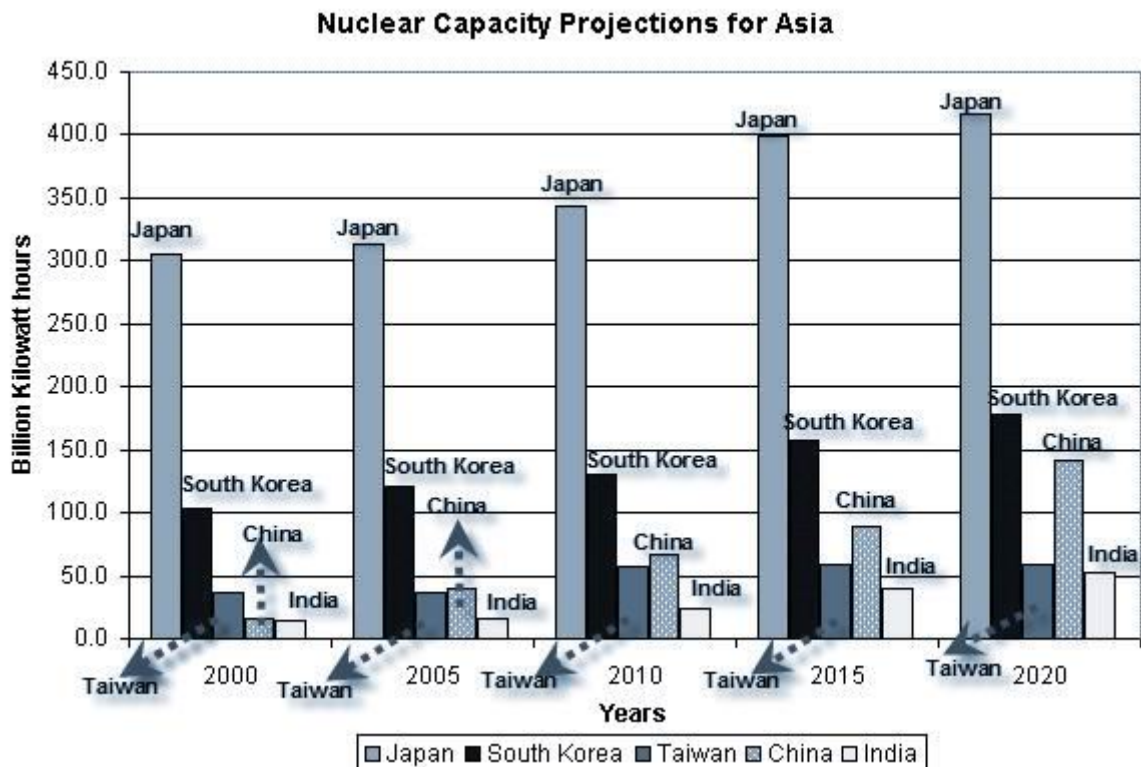
China has good condition to develop nuclear power. Economically uranium resource is 650Kt. And international uranium resource is quite large, uranium resource with cost lower than US\$80/kgU is around 3 to 4 million tons, enough for more than 50 years use for power generation. If it is used in fast breed reactor, the resource is enough for more then 3000 years. Chinese companies already have 300MW light water reactor technologies, and nuclear power plants could be construct with own technologies. Chinese companies already have ability to produce 3 to 4 set of nuclear power generators. There are more than 40 to 50 GW nuclear power plants allocated in China. China also has ability to produce, supply nuclear fuel, and process used fuels.⁵¹²

For nuclear power, China is a late starter, but the development of nuclear power has been accelerated in recent years. As of mid 2005, China had nine reactors at four sites in operation, with a total installed capacity of 7.9 gigawatts (GW). Another four reactors with a total generating capacity of 4.4 GW are under construction, while an additional six reactors with 6.0 GW of capacity are proposed. China's target is to build 40 GW of nuclear power by 2020, which means at least one nuclear power plant with two 1 GW reactors needs to be build between 2006 and 2020. In 2004, nuclear power accounted for less than 1% of China's PCEC.

Although small by comparison with other developed nuclear programs, this program represents a significant commitment to nuclear power as an important component of China's future energy mix. Nuclear power plays a strategic role for the densely populated coastal areas. China is aggressively developing its own 1,000-MW I'WR design to serve as the backbone of this program early in the next century, and hopes to increase nuclear capacity to 20 GW by 2010 and 40 GW by 2020, though capital constraints could prove daunting.

⁵¹² Jiang Kejun Management of Energy Resources in China Energy Research Institute; http://siteresources.worldbank.org/INTDECABCTOK2006/Resources/Kejun_Energy_China.pdf

Figure 8: Nuclear Generation Projections for Asia⁵¹³



China’s policy is to reprocess its spent fuel and a pilot processing facility is under construction. China intends to recycle plutonium as MOX fuel in PWRs or in breeder reactors. China has elected (o construct four regional low- and intermediate-level waste facilities and is contemplating vitrification and geologic isolation of high-level waste. China’s National Nuclear Safety Administration (NNSA) regulates nuclear safety in concert with the International Atomic Energy Agency (IAEA). China is also a signatory to the Nuclear Non-Proliferation Treaty.⁵¹⁴ China is expected to play an active role in the World Association of Nuclear Operators (WANO), which will accelerate the ability to safely operate the different reactor systems under construction.

Finally what China is planning to develop the nuclear energy status as a planned prospect is:

- In 2010 EIA projects that China’s nuclear energy consumption will quadruple, rising from 16 billion kilowatt-hours(kwhr) in 2000 to 66 billion kwhrs in 2010(reference case scenario).⁵¹⁵

⁵¹³ <http://www.eia.doe.gov/cneaf/nuclear/page/forecast/elec.html>

⁵¹⁴ Peter Nolan, China and The Global Economy.

⁵¹⁵ Energy Information Administration, International Energy Outlook, page 194.

- In 2015 EIA projects (reference case scenario), that China’s nuclear electricity consumption will rise to 129 billion kwhr, doubling the level in 2010.
- 2020 EIA projects that by 2020, China’s nuclear electricity consumption⁵¹⁶ (reference case scenario) will climb to 142 billion Kwahr, passing that of Canada (118 billion Kwahr) and Russia (129 billion Kwahr).⁵¹⁷ If EIA projections turn out to be accurate, however, the rapid growth of China’s nuclear industry will do little to offset the anticipated phenomenal growth in electricity demand or carbon emissions.

The energy production and consumption is directly related with GDP of the countries and here are the Asian countries economy and nuclear energy prospects below⁵¹⁸:

Table 8: Gross Domestic Product, in Asia, 1990 to 2025

**Gross Domestic Product, in Asia, 1990 to 2025
Billion Dollars \$(1997)**

	1990	2000	2001	2010	2015	2020	2025
Japan	3808	4395	4411	5085	5557	6046	6563
China	428	1120	1202	2228	2980	3877	4976
South Korea	297	544	562	908	1117	1310	1510
India	290	492	544	833	1078	1381	1757

China’s per unit GDP energy consumption down 1.23 pct in 2006.⁵¹⁹

In conclusion, along with the rapid economical development shortages in primary energy supply, especially in the supply of liquid form energy carriers, environment pollution and transport burden caused by the coal-dominant energy mix will become more and more serious. Intensified application of nuclear energy will help to ease all above mentioned problems.

The development scale of nuclear energy in China will be very large. The development of nuclear energy is unimaginable without the localization of nuclear energy. The localization would be fully realized if self-initiation at four aspects that is self-initiation design, self-initiation

⁵¹⁶ Ibid.

⁵¹⁷ Ibid.

⁵¹⁸ Future of the Chinese Nuclear Industry, The Energy Information Administration (EIA), Available in the address: http://www.eia.doe.gov/cneaf/nuclear/page/nuc_reactors/china/outlook.html

⁵¹⁹ Available in the address: http://english.people.com.cn/200702/28/eng20070228_352996.html - March 01, 2007

construction, self-initiation components manufacture and self-initiation operation could be implemented.

The pressurized water reactor was and will still be regarded as the priority reactor type for nuclear power plants for only electricity generation. Meanwhile, an advanced reactor meeting the utility requirement document (URD) will follow as next generation reactors. In addition district heating reactors will be further developed not only for heat supply but also for other use, especially for sea water desalinization.

5. Electricity

China is the second and third largest consumer of fossil fuels in the world. As shown in the attached documents, its per capita availability of energy is very low, even though the absolute quantities are very large, and are expected to rise rapidly during the next 10 to 20 years.

China produces nearly three times as much electricity as Canada did in 1997, a combined total of 1626 TWh. By 2020, China will be producing 5,174 TWh, more than eight times Canada's 1997 electricity production. This means that this country will be building the equivalent of Canada's entire electricity generating system approximately every three years.

China, rely heavily on coal for current electricity production, 73-74 per cent of electricity supply. By 2020, that reliance will fall to 68-69 per cent, principally through reliance on more nuclear power in China's case.⁵²⁰

This increase will happen because China is increasing the availability of electricity and other forms of energy in societies and because of rising average incomes and increasing industrialization. This increase in energy production and consumption is required for these countries to alleviate poverty and increase living standards.

Residential and commercial energy demand has resulted in a rapid increase in the use of gaseous fuels and electricity, and the leveling off of coal use. Residential and commercial share of final energy use is about 19 percent.⁵²¹

China's electricity generation capacity is second only to that of the United States, reaching 250 GW in 1997 and total electrical production reached 1.081 TWh. In the short-term China is experiencing an excess in capacity and has taken this opportunity to close many small, inefficient, and environmentally damaging thermal power stations. Major power construction

⁵²⁰ Peter Nolan, *China and The Global Economy*.

⁵²¹ **Chinese Academy of Science Staff**, *Cooperation in the Energy Futures of China and the United States*: National Academies Press, 2000.

projects have been deferred for three years. Over the next half century, China is expected to continue large-scale expansion in electric power to meet targets of modernization. According to original planning, the targeted installed capacity is scheduled to reach 290 GW by the year 2000.500 G W for the year 2010 (of which hydropower accounts for 115 GW. nuclear power contributes 20 GW), and probably 700 GW for the year 2020. Recent economic difficulties as a result of the Asian economic crisis, limitations on capital availability, and other factors, however, will slow this ambitious plan of power capacity expansion.

About 14 percent of exploitable hydro resources have been developed in China, and in 1998 hydropower accounted for over 8.4 TWh of increased generation. The Three Gorges Dam is the largest hydropower project under construction: when completed it will add 18 GW of electric power capacity. Some of the significant obstacles to increased development of hydropower are high capital costs, long payback periods, inaccessibility (i.e., distance from population centers and energy demand) of hydro resources, and site-specific concerns over ecological consequences.⁵²²

Household electricity consumption in China is 330 kWh per household per year, or about 10 percent of U.S. consumption. More than 860 million Chinese (about 70 percent of the population) live in rural areas with inadequate access to commercial energy, and, among them; in 1998 about 40 million have no access at all to electricity (Chinese State Power Corporation, 1999). This segment of the population depends heavily on biomass energy and suffers from the consequent negative health and environmental impacts from burning of these traditional fuels. The Chinese government is making a large investment to provide electric services in rural areas to alleviate this problem.

One impediment to this objective of providing commercial energy to rural areas is that the development of the power transmission and distribution (T&D) network is far from complete. Compared with power grid systems in developed countries where meshed networks have been formed, the power networks in China (six regional networks and several independent grids) are still in the early stages of development. The framework of the system is not strong enough in either system security or capacity. It is necessary to strengthen the T&D system by constructing new lines as well as upgrading old ones.⁵²³

Growth in the urban electric power distribution network in the 1990s was between 14 and 18 percent per year, reflecting China's urbanization, unprecedented in scale. Overloading of the

⁵²² Peter Nolan, *China and The Global Economy*.

⁵²³ Peter Nolan, *China and The Global Economy*.

network remains the bottleneck of meeting reliable power supply: updating and upgrading this system is an urgent need. The Chinese government is currently undertaking a program to upgrade the urban distribution system with an investment of about 200 billion RMB (about U.S. \$24 billion).

Electricity transmission line losses were reduced from almost 9 percent in 1981 to 8 percent in 1990, though this figure does not include losses in low-voltage networks and in the supply networks owned by large consumers which could be as high as an additional 7 to 8 percent. Taking into account power plant energy use, only about 75 percent of generated electric power reaches the end users in the worst case. The distribution network suffers from the same problems, especially in rural areas where distribution line losses, including non-technical losses, can be as high as 25 percent.

The estimates show that, average growth in electricity consumption in China is projected to be 4.3 per cent per year through to 2025. The largest future growth in terms of fuel share in the future is expected to be natural gas in part due to environmental concerns regarding the current reliance on coal. But oil will also increase its share, to as much as 50 per cent according to one estimate made public in February 2005.⁵²⁴

6. Renewable Energy

Since the 1970s the Chinese government has recognized the importance of active development and application of renewable energy for off-grid rural and remote areas, and this work has been included in the national five-year plans. Through a continuous effort over 20 years, significant progress has been achieved. However, renewable energy resources are not anticipated to make a significant contribution to on-grid electricity capacity by 2020.⁵²⁵ Table below shows the current status of renewable energy deployment in China. Table below shows another set of renewable energy development projections for China to 2020.

In comparison to the United States, China's wind power development is small but growing rapidly. In 1998 grid-connected capacity was 240 MW, compared to 167 MW installed capacity in 1997 and 57 MW in 1996. There are also about 17 MW of off-grid small wind units in operation. China has world-class wind resources with an estimated technical potential of 250 GW, although much of it is far from population centers. Initial site assessment has identified 3-8

⁵²⁴ Stephen Voss, 'China Says Oil to Exceed 50 Percent of Its Energy by 2010', **Bloomberg**, 14 February 2005, <http://www.energybulletin.net/4336.html> Voss cited a senior Chinese official, the director of Energy Economics and Development Strategy in China's National Development and Reform Commission, Gao Shixian.

⁵²⁵ Peter Nolan, *China and The Global Economy*.

GW. Further development of wind power resources will be dependent on advances in energy storage or backup systems to account for the inherent intermittent nature of this resource.

China has the world's largest and fastest-growing market for solar hot water heating. Over 5 million m² (heat-absorbing area) of solar water heaters had been installed as of 1996.⁵²⁶ Other solar thermal applications include passive solar-heating houses and solar cookers. The PV market in China is small but growing quickly, with about 8.8 megawatts-peak (MWp) power in IV96. About 50 percent of existing PV power is used for telecommunications. 10 percent is used for industries, and most of the rest supplies electricity for remote areas without grid coverage. Solar thermal power generation is still in the R&D stage.

Table 9: Development Status of Renewable Energy in China: (Institute of Electrical Engineering, Chinese Academy of Sciences) (Current Status)

Energy	Item	Present Situation
<i>Biomass</i>	Biomass digesters	About 5.25 million sets, 1.47 10 ⁹ m ³ /year
	Firewood forest	About 5.4 million hectares
<i>Mini-hydro</i>	Power stations	>60,000 stations, about 17,000 MW 34.3 billion kWh
<i>Tidal</i>	Power station	8 stations, 11 MW
<i>Geothermal</i>	Power stations	5 stations, 28.78 MW
	Direct use	1.6981 x 10 ⁴ TJ per year
<i>Wind</i>	Mini-Generators	150,000 sets, 15 MW
	Water lifting machines	>2000 sets, 2.11 MW
	Wind farms	19 farms, 167 MW
<i>Solar</i>	PV cells	~8.8 MW
	Hot water heaters	~5 million m ²
	Solar houses (passive)	2.7 million m ²
	Greenhouses	0.342 million hectares
	Dryers	20,000 m ²
	Cookers	150,000 sets

⁵²⁶ Chinese Academy of Science Staff, Ibid.

Table 10: Projections for Renewable Energy Development in China (Institute of Electrical Engineering, Chinese Academy of Sciences)⁵²⁷

Source	1990	2000	2010	2020
<i>Solar Thermal Utilization</i>				
Water heater				
Mm ²	1.5	9.0	15.0	30.0
Solar house				
Mm ²	0.4	10.0	20.0	100.0
Thermal Power Generation				
GW	—	—	0.1	2.0
TWh	—	—	0.2	4.0
<i>PV Power Generation</i>				
GW	0.002	0.015	0.3	3.0
TWh	—	0.05	0.9	7.0
<i>Wind Power Generation</i>				
GW	0.02	0.35	1.1	6.0
TWh	0.05	0.95	3.0	17.4
<i>Geothermal Utilization</i>				
mtce	0.35	0.8	2.0	6.0
Power Generation				
TWh	0.1	0.3	0.5	1.0
<i>Biomass energy</i>				
mtce	263	240	260	290
Traditional Technology	262	236	240	200
New Technology	1	4	20	90
Power Generation				
GW	—	0.05	0.3	3
TWh	—	0.2	1.2	12
<i>Ocean Energy</i>				
GW	0.01	0.05	0.6	5
TWh	—	0.1	1.6	15
TOTAL				
mtce	264	242	296	315
Power Generation				
GW	0.04	0.5	2.6	20.0
TWh	0.15	1.6	7.6	60.4

China has made great efforts to improve the efficiency and technology of biomass utilization through national programs for efficient stoves and rural house hold biogas digesters and, more recently, Total biomass consumption amounted to about 9 EJ in 19%, over 90 percent of it firewood and crop stalks burned for household energy needs. The United States consumes about half as much biomass fuel, but in more modern applications. Among the about 3 EJ consumed in the United States in 1996, 75 percent was used in industry, and 22 percent was consumed by households for space heating. About 27 percent of the U.S. biomass fuels are used for electricity generation.

⁵²⁷ Chinese Academy of Science Staff, Ibid.

China's New and Renewable Energy Development Outline from 1996 to 2010 requires that commercial renewable energy consumption increase from the current level of less than 2 mtce to about 120 mtce by 2020.⁵²⁸ Biomass comprises the bulk of the energy provided (about 90 mtce), followed by solar thermal applications (totaling 8.5 mtce), then wind energy (6 mtce), ocean energy (5 mtce), and solar PV and geothermal (each at 2.5 mtce).

The Chinese State Science and Technology Commission-DOS 1995 Protocol on Energy Efficiency and Renewable Energy and its six annexes provide a number of opportunities for collaboration in solar, biomass, wind, hybrid systems, geothermal, electric vehicles, and so on. In 1998, U.S. funding for the program increased to about \$1 million, compared to \$400,000-600,000 in previous years.

China also is receiving bilateral assistance in renewable energy technologies from Denmark, Holland, Germany, Spain, and Japan, Australia and Spain are also co-donors to the UNDP project.

⁵²⁸ This figure does not include current noncommercial use of renewable energy. According to the IEE projection, traditional biomass energy use will decrease to about 200 mtce by 2020.

B. CHINESE SMALL AND MEDIUM SIZED ENTERPRISES (SMEs)

Financing alternatives for small and medium enterprises in China are discussed in the present study. In particular, we analyze the significant changes and developments in China's "second board" stock market. China's extensive network of regional assets and equity exchanges, which were set up to facilitate private equity transfer, and non-performing loan transactions seem to partially fill the void for small and medium enterprises, which cannot easily obtain approval for listing on the stock exchanges. Foreign investors can identify investment opportunities in non-listed domestic state-owned and private businesses through these regional assets and equity exchanges. At the same time, foreign stock markets are now attracting the young Chinese enterprises to list their stocks on their exchanges.

Since economic reforms in 1978, the private sector has grown and become an important part of the Chinese economy. The private sector, in particular small and medium enterprises (SMEs), has become a bigger driving force behind the growth of the economy. The private sector is becoming more and more important in terms of its contribution to the nation's GDP. A recent study by Fung et al.⁵²⁹ shows that in China in 2002 and 2003 the non-state sectors contributed to more than 60 percent of production, 90 percent of employment, and 70 percent of tax revenue.⁵³⁰

According to Song⁵³¹, by the end of 2005, there were over 42 million SMEs: a number that is growing at 15–20 percent annually. It is estimated that SMEs are responsible for 75 percent of new jobs.⁵³² It is not surprising that many SMEs have been scrambling for capital to stay ahead of the growth curve. Out of the large number of SMEs (42 million), only a small proportion have been able to gain access to enough capital to grow into mature enterprises and to achieve economies of scale since the reform started in the late 1970s. This undoubtedly hampers the growth of the Chinese economy. Had SMEs been better able to finance their growth, the growth of the Chinese economy could have even been more impressive than it has been.

Since the early 1990s, the Chinese Government has sought to stimulate entrepreneurship, developing high-technology zones, science parks, and business incubators. In 1998, the State and

⁵²⁹ Fung, Hung-gay, Donald Kummer and Jinjian Shen, 2006, "China's privatization reforms," **The Chinese Economy**, Vol. 39, No. 2, pp. 5-25.

⁵³⁰ In the *The Wall Street Journal*, 23 September 2005, it was reported that Credit Lyonnais Securities Asia-Pacific Markets estimated that China's private sector contributed to more than 70 percent of the GDP in 2005, while Union Bank of Switzerland Securities, Hong Kong, estimated that private companies accounted for 30 percent of the GDP. Although these estimates differ significantly for various reasons, they both highlight the significant portion of the contribution of the private sector to the Chinese economy.

⁵³¹ Song, Lei, "The State Development and Reform Commission intends to stimulate the managers training market," *Diyi caijing ribao*, (2006), 18 October. (In Chinese)

⁵³² Zou, Ping, 2006, "SMEs absorb 75 percent of the work force," *Dazhong ribao*, 17 November (cited on 20 November 2006). Available from: <http://news.sina.com.cn/c/2006-11-17/073110525012s.shtml>. (In Chinese)

Economic Trade Commission (SETC) set up its SME office to coordinate and promote the business affairs of SMEs. The SME Promotion Law was approved for codifying the official definition of SMEs and clarifying what government financial support would be made available to them. Yet, unlike the state-owned enterprises (SOEs), which obtained policy-loan financing from the government through the state-owned banking system, private enterprises found it difficult to gain access to capital or to obtain loans from state-owned banks, limiting their business development potential. The situation did not improve even after the government created a network of credit guarantee agencies in the late 1990s and tasked the SETC's SME Bureau to oversee them.

Moreover, the establishment of the stock market in the early 1990s has not helped SMEs to raise capital for several reasons. The stringent listing requirements and quota restrictions prevent many private businesses from entering the stock market in order to raise capital, which is especially disadvantageous for cash-thirsty new high-technology enterprises. The two major stock exchanges (Shanghai and Shenzhen) in China were set up for larger enterprises, not SMEs, to raise external capital.

The capital-intensive high-technology enterprises typically need huge amounts of financing in their early stages of development. Outside China, high-technology start-up enterprises typically rely on venture capital or private equity for their early financing needs. However, the burgeoning Chinese venture capital industry has not been able to offer much assistance either⁵³³, albeit international venture and private equity funds have recently started to grow in China. Despite its importance and the urgency for China to set up a NASDAQ-type stock market where SMEs can seek financing, efforts have been stalled since 2001 when the technology industry bubble burst in the US stock market.

Over the past decade, the Chinese Government has established numerous regional assets and equity exchanges, through which SMEs can obtain capital by selling part of their ownership stake, and foreign investors can invest in domestic enterprises. These financing activities are analogous to private placements before initial public offerings in the USA. The asset and equity exchanges help to organize and facilitate these transactions and allow effective oversight and monitoring by administrators.

⁵³³ Fung, Hung-gay, Qingfeng Liu and Xiaoqin Shen, "Venture capital cycle, opportunities, and challenges in China," *The Chinese Economy*, (2004), Vol. 37, No. 4, pp.28-49.

1. The Development of SMEs

Over the past two decades, Chinese small and medium-sized enterprises (SMEs) have gone through roughly three development phases, along with the development of China's reform and opening-up. The first phase was from 1978 to 1992, characterized by the expansion of SMEs in number and scale. This resulted from the government's encouragement of and support for the development of township, collective and self-employed enterprises. The rapid expansion of these enterprises has made great contribution to economic development and improvement of the people's living standards.⁵³⁴

The second phase was from 1992 to 2002.⁵³⁵ During this period, the emphasis was reform of state-owned SMEs and the development of non-public sectors. The government adopted various measures, such as restructuring, merger and acquisition, joint partnership, leasing, contracting and sell-off, to speed up reforms of state-owned SMEs and to gradually reduce the state's ownership in SMEs. At the same time private-owned SMEs enjoyed rapid development along with the establishment of the socialist market economy. The phase was an important historical period for the development of Chinese SMEs.

With the rapid growth of the Chinese economy, many kinds of SMEs have been established and gradually developed. In 1980, the number of industrial enterprises at the level of collective township and village enterprises and above (excluding village and family enterprises), was about 377,300. Among them were 1,400 large enterprises, 3,400 medium enterprises and 372,500 small enterprises, about 0.37, 0.90 and 98.73 percent of all firms respectively.⁵³⁶ In the same year, China had 1.81 million commercial enterprises (including private businesses), more than 99 percent of which were SMEs. The number of individually owned enterprises was 686,000.

The Chinese economy experienced rapid growth in the 1980s, and there was a tremendous boost in the number of SMEs. In 1990, the total number of industrial enterprises reached 7,957,800. The proportions of large, medium and small enterprises were 0.95, 2.27 and 96.78 percent respectively.⁵³⁷ The significant increase in the number of SMEs reflects the objective

⁵³⁴ Dr Jun Li, "Entrepreneurship and Small Business Development in China"; **Journal of Small Business and Enterprise Development**, Vol.12, No.2, Emerald Group Publishing Limited, (2006).

⁵³⁵ Dr Jun Li, *Ibid.*

⁵³⁶ National Bureau of Statistics (NBS), **China Statistical Yearbook** (1981), Beijing: China Statistical Press, p. 204.

⁵³⁷ Beginning in 1984, statistics on village-owned, city and rural jointly owned, and private businesses were arranged as industrial enterprises (previously arranged as agricultural statistics), and nearly all of these firms were small or even micro-enterprises. This change in statistical measurement drastically increased the number of SMEs.

reality of its fast development at the time. Apart from an increase in industrial enterprises, the number of construction, commercial, food-and-beverage and service enterprises all increased by over 300 percent over 1980.⁵³⁸

In the 1990s, the Chinese economy maintained a trend of steady and rapid growth and the overall scale of the economy continued to expand. According to the new standards on the scale of industrial enterprises carried out in 1998, there were 7,864 large enterprises, 14, 371 medium enterprises and 139,798 small enterprises – about 4.85, 8.87 and 86.28 percent of all firms respectively.⁵³⁹

The third phase began with 2002. In June 2002 China promulgated the small and medium-sized enterprises promotion law, which symbolized that the development of SMEs has ushered in a new era. The main mission for the government in this period was to implement the SMEs promotion law, which involves the following tasks:⁵⁴⁰

- to further improve policies and measures concerning the development of SMEs;
- to remove institutional barriers that hinder the development of SMEs, especially private-owned ones;
- to create a level playing field for the development of SMEs;
- to promote scientific and technological innovations and upgrading;
- to optimize industrial structure of SMEs; and
- to enhance the overall quality and competitiveness of SMEs.

On the whole, Chinese SMEs have gained a fast growth ever since the reform and opening-up, measured in terms of size, number, financial status, or profitability. Two factors played decisive roles in this period. The first factor was the speedy development of township enterprises. Most of township enterprises were small and medium-sized, and thus became a key driving force for the development of Chinese SMEs. The development of township enterprises not only provided solutions for the transfer of rural surplus labor forces to non-agricultural sectors and increase of farmers' income, but also established a solid foundation for the accomplishment of the strategy of gradual reforms and development. The second factor was the

⁵³⁸ NBS, **China Statistical Yearbook 1991**, Beijing: China Statistical Press, (1991) p.16-17.

⁵³⁹ NBS, **China Statistical Yearbook 2000**, Beijing: China Statistical Press, (2000) p. 412-413.

⁵⁴⁰ Dr. Jun Li, *Ibid*

rapid growth of non-public sectors of the economy, notably private-owned SMEs. As economic reforms proceeded, more and more people realized the importance of non-state-owned businesses, especially private-owned SMEs. From the very beginning of the reform and opening-up, the government acknowledged that the non-public sector of the economy would be a necessary and favorable supplement to the socialist public economy. In 2004 China amended the constitution to grant the non-public economy a legal status in the socialist market economy. Such a legislative move reflects China's deepened understanding of the non-public sector of the economy, which in turn gives great impetus to the development of private-owned enterprises.

2. Current Status of Chinese SMEs

Today, SMEs are getting stronger and continue to contribute to the development of Chinese society and economy. They exert the same function as SMEs in other countries, which are mainly expressed by promoting employment, technological innovation, training of entrepreneurs, developing international economic relationships, accelerating market competition, maintaining economic vitality, and so on. Comparatively speaking, the special nature of Chinese SMEs manifests their specific influence on the transition of China's economic system and social structure. For example, the development of non-public-owned SMEs not only changes the enterprise ownership structure, but also lays an important foundation in the process of developing China's market economy. At present, the number of non-public-owned Chinese enterprises far exceeds the number of state-owned firms. Excluding over 20 million individually-owned enterprises, the proportion of formally registered non-state-owned legal entities grew from 26.1 to 59.5 percent between 1996 and 2001.⁵⁴¹

There were about 2.4 million small and medium-sized enterprises at the end of 2001 in China, accounting for 99 per cent of all registered corporations.⁵⁴² If those SMEs such as self-employed businesses, leasehold farm households and individual partnerships that are not legal persons are also included, the number is far larger. Chinese SMEs have played an important role in stimulating economic growth, increasing employment, expanding exports and promoting science and technology innovations. In terms of economic growth, the output value, sales revenues and tax revenues of SMEs in the industrial sector accounted for 60, 57 and 40 per cent respectively of the total of all the industrial enterprises. Since 1990s, SMEs have created 75 per cent of the incremental industrial output value. SMEs also dominated in most industrial sectors;

⁵⁴¹ Hung-gay Fung, Qingfeng Liu, Jot Yau, "Financing Alternatives for Chinese Small and Medium Enterprises: The Case for a Small and Medium Enterprise Stock Market", *China & World Economy* / 26 – 42, Vol. 15, No. 1, 2007.

⁵⁴² NBS, The census was taken in 2002 with December 31, 2001 as the statistical end. (2003).

over 70 per cent of the gross output value in the food, papermaking and printing industries, over 80 per cent in the garment tannery, recreation and sports outfit, plastic and metalwork industries, and over 90 per cent in the wood and furniture industries.⁵⁴³ Despite the limitation of statistical data, in which only sufficient data about industrial sectors are available, it is rather reasonable to extend the conclusion about SMEs to the other sectors according to our common observations. For example, SMEs in the wholesale and retailing industry accounted for about 33 per cent of the total number of SMEs⁵⁴⁴ and have played a crucial role in enhancing commodity circulation.

In terms of employment expansion, SMEs have created about 79 per cent of new jobs nationwide. Employees in SMEs accounted for a large proportion of the total employees nationwide: above 85 per cent in the industrial sectors, 90 per cent in the retailing industry and over 65 per cent in the construction industry.⁵⁴⁵ Especially in recent years, the development of private-owned SMEs has considerably expanded employment and become a major driving force for the employment increase, which plays an active role in absorbing workers laid-off or dispersed from both state-owned enterprises (SOEs) and urban collective enterprises. From 1998 to 2003, nearly 19 million workers laid-off from SOEs were re-employed⁵⁴⁶ and most of them went to SMEs.

In terms of foreign trade and exports, the total export value of China in 2003 amounted to over US\$430 billion and China was ranked fourth place in the world in the total import and export value in 2003.⁵⁴⁷ On the list of export commodities, some bulk export commodities are mainly manufactured by SMEs, such as garments, shoes and hats, handicrafts and metal goods, light industry products, textile and toys, which are mainly high-tech or labor-intensive products.

In terms of science and technology innovation, SMEs in China have achieved great progress in technological innovation, and become the driving force for the spread and application of new technology and innovation. By the end of 2003, China established over 100 high-tech enterprise incubators, over 30 university science parks, over 20 enterprise parks for returned overseas students, over 40 service centers for SMEs* technology innovation, and more than 500 productivity promotion centers.⁵⁴⁸ All these institutions have provided strong support for the technological innovation of SMEs. A great number of technology-oriented SMEs locate in the

⁵⁴³ NBS, The census was taken in 1996 with December 31, 1995 as the statistical end. (2001).

⁵⁴⁴ NBS, The census was taken in 2002 with December 31, 2001 as the statistical end (2003).

⁵⁴⁵ NBS, The census was taken in 2002 with December 31, 2001 as the statistical end, (2003).

⁵⁴⁶ Information Office of the State Council, “**China’s Social Security and Its Polity**”: (2004), Information Office of the State Council.

⁵⁴⁷ China’s customs statistics, www.customs.gov.cn

⁵⁴⁸ “Annual report on Torch Program” of 2003, released by the Torch High-Tech Industry Development Centre: Ministry of Science and Technology.

areas such as Zhongguancun in Beijing, Waigaoqiao in Shanghai, and the innovation and high technology zone in Shenzhen, which contribute greatly to technology innovation in China.

3. Major policies and initiatives

The Chinese government attaches great importance to the development of SMEs and has integrated issues of small business development into its overall strategic planning for national economic and social development. In order to promote the development of SMEs, the government adjusted related legislations and policies step by step, and launched a series of policies and initiatives.

3.1. Preferential taxation policies

In light of both the major difficulties facing SMEs and WTO rules and regulations, the Chinese government put forward a series of preferential taxation policies. Though some of these policies were not specially targeted at SMEs, SMEs were in fact the main beneficiaries.

3.1.1. Income tax policies for small enterprises

Currently, the enterprise income tax rate in China was 33 per cent. In order to reduce the tax burden of small enterprises, the government lowered the tax rate to 18 per cent for those enterprises with an annual profit of less than RMB 30,000 (approximately US\$3,600), and to 27 per cent for those with an annual profit of between RMB 30,000 and RMB 100,000 (approximately US\$ 12,000). In addition, the government reduced the value-added tax (VAT) rate from 6 to 4 per cent for those small enterprises with less than RMB1.8 million (approx. US \$0.2 million) of annual sales revenues.⁵⁴⁹ Township SMEs were allowed to enjoy a 10 per cent discount on their payable income tax as compensation for their expenditures on social welfare that should have been paid by the government.

3.1.2. Taxation policies, to promote employment

If a new urban job agency in its first year of operation is able to find jobs for urban residents, of which more than 60 per cent are unemployed workers, the agency is eligible for exemption from business income tax for three years; after the exemption period expires, if the agency is able to find jobs for unemployed workers that exceed 30 per cent of its total jobs found, then it gets 50 per cent discount on the enterprise income taxes for two years. For those new service businesses (excluding those providing advertising, sauna and massage services, and internet bars and oxygen bars) and commercial and trading enterprises (excluding those dealing

⁵⁴⁹ Dr Jun Li. Ibid, p.5.

with whole sale business, a mixture of whole sale and retail businesses, or other non-retail business), they are exempted from urban maintenance and construction tax (UMCT), additional education fee, and income tax for three years, provided that they employ no less than 30 per cent of laid-off workers in their total employees in the first year of operation and that they sign employment contracts of no-less-than-three-years with them. Service enterprises that meet the above requirements can also enjoy three years' exemption of business tax.⁵⁵⁰

For service enterprises founded before the preferential taxation policies took effect (excluding those in certain industries with restrictions imposed by the government on their development), they can enjoy a prescribed discount rate on their income taxes for three years, provided that the laid-off workers hired make up no less than 30 per cent of total employees and that they are offered a no-less-than-three-year employment contract. If laid-off workers become self-employed by starting own businesses (excluding those in certain industries with restriction imposed by the government on their development), they can enjoy three years' exemption of various administrative fees imposed by the government such as registration, certificate and management fees.

3.1.3. Taxation policies for high-tech enterprises

For those enterprises that locate in the state-level high-tech industry development zones and are recognised as high-tech enterprises by the authority, they are exempted from enterprise income tax for two years counting from the year they go into operation. After the two-year exemption period, the enterprises can still enjoy a preferential income tax rate of 15 per cent.⁵⁵¹

3.1.4. Taxation policies for service industries

For new enterprises that engage in transportation, posts and telecommunications, consultation, information industry and technological services, they are exempted from income tax for one year from the day they are established, and they can enjoy a 50 per cent discount on income tax in the second year.⁵⁵² Moreover, the government grants different preferential taxation policies to enterprises attached to universities and schools, new enterprises in poor and underdeveloped areas recognized by the government, and welfare enterprises employing disabled people.

⁵⁵⁰ Dr Jun Li. Ibid, p.6.

⁵⁵¹ Dr Jun Li. Ibid, p.6.

⁵⁵² Dr Jun Li. Ibid, p.6.

3.2. Fiscal policies

Since the reform and opening-up, especially 1990s, the Ministry of Finance (MoF) of China has been increasing fiscal fund inputs into SMEs and has set up several funds with SMEs as the targeted beneficiaries. These funds play an increasingly important role in the development of SMEs.

Ever Since 1999, the MoF has set up the Innovation Fund for Technology-based SMEs in order to encourage technological innovations. By the end of 2003, the MoF appropriated over RMB3 billion (approximately US\$361 million) for the fund and funded more than 4,900 innovation programs, of which most of die beneficiaries were private-owned high-tech SMEs.⁵⁵³

In 2001, the MoF set up the Commercialization Fund for Agricultural Research Findings to promote commercialization and transfers of sophisticated and practical technologies in high-tech agricultural enterprises. By the end of 2003, the MoF appropriated a budget of nearly RMB1 billion (approximately US\$120 million) for the fund, which considerably contributed to the commercialization of agricultural researches findings and the development of high-tech agricultural enterprises.

The MoF has also established the Fund for International Market Exploitation by SMEs to encourage them to participate in global competition, explore international markets and expand exports.

Since 2003, the MoF has increased its budgets in some special funds to support SMEs in their establishment of service system, business specialization and cooperation with large enterprises.⁵⁵⁴

Motivated by the central government, some local governments actively adopt measures to allocate special funds to promote the development of SMEs, by supporting the establishment of a national credit guarantee system for SMEs, subsidies for SMEs' interest payment for technology updates, and international market exploitation, etc.

⁵⁵³ David Shambaugh, **Power Shift: China and Asia's New Dynamics**, (2006) University of California Press, p.267.

⁵⁵⁴ Dr Jun Li. Ibid, p.10.

3.2.1. Financial and credit policies

Improving financial services, adjusting credit structure and enhancing support to SMEs. Since 1998, The People's Bank of China (PBC) has issued a series of documents, such as "Opinions on further improving financial services for small and medium-sized enterprises", "Circular on enlarging floating band of loan interest rate for small enterprises", "Guidance on improving financial services for small and medium-sized enterprises", "Guidance on enhancing credit supports for SMEs with marketability, efficiency and credibility". All these documents have initiated a series of policies and measures to improve financial services, adjust credit structure and provide diversified financial products, thus improving the business environment for SMEs.

Speeding up the development of the SME credit guarantee system and improving the financing environment for SMEs. In 1999, the former State Economic and Trade Commission (SETC) issued the "Guidance on pilot construction of the SME credit guarantee system", which called for establishing a system to provide credit guarantee services to SMEs for indirect financing. Credit guarantee has become an effective instrument to tackle the financing difficulties faced by SMEs.⁵⁵⁵ In 2001, the MoF issued the "Provisional rules on risk management of credit guarantee institutions for SMEs", which specified the organization, business coverage, operational principles, premiums, provisions and deposits of the guarantee institutions. This document has promoted active and stable supplies of credit guarantee services for SMEs.⁵⁵⁶

In 2001, the State Administration of Taxation (SAT) issued the "Circular on exempting SME credit guarantee institutions and reinsurance institutions from business tax", which grants three-year business tax exemption to non-profit experimenting institutions nationwide that provide credit guarantee and reinsurance to SMEs. In 2004, the National Development and Reform Commission (NDRC) and SAT jointly issued the "Circular on issues relating to business tax exemption for SME credit guarantee institutions", which extends the preferential treatment to more beneficiaries and is expected to stimulate the development of such guarantee institutions.

⁵⁵⁵ Dr Jun Li. Ibid, p.11.

⁵⁵⁶ Dr Jun Li. Ibid, p.8.

3.2.2. Regulatory policies

In order to promote a healthy development of SMEs, the General Office of the State Council issued the “Circular on transmitting and issuing the opinion of the state economic and trade commission on several policies of encouraging and promoting the development of SMEs” in August 2000. As the first consolidated document about SME promotion, the opinion puts forward 25 policies and measures with focus on eight issues, such as propelling structural adjustment, encouraging technology innovation, enhancing fiscal and taxation support, broadening channels of financing, expediting the construction of credit guarantee system, improving socialized service system, creating an external environment for fair competition, and strengthening organization and guidance. These policies and measures have improved the regulatory environment and accelerated the legislation process for SMEs.

In 1999, the former SETC issued the “Opinion on strengthening trainings for SME managers” to elevate the qualifications of proprietors and managerial staff in SMEs.

In 2000, the former SETC promulgated the “Opinion on several issues concerning the development of socialized service system for SMEs” in order to mobilize every quarter of the society to offer services to SMEs.

In 2001, ten state ministries and commissions including the former SETC jointly issued the “Opinions on enhancing credit management of SMEs” to encourage SMEs to pay higher attention to their credibility and enhance their credit status, and to promote the construction of the SME credit system.⁵⁵⁷

In 2001, the former SETC and the General Administration of Quality Supervision, Inspection and Quarantine jointly issued the “Opinions on enhancing SME quality supervision” to build up quality of products and strengthen quality management of SMEs.

4. Financing Alternatives for Small and Medium Enterprises

Financing the growth of SMEs is critical to the development of China’s economy because of the increasingly important role they have played in the economy. Internal and external sources of finance are theoretically available to the private sector in China.

Internal financing includes founders’ equity investment and retained earnings, if there is any. Founders’ equity investment might include founders’ own equity as well as funds from friends and family. Typically, these are personal savings, which are not adequate for financing

⁵⁵⁷ Dr Jun Li. *Ibid*, p.11.

fast growing business, especially in capital-intensive industries. Retained earnings are also a limited source of capital for new businesses, particularly for those industries that take years to mature, such as the biotechnology and pharmaceutical industries. Consequently, internal financing is probably a good source of financing for starting up but not a continuous source for providing additional capital to meet the growth needs of SMEs, especially in capital-intensive industries, where external financing must be sought. Although raising capital externally is not easy in a vast country with imperfect information, it is necessary. In the case of SMEs, we might find evidence that the contribution of financial intermediaries to economic growth is significant. As argued cogently by Beim and Calomiris⁵⁵⁸, financial development is important to the economic growth.

External sources of financing for SMEs include bank loans, venture capital and private equity funds, and the stock market.

4.1. Bank Loans

It is not easy for SMEs to get loans from the state-owned banks. State-owned banks are conservative in their lending because they have been plagued by financial troubles since the 1980s, the most serious of which was the massive non-performing loans and the government had tried to resolve it. One of the major obstacles to SMEs obtaining bank finance had been the perception of the banks that SMEs were more prone to high default risk than larger enterprises. To resolve the perception problem, in the late 1990s, the Central Government set up a network of more than 200 guarantee agencies nationwide to guarantee approximately US\$120 million a year, 70 percent of which went to existing large enterprises and 30 percent went to high-technology start-ups.

More than 100 cities established credit guarantee institutions which were expected to help guarantee US\$4.8bn in bank loans for the SMEs.⁵⁵⁹ Although well intended, the same dilemmas or obstacles were faced with the credit guarantee system as had been faced by banks dealing with SMEs during banking reform. First, the criterion set by the SETC was too tough for most SMEs to qualify for their service: less than 1 percent of China's SMEs are actually qualified to use the guarantee system.⁵⁶⁰ The burden of the lending decision was shifted from banks to the credit guarantee agencies. Worse still, credit guarantee companies prefer supporting larger enterprises

⁵⁵⁸ Beim, David O. and Charles W. Calomiris, *Emerging Financial Markets*, (2001), Boston: McGraw Hill-Irwin.

⁵⁵⁹ Pei, Ni, 2002, "Let weakness become strength," *Zhongguo chuangxinwang (China Innovation Net)*, 22 April (cited on 1 September 2006). Available from: <http://www.chinahightech.com> (In Chinese)

⁵⁶⁰ US Embassy in China, 2002, "China's small and medium enterprises: Room to grow with WTO" cited on 16 September 2006). Available from: <http://www.usembassy-china.org.cn/econ/ptr/smes2002.html>

over smaller ones, according to the findings of the State Council's Development Research Center.

For these reasons and in response to the lack of a commercially-oriented financing system to meet SME needs, external agencies like the World Bank and International Finance Corporation (IFC) have granted aid to the local governments in various regions of China especially the central areas such as Sichuan province, to provide technical assistance to support the development of private SMEs. Other agencies help to set up credit evaluation and operating systems to enhance access of SMEs to finance through technical assistance to partner financial institutions (e.g. state-owned banks), to prepare and support SME finance initiatives, and to give advice to the government in improving the regulatory and institutional framework for SME finance.

It should be noted that besides advising on the credit guarantee system, these external agencies and consultants typically recommend that the credit guarantee agency: (i) expands its services to meet SMEs' financing needs, such as factoring service; (ii) re-guarantees to share risks with other credit guarantee companies; and (iii) secures alternative sources of funding, as the government is the only source at present.

In sum, even with the credit guarantee systems in place, bank loans do not seem to be a viable financing option for the SMEs, at least at present.

4.2. Venture Capital and Private Equity Funds

Until very recently, venture capital in China was still a state-controlled business. The Chinese Government has adopted a series of policies to encourage the private development of the venture capital industry. Since the mid-1990s, many government-sponsored venture capital funds have been established to provide financial support for SMEs at the national, provincial and local levels. International foreign private equity funds can now invest in Chinese domestic businesses either through the establishment of a new venture-capital backed company or by investing directly in an existing Chinese enterprise.

Private equity participants in China spent US\$4.03bn on acquisition and investment in late March 2006, compared with US\$2.06bn for all of 2005.⁵⁶¹ Investments using venture capital, both domestic and foreign, amounted to over US\$1.07bn in small private, technology enterprises

⁵⁶¹ Geiger, Keri, 2006, "CLSA taps Asian private-equity flow," *The Wall Street Journal*, 22 March, p.B3. Hong, Qihua, 2006, "Trading volume of SUAEE exceeded RMB 400 billion in 2005," *Diyi caijingribao*, 20 January, p.4. (In Chinese)

in 2005.⁵⁶² This trend of venture and private equity capital flows into China is encouraging, and it indicates a huge potential for SMEs seeking financing. It will hopefully serve as a catalyst for accelerating the development of a more dynamic, efficient capital market for the SMEs.

4.3. Stock Market

In most countries, the capital markets represent the most important external source of financing for enterprises that need capital in the long run. Mehta and Fung⁵⁶³ suggest that the capital market of a country is important because it facilitates the efficient allocation of resources and provides an important mechanism whereby signals reflecting underlying information can be assessed by enterprises and investors. This is consistent with the view that financial development helps economic development, as we discussed earlier. Given that equity capital is more appropriate than debt for most SMEs, which are young, growing enterprises, we limit our discussion to the stock market.

It is not that China needs a second board or a Growth Enterprise Market (GEM) because the main board of the stock market cannot do its job in raising capital for SMEs. What it needs is a stock market through which SMEs can raise capital much easier and in a more expeditious manner: SMEs generally do not need to receive Central Government approval to list on China's domestic stock exchanges. The establishment of the second board has been postponed without a definite timetable because the main board has not been doing well. The concern has been whether the SME sector would drag down its main board because of excessive risk perceived by investors but favored by speculators. The issue facing China is whether China is able to curtail the excessive speculation in the stock market. It appears that China is willing to trade off the need for the growth of SMEs for stability on the main board. This policy stance is consistent with the lesson learned from currency crises that occurred in Latin American and Asian countries: sudden financial liberalization might create instabilities when the underlying institutional structure or economy contains serious weakness.

Given the growth opportunity faced by the SMEs in light of the WTO agreement and the continuing trend of the globalization of trade, the lack of financing for the SMEs would significantly impact the country economically, socially and politically. Needless to say, the slow

⁵⁶² Buckman Rebecca, "VC firm makes moves into China," **The Wall Street Journal**, 15 February, p.5. Burstein, Daniel, 2000. "Dragon equity: Thoughts on the role and future of private equity in China," in Rick Lake and Ronake A. Lake, eds, *Private Equity and Venture Capital: A Practical Guide for Investors and Practitioners*, London: Euromoney Books (2006), pp. 37-4

⁵⁶³ Mehta, Dileep R. and Hung-gay Fung, *International Bank Management*, (2004) London: Blackwell Publishing.

growth in financial development will hamper the growth in economic development that China has been diligently working on for the last 2 decades. There has been plenty of evidence that financial development contributes importantly to economic development.⁵⁶⁴

Since the establishment of the stock exchange in the early 1990s, SMEs have been trying to gain access to the market for capital. Fung and Liu⁵⁶⁵ point out that China's SME market development tracked the performance of the "NASDAQ market"* in the USA in the late 1990s and early 2000s. It started in March 1998: inspired by the remarkable success of the NASDAQ in raising capital for high-technology firms in the USA, the China National Democratic Construction Association (CNDCA), a small domestic political party, proposed to the government that enacted policies encouraging the development of the venture capital industry and related financing sources for the high-technology industries, including a NASDAQ-type stock market. By the end of that year, the State Council asked the Chinese Securities Regulatory Commission (CSRC) to research and to provide suggestions on the establishment of a SME stock market. By March 1999, a number of government agencies and the Guangdong provincial government had provided advice to the CSRC, including proposed implementation schemes submitted by the Shenzhen Stock Exchange. Support from high-level officials gave the impression that a SME stock market would soon become a reality.

It took almost a year for the Standing Committee of the People's Congress to specifically remove the stringent listing requirements to give way for high-technology corporations. In April 2000, the CSRC submitted a proposal on the establishment of a "second board" and the listing requirements, stock circulation, and risk control measures. That proposal was approved by the State Council within 1 month and the "second board", the Growth Enterprise Board (GEB), was born.

While the preparation for the establishment of the GEB was underway in earnest, the US stock market started to experience jitters. Some other regional growth-oriented stock markets

⁵⁶⁴ Beim, David O. and Charles W. Calomiris, **Emerging Financial Markets**, (2001), Boston: McGraw Hill-Irwin.

⁵⁶⁵ Fung, Hung-gay and Qingfeng Liu, 2006, "China's financial reform in banking and securities markets," in Hung-gay Fung, Changhong Pei and Kevin Zhang, eds, **China and the Challenge of Globalization: The Impact of WTO Membership**, New York: M. E. Sharpe, pp.145-63.

* NASDAQ (originally an acronym for National Association of Securities Dealers Automated Quotations system) is an American electronic stock market. It was founded in 1971 by the National Association of Securities Dealers (NASD), who divested it in a series of sales in 2000 and 2001. It is owned and operated by The NASDAQ Stock Market, Inc. (NASDAQ: NDAQ) the stock of which was listed on its own stock exchange in 2002. NASDAQ is the largest electronic screen-based equity securities market in the United States. With approximately 3,200 companies, it lists more companies and, on average, trades more shares per day than any other U.S. market. The current chief executive officer is Robert Greifeld. <http://en.wikipedia.org/wiki/NASDAQ>

experienced similar crashes during the same period, exposing the risks of excessively relaxing listing and information release requirements, and having too many listed firms concentrated in a few industries. These events raised concerns among the top Chinese Government officials and considerably slowed down the development of GEB. The plan was eventually shelved after the US technology bubble burst in October 2002. The former Chinese Premier Zhu Rongji made some revealing remarks during this period that China's stock markets should learn from the lessons of Hong Kong and other financial markets, and that the conditions for setting up such a board were found to be "immature".

It might be coincidental that the government's interest in the GEB increased again when the NASDAQ began to recover in 2003. In November 2003, CSRC Chairman Shang Fulin stated that the GEB should be developed in multiple steps, with the first step on a "SME board" to accumulate experience. In January 2004, the State Council promulgated the Several Opinions on Promoting the Reform, Opening, and Stable Development of the Capital Market, widely known among investors as the Nine Opinions, which stressed the need to use a multiple-step approach to developing the GEB and establishing a multi-level stock market where SMEs can seek funds. On 17 May 2004, approved by the State Council, the CSRC issued the Implementation Scheme of the Establishment of the Small and Medium Enterprise Block on Shenzhen Stock Exchange (it is often called the Implementation Scheme). Ten days later, the SMEB was formally launched. Although the SMEB was different from the GEB in many ways, it was regarded as a step forward in the development of the GEB. The CSRC, however, insisted that the SMEB was a component of the main board, enabling high-growth and high-technology enterprises to have their stocks listed.⁵⁶⁷

As of December 2005, 50 enterprises had been approved to go public and be listed on the SMEB. Approximately 80 percent of them are privately-held and the remainders are state-owned. Most newly-listed enterprises are from traditional industries like pharmacy, utilities, appliances, machines, while only a few are information technology companies (e.g. dotcoms), as a result of the same stringent listing requirements as on the main board. All of them have completed the state share reform (i.e. their non-tradable shares have been converted to tradable shares).

The SMEB has experienced early success measured by the performance of the SMEB index. On 1 December 2005, the SMEB was 43.9 percent higher than the base date of 7 June

⁵⁶⁷ Zhang, Yujun, 2005, *The New Shenzhen Stock Exchange*, Beijing: China Finance Press. (In Chinese)

2005.⁵⁶⁸ The percentage price increase for the SME board is remarkably large as compared to the 4.25 percent increase for the main board in Shenzhen and 6.63 percent for the shares listed in Shanghai during the same period.⁵⁶⁹ This reflects the high expectations of investors for the SMEB as well as the potential for the SMEs to raise capital.⁵⁷⁰ At least for the short period that it has been in existence, the SMEB seems to be able to attract investors and if that is sustainable this may present a viable conduit for SMEs to raise capital.

5. Conclusion

SMEs play a significant role in promoting fast and healthy economic and social development. In retrospect of the development of SMEs in China, it is well recognized that the subjective initiative of SMEs should be brought into full play to boost their internal driving force for development on the one hand, and the laws of the market economy should be respected and the institutional barriers hindering the growth of the SMEs should be removed to create an enabling external environment for the common development of all enterprises of varied ownership on the other hand. The following are experiences obtained from the past two decades' practices implemented by the Chinese government.

The economic laws and the fundamental role of the market in allocating resources should be respected to guide SMEs to a sound track of industrial development. One important reason for Chinese SMEs to score such a great achievement since the reform and opening-up was launched lies in the right strategy that encouraged SMEs to develop in accordance with their unique nature, instead of following the outdated practices of coercing SMEs to concentrate on heavy industry. SMEs are blessed with such unique nature as small investment, fast yield, flexible operation and quick adaptability to market changes. They can only achieve robust development when the government can abide by the objective laws of the market economy, bring the role of the market in allocating resources into full play, consider the development needs of SMEs and guide them to the sound track centering on the light and tertiary industries.

The self-operation status of SMEs should be fully respected, so as to facilitate the establishment of a sound mechanism of self-investment and self-development of SMEs. The fast development of SMEs, especially private ones, has become the most dynamic facet of the

⁵⁶⁸ The SMEB index was compiled by using Laspeyres' concept of a weighted arithmetic average and all the outstanding shares of the 50 component stocks with a base value of 1000.

⁵⁶⁹ The main board's growth rate is calculated by using the Shenzhen Composite Stock Index and the Shanghai Composite Stock Index. <http://info.chinanasdaq.com>, 1 December 2005.

⁵⁷⁰ The great performance might also be attributable to the revaluation of shares as a result of the resolving of the non-tradable-share hangover problem.

Chinese economy, in some areas, private SMEs have become the backbone of the local economy. This should be attributable to the relaxed environment provided by the government to SMEs in the process of reform, opening up and the improvement of the market economy. Meanwhile, the role of SMEs as major players in the market has been brought into full play. They adapt themselves to the requirements of the market economy and adjust their development strategy and industrial structure to formulate a healthy mechanism of self-governance, self-determination and self-development, thus boosting their development initiative and dynamism. This is the overriding reason for the rapid growth of China's SMEs, the private ones in particular, since the reform and opening-up program was started.

It is imperative to encourage SMEs to optimize industrial structure and enhance their competitiveness. Chinese SMEs have gained an amazing expansion in terms of number and scale. A group of SMEs have stood out and some of them have even grown into large enterprises or conglomerates. For example, Haier Group, Lenovo Group Ltd (formerly known as Legend Group Ltd), UFSOFT Co. Ltd and Wanxiang Group Corp. were all SMEs at the beginning, and now become internationally well-known large enterprises. On the whole, however, most of SMEs still hang around at a low level of development. One important reason is that Chinese SMEs have a short period of development and still pursue the extensive mode of growth. Therefore, their management philosophy, style, industrial structure and product mix do not meet the demands of market competition. It is still a demanding issue confronting SMEs as to how to meet the requirements of the market reform, enhance industrial structure and transform the extensive business mode into an intensive one. Therefore, it is a fundamental way for SMEs to adapt themselves to the WTO requirements and market competition by strengthening institutional capacity in management, technology and personnel training, enhance overall qualification and build up vitality and competitiveness. This is important experience summed up from the rapid development of SMEs since the reform and opening-up.

It is important to properly handle the relations between the government and enterprises and bring the role of the government in macro control into the full play so as to create a fair competitive environment for SMEs. Neither private nor state-owned SMEs can develop without government support. SMEs are often in an unfavorable position in market competition, have difficulties in competing with large enterprises and remain vulnerable to market risks, which result from their nature of business, i.e. small size and weak capacity. Taking into account both the nature and important role of SMEs in the economic and social development, the Chinese government has transformed its functions in line with the requirements of the market economy

and improved its way to support SMEs. While facilitating the strategic restructuring of the economy and implementing the strategy of nurturing large enterprises and conglomerates, the Chinese government has issued policies to relax control over SMEs and adopted various effective methods, with the ownership reform as the focus, to accelerate the reform of state-owned SMEs. Evidence has proven that the vitality and competitiveness of SMEs and the comprehensive and coordinative social and economic development can be enhanced, only if the government adopts appropriate economic policies that are in line with the nature of SMEs, properly handle its relations with enterprises, exercise macro controls of appropriate intensity and timing, and create a more fair, open and enabling external environment for enterprises of varied ownership.

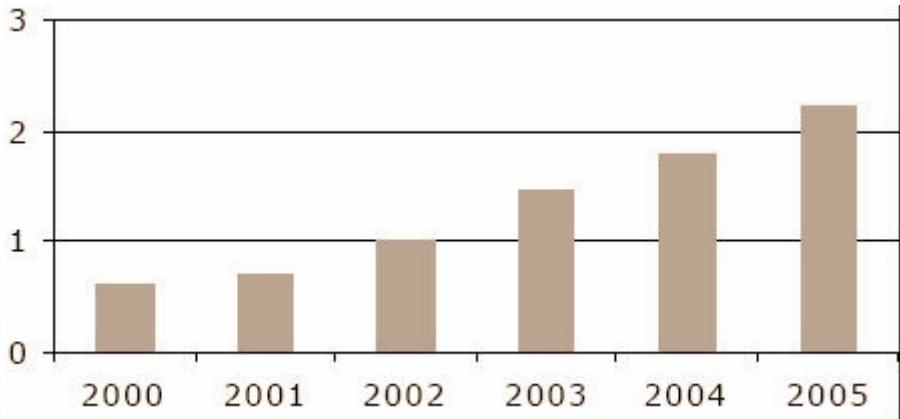
C. SECTORAL ANALYSIS OF INDUSTRIES OF CHINA

1. Auto Industry

Automobile industry is one of the emerging sectors in China economy. So the China government focuses more on its expansion both in domestic and overseas market. China’s entry into the WTO opens the fabulous business opportunities for foreign companies in automobile industry. A few of the reasons behind the growth of passenger vehicle in China include easy availability of auto loans, increased purchasing power & changing consumer preferences, automotive consumption policy and Chinese government’s expansive road infrastructure plans.

The rise in domestic demand and decline in prices of steel were the key factors attributing to the growth. China will reduce its tariff on complete automobiles to an average rate of 25%.⁵⁷¹ The booming automobile industry and increasing demand from the local market reflect foreign players have great chance to score more in China market.

Figure 9: Automobile Production in China⁵⁷²



Source: Cygnus Research *

During the period of Jan-Oct 2006, the China’s automobile industry witnesses the upward trend both in production and sales. During the period the auto industry manufactures 5.89m units of vehicles a growth of 27.56% Year over Year (YoY), while sales gone up by 25.69% YoY to

⁵⁷¹ China Industry Monitor: Automotive, Cyngus Bussiness Consulting & Research Knowledge Partner For Profitable Growth, Vol. 612, December 2006 - www.cygnusindia.com

⁵⁷² Ibid.

* CYGNUS BUSINESS CONSULTING AND RESEARCH is world class knowledge services organisation focusing on analysis and research of Economies, Industries and Companies. Solutions and services offered by the company span the entire value chain of information, analysis and research. Cygnus Business Consulting and Research has built competencies in consulting and business research. A comprehensive suite of business intelligence products serve as a foundation for customized research and consulting projects. The company has a talented and motivated team of over 70 professionally qualified and experienced employees who are strongly committed to upholding the highest standards of research integrity and cutting edge analysis. We leverage the industry domain experience of the team along with the deep knowledge and skills in finance and business research across various sectors and sub-sectors, to produce an insightful analysis and research.

5.77m units. For the month of Oct'06, the auto industry manufacture 588,000units of vehicles and managed to sales 576,300units of vehicles, a growth of 41.43% and 27.55% YoY respectively. The vehicle sales of the 10 auto makers came to 4.844m from Jan-Oct 2006. This accounted for 84% of the country's total. The country's own brand sedans enjoyed robust business in Jan-Oct2006 with sales totaling 3.04m units a growth of 39.96% YoY.⁵⁷³

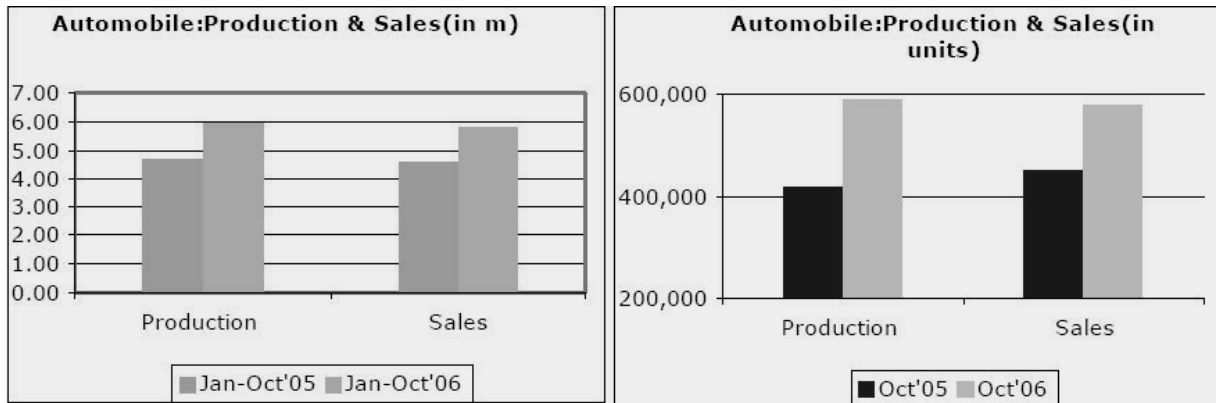
China's demand for automotive components has grown at a fast pace in the past decade. In the next five years, both production and demand will continue to grow. The rapid growth of China's automotive industry has led to the development of significant automotive parts. The Chinese auto parts industry is largely focused around the Yangtze River Delta, which accounted for 42% of total production in the country.⁵⁷⁴ To become a leading center for auto parts production, it is vital to rectify these weaknesses by developing more sophisticated production techniques. The country shall make products that are higher up the value chain (for example electronic fuel injection systems, airbags, central-locking systems and on-board Global Positioning).China Automotive is growing with increase of both domestic and international customer base. Moreover the innovative products and advanced technology drive the growth. The company plans to sign of a joint venture agreement with Sensor System Solutions, Inc. in the end of the year to produce sensors for the automotive market. The growing strong demand in China with initial annual output of 4.5m sensors and estimated net sales of US\$40m.⁵⁷⁵ This technology also complements and is becoming an increasingly important component of electronic control systems. Electronic-controlled power steering systems represent a significant new market opportunity for China Automotive. These systems are attractive for a variety of reasons. These are lower vehicle fuel consumption and environmental friendly over hydraulic platforms. CAAS is focusing in the development of automotive electronic-controlled power systems in cooperation with Tsinghua University, a world-renowned engineering institution in China.

⁵⁷³ Ibid.

⁵⁷⁴ **China Industry Monitor:** Automotive, Cyngus Bussiness Consulting & Research Knowledge Partner For Profitable Growth, Vol. 701, January 2007 - www.cygnusindia.com

⁵⁷⁵ Ibid.

Figure 10: Automobile Production & Sales in China⁵⁷⁶



After China joins the WTO, the domestic auto industry is facing great challenges from the outside, so the industry is at a crucial historic moment. As globalization is an irreversible trend in the development of the auto industry, China's auto industry will unavoidably be driven into this trend, whether China joins the WTO or not. Faced with globalization, China's automobile sector has weaknesses such as small scale, irrational allocation, and low efficiency. At the same time, the global auto industry is shifting to developing countries in the process of globalization. "That means globalization not only brings about challenges, but also provides opportunities for China. The ideal partner for China's auto industry would be large multinational enterprises that are not only willing to set up research centers in China, but also intend to build large-scale production bases.

The Chery Automobile Co. Ltd., China's, plans its initial public offering (IPO) in 2008, possibly choosing both the mainland A-share market and the Hong Kong market. Chery, which was established nine years ago in eastern China's Anhui Province, is now one of the few successful auto companies in China producing cars with Chinese brands.⁵⁷⁷ Unlike many joint ventures in the Chinese auto industry that depend on foreign technology and sell home-made cars with overseas brands, Chery relies with its own research and development to turn out products with proprietary intellectual property right (IPR). The company will establish 10 joint ventures across China to produce automotive interiors and two technology centers in Changchun of Jilin Province and Shanghai. It has a dominant position in the Chinese market for car seats. Chery will acquire technical know-how from the American company in order to improve its auto parts supply system and make its vehicles more competitive in international markets.

⁵⁷⁶ China, Association of Automobile Industry.

⁵⁷⁷ **China Industry Monitor**: Automotive, Cyngus Bussiness Consulting & Research Knowledge Partner For Profitable Growth, Vol. 612, February 2007 - www.cygnusindia.com

Luxury car sales are growing rapidly in China. The country accounts 20% of the luxury car market in the world. Thus luxury auto manufacturing company has lots of potential in China's auto market. The newly wealthy social group in China wanted to demonstrate their success, offering an enormous potential market for luxury cars. By 2040 and perhaps much sooner, China may have a more gross domestic product than the United States, making it the world's No. 1 economy. It now ranks at No 3. As the Chinese people's standards of living improved, they became more selective in purchasing cars.⁵⁷⁸

Daimler Chrysler (China) Corporation Ltd was established in Beijing. The company is responsible for the coordination and development of cars and commercial vehicles in the Special Administrative Region of Mainland China. Their vehicle brands include Mercedes-Benz, Maybach, Smart, Jeep, Chrysler, tournament week, and so on. Daimler Chrysler (China) Co, Ltd is also responsible for the existing joint ventures, automobile financial institutions and the development of DaimlerChrysler Services Group.⁵⁷⁹

In the view of China's auto market, DaimlerChrysler is expanding its production and sales of cars and commercial vehicles. DaimlerChrysler's joint venture in Beijing Benz-DaimlerChrysler Automotive Co. officially opened a new factory in Beijing to enhance the production capacity in the country. The new plant will begin producing Mercedes-Benz C-class and the Chrysler 300C. The company is planning to launch new models to attract the upcoming customers in China.⁵⁸⁰

Primarily due to lower net sales, Brilliance Auto has good long term prospects and growth potential. The company has good strategic alliances with global major BMW, Porsche and Mitsubishi, which will help them in the long run. The impact of policy measures and the ever intensifying domestic competition is sure to be there in the coming days. However, if the company can increase its sales volume (possibly with the help of exports), it will definitely improve its profit. The country's top 10 vehicle sellers in the 10-month period this year are: Shanghai Automobile Industry Corporation, FAW Volkswagen, Dongfeng, Beijing Hyundai, Chang'an, Guangzhou Honda, Chery, Harbin Hafei, Shenyang-based Brilliance and Geely.⁵⁸¹

⁵⁷⁸ Harry Harding, *The Debate over America's Policy toward China, 1989-97*, The George Washington University, in Wang Gungwu, John Wong: **China's Political Economy**, Singapore University Press, World Scientific, p.279.

⁵⁷⁹ <http://www.daimlerchrysler.com/>

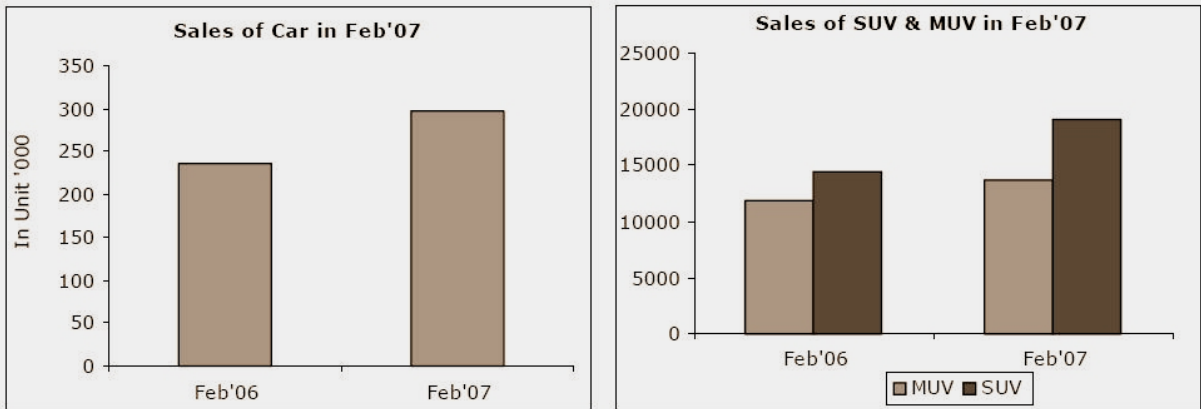
⁵⁸⁰ Ibid.

⁵⁸¹ Nolan, P., **China and the Global Economy: National Champions, Industrial Policy and the Big Business Revolution**, (2001), NewYork Basingstoke: Palgrave, p.57.

Encouraged by stronger than expected performance in 2006, the company is expected to raise its 2007 sales goal by 20%. The group, which operates a joint venture with German carmaker BMW through its listed arm, plans to move 300,000 vehicles in 2007. The figure is up from its previous sales target of 250,000 units announced in early 2006. Based in north-eastern Chinese city of Shenyang, the company expects to report 45 billion Yuan in 2007 sales revenue, a jump of 41% from 2006. Its sales ranked it as the ninth-biggest automaker. Brilliance Automotive Group aims to sell 35,000 vehicles abroad in 2007, up from 6,500 units in 2006. The group in November agreed with a German car trader to ship a total of 158,000 own-brand sedans to Europe by 2011, the biggest overseas sales deal won by a Chinese automaker so far. The company also started assembling its own brand sedans in Egypt 2006 with a local partner.⁵⁸²

According to the China Automobile Industry Association, during January-February 2007, sales of Chinese cars went up to 712,200 units (excluding imports), a growth of 33% over the same period in 2006. The top ten sellers were Santana, Buick Excelle, Jetta, Charade (Xiali), Camry, Hundai Elantra, Family, QQ, Accord and Passat Lingyu. The leading ten carmakers in terms of sales during February 2007 were Shanghai GM, Shanghai VW, FAW VW, Chery, Beijing Hundai, Geely, Guangzhou Honda, Tianjin FAW, Dongfeng Peugeot Citroen and Dongfeng Nissan. Due to the weeklong Chinese Lunar New Year holiday and the fact that February is the shortest month, motor vehicle sales in the 28-day period were down on the January figures, despite a YoY growth.

Figure 11: Sales of Car & SUV & MUV in February 2007⁵⁸³



⁵⁸² **China Industry Monitor:** Automotive, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 612, February 2007 - www.cygnusindia.com, also available in Cygnus Research.

⁵⁸³ Chinese Automobile Manufacturers Association International, <http://www.china786.com/auto/>

According to the China Automobile Industry Association, in February 2007, 297,800 units of cars were sold. It was a growth of 25.86% compared with figures a year earlier, but down 28.16% from the previous month of 2007. The sales of Multi-purpose Vehicles (MPVs) stood at 13,700 units, a growth of 14.7% YoY. However, the sales of Sport Utility Vehicles (SUVs) were 19,200 units, a growth of 32.7% YoY.

2. Steel Industry

China's steel exports saw blistering growth in the first three quarters of this year. The nation exported 28.59m tonnes of steel products in the first three quarters, rocketing 81% from a year earlier. The rapid growth was mainly the result of strong global demand for steel products and much higher prices in the international steel market than in the domestic market. However it is expected to go down to normal levels due to the shrinking gap between steel prices at home and abroad as well as China's recent measures to control steel exports. To control steel exports, China slashed the tax rebate for steel shipments to the overseas market from 11% to 8%. The nation imposed a 10% tariff on exports of billets, pig iron and ferroalloy. In contrast to the sharp growth in steel exports, China's imports of steel products tumbled by 29% year on year to 14.14m tones from January to September 2006.

The ongoing internal consolidation of China's steel sector is facilitated by the Chinese Government's policy on the steel sector, including reduction of export value-added tax refunds, and its iron ore import license system. Internal consolidation would also remove China's inefficient capacity utilization and lower its demand for iron ore. In 2004, China's top 10 steel makers accounted for 34.7% of the domestic market. The ratio dipped in 2005 to around 33%, despite government efforts to lift it. As consolidation accelerates, Chinese steel makers would become stronger and able to acquire overseas competitors. Baosteel Group, China's top steel maker, will be a major player in steel acquisitions.⁵⁸⁴

The share prices on China's Shanghai and Shenzhen stock exchanges reached a five-year high driven by steel and metallurgical stocks. The two bourses recorded a total turnover of 42.8 billion Yuan. The rally was led by steel and metallurgical stocks with the Shanghai-based Baosteel registering a 10% rise in its stock price. China can expect to see imported iron ore prices leveling off next year as steel production remains stable and iron ore output grows steadily. Iron ore imports stood at 247m tones for the first nine months, up 24.2% over the same

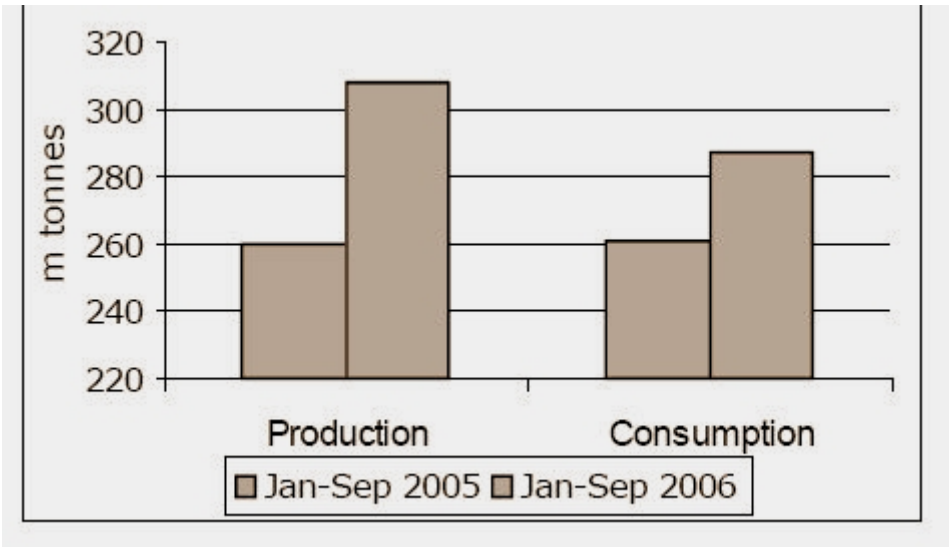
⁵⁸⁴ http://www.baosteel.com/group_e/indexe_n.html

period last year, but 7% points lower than the pace at the same time last year. China produced 406m tones of crude iron ore in the first nine months, up 37.7% year on year.⁵⁸⁵

Profits of China’s steel companies may rise next year as metal prices rise again, driven by increasing exports and domestic demand. Export orders will increase as production cuts in the US and the European Union help to stabilize international prices. Producers in the US are cutting an aggregate 4% of the nation’s output of flat steel, or the sheets and coil used in cars and appliances. China’s steel prices may increase by 5% next year and by a further 2% in 2008. China’s growth in steel demand is likely to outstrip the increase in supply in 2007. The nation’s steel demand will expand as much as 14% in each of the next two years, as compared to a 9% rise in crude steel capacity in both 2007 and 2008.

China’s economy has grown an average 9.5% in the past year; and is likely to require more of steel for equipment, buildings and transport facilities. The Chinese steel consumption reached 287m tones in the first nine months of 2006 up 28.7m tones, an increase of 10% over the same period last year. The production in the first nine months of the year registered 308.43m tones of steel production an 18.4% growth over the corresponding period last year. The supply growth of 18.5% is proportionately higher than the demand growth of 10%. This has led to stabilization in steel prices.⁵⁸⁶

Figure 12: Production & Consumption of Steel January – September 2006⁵⁸⁷



⁵⁸⁵ Nolan, P., China and the Global Economy, p.57

⁵⁸⁶ **China Industry Monitor:** Steel, Cyngus Bussiness Consulting & Research Knowledge Partner For Profitable Growth, Vol. 612, December (2006)

⁵⁸⁷ Cyngus Research, December 2006.

The growth in production is relatively higher than the growth in consumption pattern in China. This has helped in stabilizing the domestic prices of the steel. The prices of domestic steel products remained stable throughout the month of September registering only a minor rise in the prices of all the products. International steel prices were higher than the domestic market's by US\$100 to US\$150 per tone on an average by the end of September 2006. China's steel prices may increase by 5% next year and by a further 2% in 2008. The profits in the Chinese steel industry are expected to rise again as the metal prices stabilize due to increased exports. The profits of steel companies for the month of September rose by 5.9% after declining by 2.5% in August 06.

Chinese government slashed the tax rebate for steel shipments to the overseas market from 11% to 8% in September 06 in order to control steel exports. Despite the slash in tax rebate the steel exports saw steady growth in the first three quarters of 2006. The nation exported 28.59m tones of steel products in the first three quarters, rocketing 81% from a year earlier. In September China exported 4.11m tones of finished steel a growth of 4.4% over the previous month. In contrast to the steady growth in steel exports, China's imports of steel products tumbled by 29.3% to 14.14m tones from January to September 2006, as compared to the corresponding period last year. Imports of finished steel in September dropped to 1.4m tones, a fall of 28% over the imports in September 2005.

In the first three quarters of 2006, China's iron ore output jumped by 37.7% to 405.82m tones. In spite of the rise in iron ore production the iron ore imports climbed by 24.2% to 247.13m tones from January to September 2006. This growth in imports could be attributed to the growing production of steel in the country and the deteriorating quality of the iron ore produced in the country. The iron ore prices in the country are also higher than the international prices because of the higher mining cost in the country. The iron ore capex/tone for China is estimated in the range of US\$75 to US\$115 per tone, where as the western world average is around US\$54 per tone. The world iron ore market is still dominated by the three major producers (CVRD*, Rio Tinto*, BHP*), and they will be in a stronger position during the annual

* Companhia Vale do Rio Doce (CVRD) is a global diversified mining company, the second biggest mining company in the world, and the largest logistics operator in Brazil. Founded in 1942 in Itabira as a public company, it became the leader in production and exportation of iron ore and pellets (in a process called pelletizing). The company's privatization was completed in 2002. CVRD is also a world-class producer of nickel, manganese, ferroalloys, copper concentrate, bauxite, potash, kaolin, alumina and aluminum. In 2006, CVRD acquired Canada's second largest mining company, Inco Ltd., in an all-cash offer. This purchase was the largest acquisition ever made by a Brazilian company. The deal was approved in principle by the Canadian government's investment review board on October 19, and accepted by Inco shareholders on October 23. CVRD has indicated that it would keep Inco open as its nickel mining division, with its head office to remain in Canada; the Inco division will also assume responsibility for CVRD's existing nickel mining projects in

supply contracts. The Chinese steel industry thus, will have to still rely on the world market for its iron ore requirements.⁵⁸⁸

Steel production is likely to continue to grow at the rate of 12% till 2010 and then at a decreasing rate. This in turn will keep the demand for the iron ore growing. The domestic iron ore production is growing, but imports will still be flowing in due to the technical advantage. The imports of iron ore in 2006 is expected to cross 320m tones and to grow at a slow rate of 10% then on.⁵⁸⁹

The Chinese steel industry will face challenge to shift its reliance on domestic production from imports, mainly due to the quality of iron ore. It will also be difficult for the government to cut the steel production, as it may raise the unemployment level in the country. China is also facing dumping charges on account of offloading its steel production in the global market.

The imports of iron ore is witnessing a decline in the growth rate, but will continue to dominate the steel industry in short run as the consolidation, steel production cut and domestic iron ore will take time to affect the import trend. Switching to domestic iron ore would bring down expenses of the steel companies by one-third. In long run, these factors would help bring down the import prices and thus, increase the Chinese steel firm's profitability.

The steel exports for the first ten months have grown at a rate of 71%; the gap between the exports and imports has further widened. The net imports of almost 35m tones till October 2005 have been turned into net exports of 24m tones for the corresponding period in 2006. The exports of steel products reached a new high of 40m tones in October. The consumption on the other hand grew by only 4.59% in October06. The apparent consumption of steel for the first ten months reached 320m tones, a growth of 4.56%.

The steel exports for the first ten months have grown at a rate of 71%; the gap between the exports and imports has further widened. The net imports of almost 35m tones till October 2005 have been turned into net exports of 24m tones for the corresponding period in 2006. The exports

Brazil. In February 2007 Vale purchased the Australian coal mining company AMCI Holdings for 835 million Australian dollars. <http://en.wikipedia.org/wiki/CVRD> and http://en.wikipedia.org/wiki/Vale_do_Rio_Doce

* Rio Tinto is a multinational mining and resources group founded originally in 1873. The group is one of the world's largest mining companies, with a pre-tax profit of approximately 10.2 billion US dollars in 2006 on consolidated turnover of 25.4 billion USD. http://en.wikipedia.org/wiki/Rio_Tinto_Group

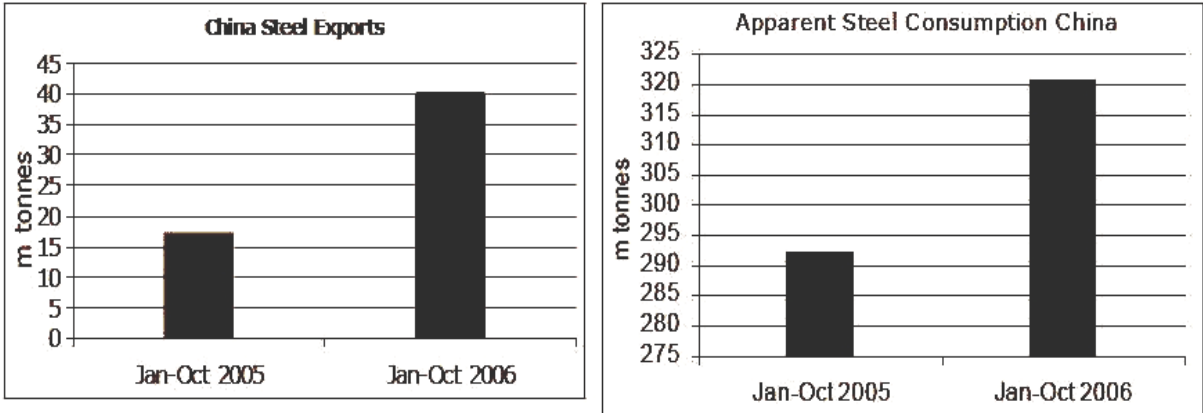
* BHP Billiton is the world's largest mining company. It was formed through the 2001 merger of the Broken Hill Proprietary Company (BHP), an Australian company, and Billiton, a British company with extensive operations in South Africa. <http://en.wikipedia.org/wiki/BHP>

⁵⁸⁸ China Industry Monitor: Steel, Ibid.

⁵⁸⁹ **China Industry Monitor**: Steel, Cyngus Bussiness Consulting & Research Knowledge Partner For Profitable Growth, Vol. 612, January (2007).

of steel products reached a new high of 40m tones in October. The consumption on the other hand grew by only 4.59% in October06. The apparent consumption of steel for the first ten months reached 320m tones, a growth of 4.56%.⁵⁹⁰

Figure 13: China Steel Exports and Consumption 2005 – 2006⁵⁹¹



China has consumed 375m tones of steel by the end of 2006. The Chinese steel production also has been growing rapidly, creating scope for further rise in exports with its steel products being in great demand. Though the government is trying hard to cut the steel production by 100m tones in its five year restructuring plan, it is not expected to create a supply crunch. The consolidation rounds and production cut would resolve the overproduction problem. Moreover, it would make China less reliable on iron ore imports. Chinese steel industry has positive prospects considering the production and iron ore import; situation will improve in wake of the current developments.

China’s steel production has grown by 18.03% to 412m tones in the year 2006 compared to the previous year. The growth rate has declined from 24.56% in previous year to 18.03%, in 2006; despite consumption, production and exports saw an upward trend. The effect on production was seen because of increase in international demand of Chinese steel, especially by US and domestic auto demand.

Exports from China have grown by 31.13% in 2006 to touch the figure of 43.01m tones along with imports, also up, but at a moderate rate of 24.06%, compared with the previous year. Though China consumed, approximately, 35% of the total world’s steel production at 230.02m tones, government checked the imports of steel from foreign countries. China exported mainly to US and European Union (EU25). China’s supply to EU25 grew with 330% from previous year.

⁵⁹⁰ China Industry Monitor: Steel,
⁵⁹¹ **China Steel Industry Monitor**, ISI Emerging Markets, A Euromoney Institutional Investor Company.

Figure 14: Steel Exports & Imports⁵⁹²



China produced 57.62m tones of iron-ore in December 2006 adding up to 463.31m tones in the year till date. China imported 325m tones of iron ore in 2006, a rise of 18.1% as compared to imports in 2005. The rules relating to iron-ore imports have tightened twice since 2005. Now, the importer would require registered capital of 20m Yuan (US\$2.56m), double of what was needed currently. That is expected not to affect the supply.⁵⁹³

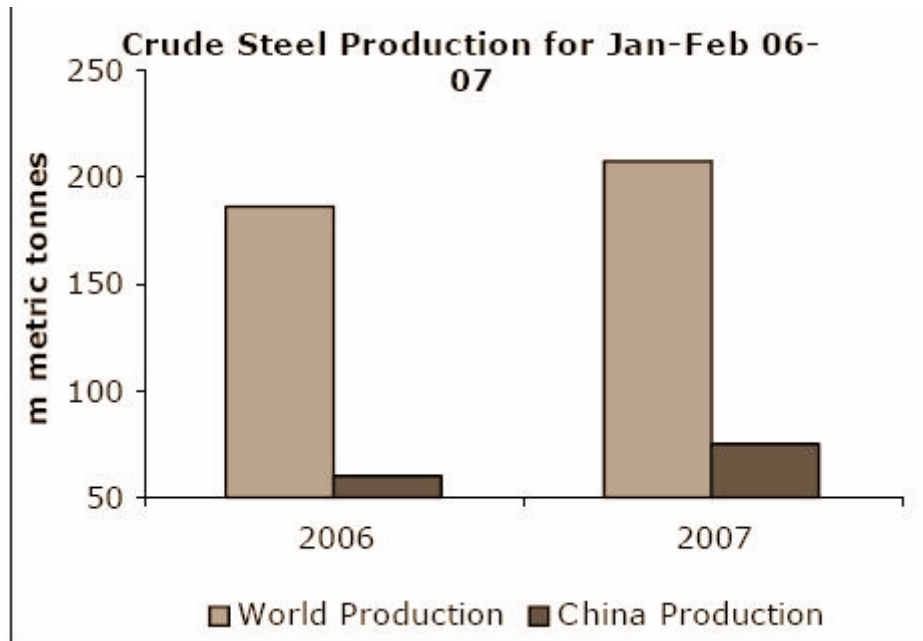
The world crude steel production during January-February 2007 was 206.9m metric tones, a growth of 11.105% over corresponding figures of 186.22m metric tones, the previous year. China's cumulative steel production during January-February 2007 was 74.5m metric tones, registering a growth of 23.71% as compared to the corresponding period in 2006. China contributed to 36% of the world steel production for the first two months of 2007.⁵⁹⁴

⁵⁹² National Bureau Statistics of China.

⁵⁹³ Ibid.

⁵⁹⁴ **China Industry Monitor**: Steel, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 704 April (2007).

Figure 15: Crude Steel Production⁵⁹⁵



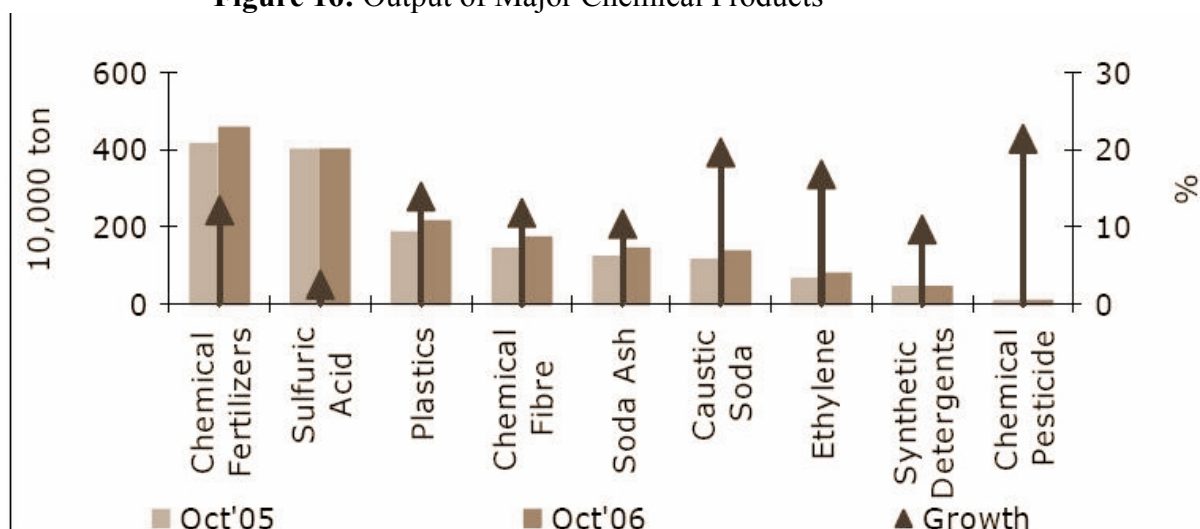
Finally, Chinese steel industry has grown rapidly over the past few years, surpassing the 400m tones mark in the current fiscal, 2006. In the process, it has turned into a net exporter from being the net importer. Over the years, the industry has also witnessed rising demand for its steel products from the automobile, construction, and shipping industry. The huge demand for the high-end steel products creates a ready market for the company products. As overseas steel demand is expected to rise for the sixth straight year in 2007, followed by increased domestic demand owing to economic growth and technological innovations by the company. These positive developments indicate that the company's present sustainable growth could continue for the coming years.

3. Chemicals Industry

From January to October 2006, the industrial enterprises (all state-owned enterprises and non-state enterprises with an annual sales income over 5m yuan,) achieved 1,469.7 billion yuan, a year on year rise of 30.1%. Within various branches of industry, the growth rate of petroleum & natural gas exploitation went up by 30.4%; that of chemical industry and fibre industry increased 17.6% and 14.6% respectively, while petroleum processing and coking industry had a continuous deficit of 46.2 billion yuan.

⁵⁹⁵ www.worldsteel.org

Figure 16: Output of Major Chemical Products⁵⁹⁶



In October 2006, production of major products showed an increasing trend over same period the last year. Chemical fertilizers recorded the highest production followed by sulphuric acid, plastics and chemical fiber in October 2006. The rise in the chemical fertilizers is attributed to the rise in bumper crop production during the first nine months of 2006. The fiber industry was growing rapidly due to growing demand. But the figures show that chemical pesticides have seen the fastest growth in terms of growth rate. The growth has been 21%; caustic soda surged by 20%, Chemical fertilizers have seen a surplus of 12%, Sulphuric acid 3%, Ethylene 17%, Chemical fibers 12% and Plastics 14%. On the other hand, Synthetic Detergents declined by 25% in October 2006 compared to October 2005.⁵⁹⁷

The rise in demand of chemical products is the main driver for the increasing imports of chemical products. China is facing the problem of increased domestic chemical consumption, which in turn is boosting the imports and affecting the international trade. There has been a significant rise in imports of chemical products in September 2006 as compared to September 2005.⁵⁹⁸ China must increase its production capacity to overcome the problem of domestic consumption, so that it can concentrate on exports to foreign nations.

For the period Jan-Oct 2006, the exports in terms of value of chemical products have increased by an impressive rate of 24% as compared to the corresponding period of previous year. Though the volume of imports is larger than that of exports, the increase in import worth during the Jan-Oct 2006 period touched a modest 9.3%, as compared to the corresponding period

⁵⁹⁶ **China Industry Monitor:** Chemicals, Cyngus Business Consulting & Research Knowledge Partner for Profitable Growth, Vol. 612, December (2006).

⁵⁹⁷ Ibid.

⁵⁹⁸ National Bureau of statistics of China, Cyngus Research

of previous year. Among the chemical products, the exports of caustic soda and plastics have risen significantly by 13.6% and 17% respectively, during the Jan-Oct 2006 period as compared to the corresponding period of previous year.

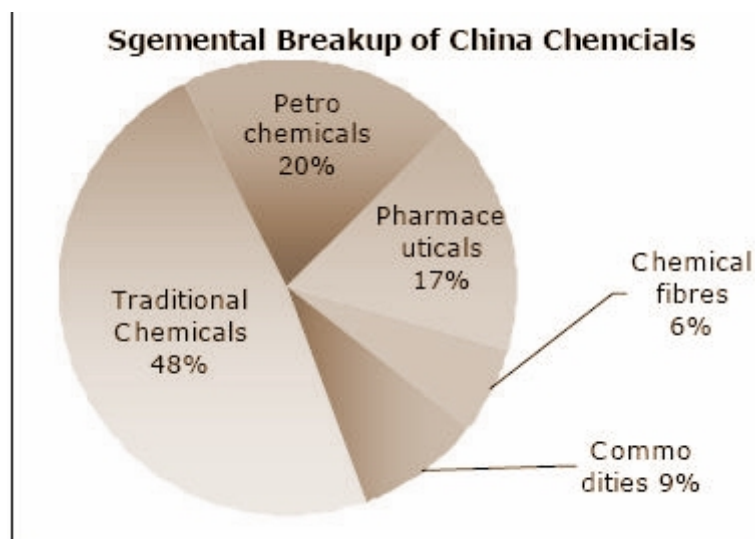
During October 2006, the total output of major chemical products has increased by nearly 12.4% as compared to the same period of previous year. The maximum increase in production has been witnessed in the chemical pesticides segment, with the increase being almost 40%. Other products like Caustic Soda, Plastic products, Ethylene and chemical Fibers have all achieved a good growth of over 18% in production.⁵⁹⁹

China's chemical industry accounts for an impressive 10% of GNP. The chemical industry in China is developing very fast. China's output of primary chemicals is quite high and rising from year to year, while its output and trade value are increasing steadily. The total production value of China's chemical industry is increasing at 8-9% per year. Sales in 2001 were worth a total of RMB60.3m, which was 8.64% more than that for 2006. Some US\$30 billion is invested in China's chemical industry every year, with foreign investment accounting for 55-60% of this amount. Imports and exports are also increasing fast, with imports totaling US\$32.75 billion – or 14% of the total – and exports US\$19.45 billion in 2001. Although these facts are impressive, there are still some problems to be solved.

Traditional chemicals based on coal, metal ores, salt and organic compounds, account for 48% of the total, followed by petrochemicals and natural gas (20%), pharmaceuticals (17%), chemical fibers (9%) and commodities (6%). The total production value of China's chemical industry is increasing at 8-9% per year. There are tens of thousands of chemical corporations in China, more than 10,000 of which are joint ventures. There are nearly 80 different chemical stocks on the market or 137 if petrochemicals and fibers are also included.

⁵⁹⁹ **China Industry Monitor:** Chemicals, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 612, January (2007).

Figure 17: Segmental Breakup of China Chemicals⁶⁰⁰



In the year 2006, the country faced many unfavorable factors such as the high price of raw materials, outdated technologies and saw a decreased export growth. Despite all the above unfavorable factors, the China Chemical Industry continued revaluation of RMB; chemical fiber industry accelerated technological progress and structural adjustments. In addition to the above, the industry also witnessed the lowered tax rebate rate of textile exports, which resulted in a healthy trade performance. Production and sales were relatively brisk; imports continued to decline, and export growth captured a high rate; industrial economic benefits increased significantly; the operating quality continuously improved and enterprises and industrial competitiveness enhanced. The exports of China's Chemical Industry has significantly grown from US\$324.25 to US\$402.4 by 24.1017%, while the imports of chemical industry has shown a growth of only 10.94%, which is very low when compared to the growth in exports.

The future of China Chemical industry shows a positive trend of development with a high concentration. The development will be seen throughout all the segments of Chemical industry such as fertilisers, including DAP and NPK composite fertiliser, natural gas, petrochemicals industry and ethylene. Efforts are being made to increase the output of ethylene to nine million tonnes per year and to increase China's ethylene self-sufficiency rate from 43% to about 60%. The Chinese government is encouraging foreign investment in large ethylene plant and many of these, such as Nanjing Yangzi/BASF (800,000 tonnes ethylene per year), Shanghai Petrochemical Company/BP (900,000 tonnes ethylene per year), and Huizhou National Offshore Oil Corp/Shell (600,000 tonnes ethylene per year) have already been built. A number of others,

⁶⁰⁰ www.dechema.de, Cygnus research

such as Fujian Petrochemical Company/Exxon, Tianjin Petrochemical Company/Dow, Lanzhou Petrochemical/Phillips, are still in the pipeline. These will increase production capacity, optimise product quality, enhance competitiveness, increase recycling rates and reduce costs.

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China's economy will continue to grow rapidly and demands for petroleum and petrochemical products will increase steadily, while international crude price is expected to remain high. In Chemicals Segment, the Company will focus on successful start-up of new facilities and maintain safe and stable operation of the existing facilities. The product mix will also be optimized, and the linkage between production and sales will be strengthened to produce more profitable products to meet robust demand so as to increase profitability. In addition, the Company will fully leverage the specialized operation of the newly established chemical sales company to improve its overall competitiveness. The Company will continue to adhere to the operation guidelines featuring "reform, adjustment, innovation and development" and aggressively, endeavoring to fulfill the annual production and operation targets, and maintain its good performance.

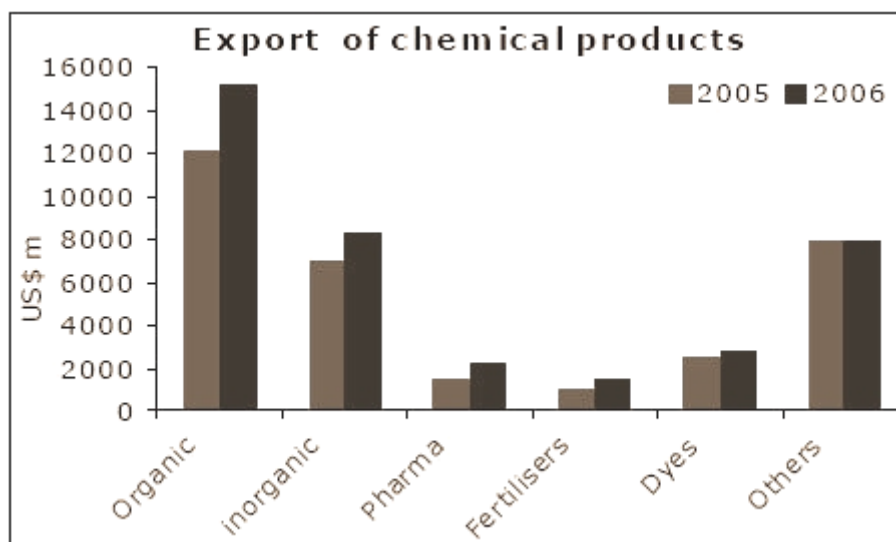
The chemical industry in China has a turn over of 166 billion euros. The country is now third in world rankings behind America and Japan. From January to October 2006, the industrial enterprises (all state owned and non-state enterprises with an annual turnover over 5m Yuan) achieved 1,469.7 billion Yuan, a year on year rise of 30%.⁶⁰² Within various branches of

⁶⁰¹ **China Industry Monitor:** Chemicals, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 612, February (2007).

⁶⁰² **China Industry Monitor:** Chemicals, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 704, April (2007).

industry, the growth rate of petroleum and Natural gas went up by 30%; that of chemical and fiber industry increased 17.6% and 14.6% respectively. The chemical industry in China continues to expand and foreign investment is a significant factor which is driving growth.

Figure 18: Export of Chemical Products⁶⁰³



Chemical industry grew at 18% and for the year 2006, exports in terms of value of chemical products increased by 24% as compared to the corresponding period of the previous year. However, China still imports large quantities of petrochemicals, polymers, fine chemicals, and special chemicals. The volume of imports is still larger than that of exports; the increase in import during January- November 2006 touched a high of 10% as compared to the corresponding period of previous year.

4. Pharma Industry

China's biogenics industry has experienced rapid expansion and will continue to have steady growth in future years and the production value is estimated to exceed US\$12.5 billion in 2015. The state and local governments are making efforts to fuel the expansion of the biogenic industry, while enhancing IP protection for both domestic and foreign biologics. The challenges for pharmaceutical companies include IP, complex distribution channels and pricing. It is a country with a large market potential to produce biogenics and will play a vital role in the world's biogenics market in the future

The pharmaceutical industry in China is likely to grow at a compound annual growth rate of 5-8% over the next five years.⁶⁰⁴ The rapid growth of the pharmaceutical market coupled with

⁶⁰³ China stats, Cygnus Research

rising standards in diagnosis and recovery rates continued to attract global pharmaceutical firms in investing heavily in Chinese companies. The company will implement the proactive approach which will enhance the top line of the company in five therapeutic areas for the second half ending 31 Mar'07. The adoption of the new technology from US and Europe in production of bulk material will drive the bottom-line of the company while exploring new markets in US, Europe and other developing countries.

The Chinese pharmaceutical industry has grown rapidly; it is still characterized by small-scale operations with a scattered geographical layout. There are more than 4,063 pharmaceutical enterprises, out of which 17.52% are large and medium-sized enterprises, and the remaining 82.48% are small-sized enterprises, according to the official statistical classification.⁶⁰⁵

Contract Research Organisation (CRO)-based chemistry and pharmacology companies are emerging in China. Most were founded by Western-trained Chinese scientists, who returned to develop their business models. These models involve value-creation, which can be driven by cost-efficiencies passed on to the partner, coupled with high quality and timely output. Overall, this approach has had mixed success as most CRO-based relationships are not motivated primarily by cost savings. The quality of the work and the timeliness of delivery drive long-term relationships CROs in China. These qualitative efforts are now striving to improve the services. Clearly, China will become an important player in local and global healthcare from both provider and utilisation perspectives.

China's pharmaceuticals sector is poised for significant growth, making it attractive for multinationals; it is also a complex and difficult market to penetrate, posing many challenges for multinational companies. A new series of market studies by Kline & Company explores these challenges and opportunities in China and other emerging national markets. According to estimates from the global specialty excipient market for oral solid-dosage-form pharmaceuticals, 2005-2015, the mature markets of the US and Western Europe are growing at 2.3% and 2.6%, respectively, while China's emerging market is growing at 8%.⁶⁰⁶

China Pharma Holdings completed private placement of approximately 2.5m shares of its common stock at the price of US\$1.70 per share. It also used its 2.5m Class A three-year warrants to purchase an aggregate of 1.25m shares of its common stock at a strike price of

⁶⁰⁴ **China Industry Monitor:** Pharmaceutical, Cyngus Bussiness Consulting & Research Knowledge Partner For Profitable Growth, Vol. 701 January (2007).

⁶⁰⁵ **China Industry Monitor:** Pharmaceutical, Cyngus Bussiness Consulting & Research Knowledge Partner For Profitable Growth, Vol. 703 March (2007).

⁶⁰⁶ **China Industry Monitor:** Pharmaceutical, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 702 February (2007).

US\$2.38 per share. The net proceeds to the company of approximately US\$3.85m will be used for development of new drugs in pipeline and working capital to support its growth. The transaction benefits both the customers and shareholders of China Pharma Holdings, by expediting the progress of new drug development programmes and strengthening the financial position.

The production licenses for nearly 170,000 medicines will be reviewed under strict quality examination procedures before they expire at the end of the year, according to the State Food and Drug Administration (SFDA). The campaign will begin in the second half of the year to re-examine drug companies who acquired a Good Manufacturing Practice (GMP) certificate for registering new medicines in 2004 and 2005.⁶⁰⁷ Drugs that fail the tests will be removed from the market. The SFDA carried out 35 unannounced inspections of drug manufacturer companies last September 2005 and stripped 15 companies of their GMP certificates. Analysts say a stricter re-registration system for existing drugs is expected to help eliminate shabby products from the market, improve the research and development capabilities of pharmaceutical companies and fuel mergers and acquisitions.

China will step up its battle against fake and dangerous drugs, deepening a probe into pharmaceutical production following a scandal involving a former senior safety official. Fake or bad drugs killed several people in China in recent years and raised questions about safety. Public fears grew in 2004, when at least 13 babies died⁶⁰⁸ of malnutrition in Anhui province after being fed fake milk powder with no nutritional value. Another consumer issue in China has been food safety. In recent years, everything from honey to eggs and carp have come under suspicion, often for containing potentially carcinogenic or toxic substances. The Ministry of Commerce said that a new food safety law is to come into effect on May 1, 2007 which mandates fine up to 30,000 yuan for violators.

China, being one of the largest drug markets around the world at the end of 2006, sales in the Chinese drug market reached US\$12 billion, an increase of 3.8 fold over 1998 level. China is expected to become the fifth largest drug market in the world by 2010 due to a series of factors – an increasingly ageing population, accelerating growth of urban population, expansion of healthcare covering urban and rural areas. These factors will help the drug market to grow at a rate of 20-25% per annum in next five years. By 2006, sales of imported drugs have shared one-

⁶⁰⁷ **China Industry Monitor:** Pharmaceutical, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 704 April (2007).

⁶⁰⁸ Ibid.

fifth of the Chinese drug market. As China joins the World Trade Organization (WTO) and integrates more completely into the global economy, it will further open the door to a lucrative drug market for overseas pharmaceutical companies.

The pharmaceutical industry growth in China is likely to be around 15–16% and the market size will reach USD\$15 billion US\$16 billion in 2007.⁶⁰⁹ The boom of CRS business in domestic and overseas market open unprecedented opportunities for the company. The improving service level and broadened international cooperation are likely to give a boost to the top line for the coming years. With CRS business growing at rapid growth rate coupled with excellent performance by Clinical Research Organizations in Asia, the company is riding high. The profit earning potential and market performance will continue to grow with introduction of new prescription products in several therapeutic fields into the domestic market in 2007.

5. Textile Industry

5.1 Outlook to the Textile Industry

According to recently published statistics, China's textile and apparel export recorded US\$107.775bn for the period of first nine months of year 2006. The exports witnessed about 9.3% growth over last years export for the same period. In terms of export destinations, the U.S. ranked first followed by Japan and Hong Kong. Textile exports to the U.S. reported at US\$15.99bn was up by 9.31% from the same period of last year. Where as textile exports to Japan and Hong Kong recorded at US\$14.723bn and US\$13.393bn respectively for the period Jan-Sept 2006.

As per the report published by China Textile Industry Association, country's yarn output reported at 13.888m tonnes by for the period of Jan-Oct 2006. This is an increase of 20.71% from the same period last year. While national total cotton cloth output grew by nearly 20% to record at 19.113bn meters for the period of Jan-Oct 2006.

According to the Customs statistics from the EU and the US, China's restricted textile exports to the US and the European Union have shown a seasonal rising trend, but overall clearance rate is lower. For the period of Jan-Oct 2006, the average clearance rate of textile export to the US in the 21 restricted categories was 37.36% where as the average clearing rate of textile exports to the EU in the 10 restricted categories was 46.52%.⁶¹⁰

⁶⁰⁹ Ibid.

⁶¹⁰ **China Industry Monitor:** Textiles, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 612 December (2006).

Worldwide, the home textiles sector demand is expected to grow at about 7%. According to survey by Mckinsey, the global trade in home textile is projected to be at US\$23 billion by the end of 2010.⁶¹¹ With a rise in high class hotels and growth in housing sector, the need for infrastructure, furnishings and decoratives is likely to grow too. Subsequently, the draperies segment of the home textiles is expected to grow on par with the growth of the hotel and infrastructure industry. The percentage numbers of companies that use capacity to highest level are less, which provides them with opportunity to grow laterally in the industry and the segment, leaving the chance for the technology upgradation.⁶¹² With the Chinese GDP growing at 10%, constantly supported by the world economy in various fashions by the rising population, housing infrastructure, and tourism sector requiring the beddings, upholstery and other home textiles, the Chinese home textiles is bound to touch the higher mark in the global share from present 38%, especially in the post quantitative restrictions era after 2008 by EU and USA.

The textile exports of China have increased by 24% for the first ten months of the calendar year 2006 over the same period last year touching US\$120 billion.⁶¹³ It pushed up the sales graph also. Also decreasing unemployment level in Hong Kong and rise in income of the people results in increasing purchasing power that created favorable climate for retail segment for the company.

China is making its presence felt in textiles exports world over. But it is a fact that their textiles industry growth is predominantly driven by domestic consumption as exports contribute a little over 30% of overall production. The lifestyle and dressing style of Chinese people are changing rapidly. The business attire consists of a well stitched business suit rather than traditional Chinese dress. Women are beginning to adopt western business formals. The changing tastes in way people dress can be noticed not in business circles only but also in daily wear segment. The traditional Chinese dresses are only reserved for traditional festivals, functions, special events or marriages. Even the dresses for factory workers have been adapted to western cultures like they have uniforms for floor workers now. The rising consumption patterns of Chinese people are fuelling the growth of domestic apparel market.

The market is led by women's wear segment followed by children's wear and men's wear. Thermal clothing is the smallest segment. The men's wear sector includes all garments made for

⁶¹¹ **China Industry Monitor:** Textiles, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 701 January (2007)

⁶¹² Doç. Dr. Mesut Hakkı Çaşın - Can Kiroğlu, IMF: Uluslararası Ekonomi Politğin Kurumsal Aktörüne Kritik Bir Bakış, **Yeni Ekonomi Politik, Stratejik Öngörü** Sayı 8, (January 2006)

⁶¹³ **China Industry Monitor:** Textiles, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 702 February (2007)

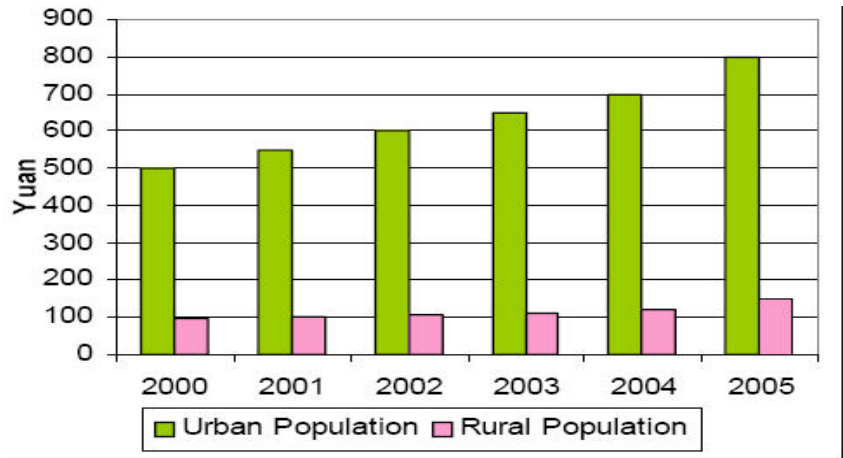
men and boys including both outer and under garments. The Women’s wear segment consists of all women’s and girls’ garments including dresses, suits and coats, jackets, tops, shirts, skirts, blouses, sweatshirts, sweaters, undergarments, lingerie etc. The children wear segment consists of garments for children between the ages of 0-10 years.

Figure 19: Percentage of different Segments in Total Sales⁶¹⁴

Segment	2003	2004	2005
Women’s Wear	25.9	26.6	28.6
Knitted Underwear	20.5	18.6	16.6
Children’s Wear	8.0	8.1	8.0
Casual Wear	7.8	8.4	7.5
Woolen Wear	7.9	7.2	6.9
Men’s Wear	7.0	6.6	5.8
Thermal Clothing	3.8	3.6	4.3
Trousers	4.1	3.6	3.5
Others	15.0	17.3	18.9

The rising per capita income of Chinese population is the major factor in driving the Apparel sector towards a growth path. The urban per capita income in first 9 months of 2006 increased by 10% over the same period in 2005, to reach US\$1120.67. The rural per capita income in first 9 months was US\$351.78 which increased by 11.4 % over the same period in previous year. The total per capita spending of Chinese on clothing is also showing an upward trend, the urban expenditure on clothing rose from 500 Yuan in 2000 to 801 Yuan in 2005, and the same figure for rural household increased from 96 Yuan in 2000 to 148 Yuan in 2005.

Figure 20: Per Capita Expenditure on Clothing⁶¹⁵



⁶¹⁴ China National Commercial Information Centre

⁶¹⁵ National Bureau of Statistics of PRC.

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As per the report published by China's textile machinery industry, the demand for textile machinery is expected to remain stable in future. The demand from both homes as well as from abroad is likely to remain static on the back of stable growth in world GDP. Other factor conducive for strong demand is the supportive policy of the government.

Textile industry has come out to be one of the worst hit industries on account of losses arising out of currency conversion. As per statistics, the top publicly listed textile and apparel manufacturers reported losses on account currency conversion to the extent of 16.32m Yuan. Notably, the losses for whole of the last year were 9.53m Yuan.

China has amassed a US\$105 billion as surplus in its textile trade for the first ten months of 2006 with the European Union as the top importer. The import and export value of China's textile and clothing products rose by 17.67% from a year ago to US\$135 billion. China exported over US\$120 billion worth of textile and clothing products in the first ten months, up by 23.94% year-on-year. Imports of textiles and clothing rose by 5.66% to US\$14.6 billion. Asian countries' imports of China-made textiles and clothing products valued at US\$57.8 billion with a year-on-year growth of 21.48%, while European imports rose by 30.55% to US\$29.9 billion for the first ten months of 2006. China's export of textile and clothing to the United States was US\$16.97 billion up by 12.55% for the ten months of 2006.⁶¹⁷ According to the statistics, EU was the top

⁶¹⁶ China Industry Monitor: Textiles, Vol. 701.

⁶¹⁷ Ibid.

importer of China-made textile and clothing products followed by Hong Kong, the United States and Japan.

China Government has introduced amendments in tariff rate in order to encourage imports of new technology to control consumption of energy resources and to curb export of environmentally polluted products. The tariff rate on tight spinning machine has been reduced from 6% to zero. Spinning technology has been listed in the “Progress of Science and Technology Development Program of China Textile Industry”, making it one of the key technologies requiring it to be encouraged for country’s economic development. Some textile units want Chinese Government to reduce the import tariffs on some high-tech textile machines and key parts, which domestic units are not capable to produce.

According to the Planting Intentions Survey conducted by the National Development and Reform Commission (NDRC), of 16,870 rural families in 881 counties in 30 provinces, China’s cotton area will increase slightly in 2007. The survey reveals that the family planting area on average is 0.87mu, up by 1.5% compared with last year 2006. The reasons of expanded cotton sowings are follows: the wider uses of BT cotton decrease the labor demand; the income from cotton is around US\$103.41per mu which has exceeded that from wheat and corn (US\$76.27/mu)⁶¹⁸; the soils in some areas are more suitability for planting cotton rather than competing crops.

Recently, China Textile Industry Association made a decision to confer Shishi city as ‘China textile trends release base’. Association will officially award the plaque to Shishi city on the opening ceremony of the 10th STCF (strait textile and clothing fair) on April 18, 2007. It is worth mentioning that up to this date, Shishi city is the first city to win the title in the country. Based on Fabrics, China Fabrics systems engineering as its core, Shishi ‘release base’ will undertake textile fabric trend research and publication regularly according to international practice. The main purpose of establishing this base is to raise the overall level of China’s textile product development, enhance market competitiveness of Chinese textile fabrics.

According to General Administration of Customs statistics, China earned a trade surplus of over US US\$39.5 billion in the months of Jan and Feb 2007. In Feb alone, the trade surplus reached US\$23.7 billion as exports touched the US\$82 billion mark, up 51.7 % from the same period in 2006. Exports for the two months recorded year-on-year climb of 41.5 % to US\$168.7 billion. Machinery and electronic products exports during the period rose 38.4% to US\$98.5

⁶¹⁸ **China Industry Monitor:** Textiles, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 704 April (2007)

billion. Garment and apparel exports have also seen an improvement of 44.2 % to US\$15.56 billion and footwear exports increased 36.2 % to US\$4.25 billion. However, imports saw a rise of 20.6 % to US\$129.1 billion for the Jan-Feb period.⁶¹⁹

According to the data from General Administration of Customs, exports of textile and apparel during Feb were valued at around US\$11.244 billion, down 7.37% from last month Feb 2007, and up 71.26% compared with the same period last year. Among them, yarn fabric and products were US\$3.822 billion, clothes and apparel attachment was US\$7.422 billion. In first six month of 2006/07 season (2006.09-2007.02), cumulative export of fabrics clothes was about US\$75.999 billion increase by 29.93%YoY. Among them, yarn, fabric and products increased by 22% to US\$25.004 billion, clothes and apparel attachment increased by 34.21% to US\$50.994 billion compared to the same period of last season.

5.2. Textile Industry Performance

China's textile industry grew rapidly in the first three quarters ending Sept 2006 owing to the upbeat domestic apparel market. From January 2006 to September 2006, the industry sales reached US\$216 billion, which is an increase of 22.69 % over the same period the last year and profits rose to US\$7.64 billion, which is up by 23.69 % over last year.

From January-September 2006, the import and export amount of China's textile and apparel totaled US\$121.234 billion, up 21.85% from the corresponding period of last year, accounting for 9.53% of the country's foreign trade value.⁶²⁰

During the same period, Textile and apparel export reached US\$107.77 billion, rising 24.25% from the same period in 2005, of which, textiles exports were US\$38.45 billion, up 18.32% from the same period the last fiscal. The Apparel export also grew by 27.64% to US\$69.32 billion in nine months ended Sept 2006. This growth has been because of increased export of cotton by China from USA. Another reason for rise can be the FIFA World Cup, which has resulted in increase of sports related merchandise, which are major products of regions like Haerbin city in China.

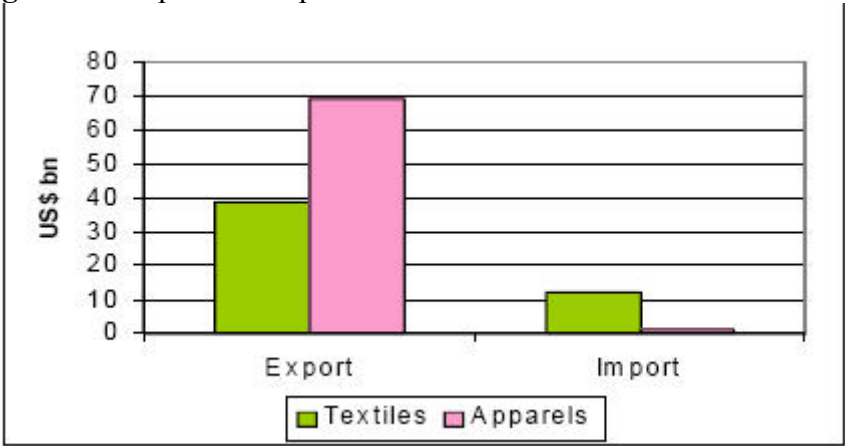
In Sept 2006, Textile and apparel import amounted to US\$13.45 billion, 6.08% higher from the same period in 2005. During the same period, textile import was US\$12.16 billion, 5.39% above the same time in 2005, apparel import registered a growth of 13.10%

⁶¹⁹ www.tdctrade.com/chinastat/index.htm

⁶²⁰ **China Industry Monitor:** Textiles, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 612 December (2006).

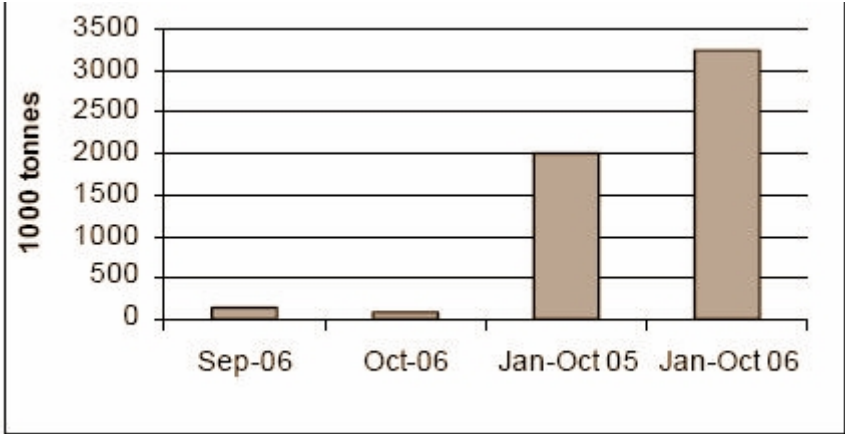
corresponding to the same period in 2005 as it reached US\$1.299 billion. This majorly consists of the cotton imports from the US, which has increased substantially over 2005.⁶²¹

Figure 21: Exports & Import Rate in First Nine Months 2006⁶²²



China imported 85,000 tonnes of cotton in October, which is 36.6% down from September and 57% down from last year. Cumulative cotton imports from January to October 2006 were 3.25m tonnes, which is 62.4% up from last year. The major factor for drop in imports could be the harvest season of cotton crops in China that began in early October. See figure below;

Figure 22: Cotton Imports⁶²³



Yarn production during October 2006 increased by 19.02 % over October 2005 as it reached 1.52m tonnes. The total Yarn production during Januray 2006-October 2006 was 13.89m tonnes, which was up by 20.7% over the same period the last year.

⁶²¹ Ibid.

⁶²² **China Industry Monitor:** Textiles, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 612 December (2006).

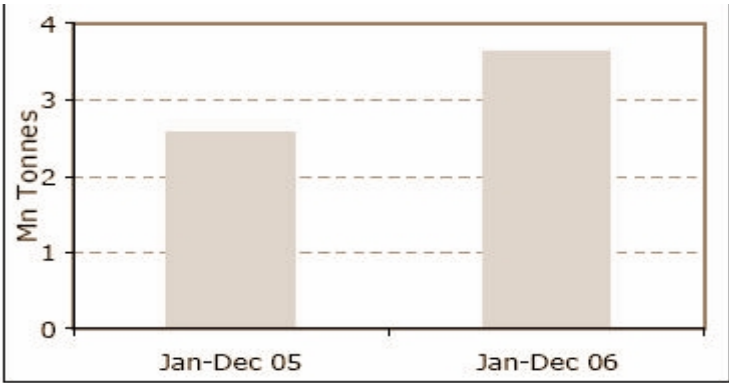
⁶²³ Ibid.

Exports of textile and apparel during November 2006 were valued at around US\$12.72 billion, up by 2.96% representing an increase of US\$366m from last month. Among them, yarn fabric and products were US\$4.214 billion, clothes and apparel attachment was US\$8.506 billion.

From January to November 2006, cumulative export of fabrics clothes were about US\$130.645 billion up by 24.66% year-on-year, yarn, fabric and products increased by 18.17% to US\$44.361 billion, clothes and apparel attachment increased by 28.28% to US\$86.283 billion compared with the same period last year.⁶²⁴

The import volume of the cotton went up by a wide margin in December 2006 as the exports of textile surged by 4.7% on monthly basis. In November 2006, China imported 240 kilo tonnes of cotton, up by 55.3% valued 85,800 tonnes compared with last month, and at the same time down by 30.8% worth 107.1 kilo tonnes year-on-year basis. The total raw cotton imported during the calendar year 2006 is valued 3.642m tonnes up by 41.8% as compared to same period last year.

Figure 23: Imports of Raw Cotton⁶²⁵



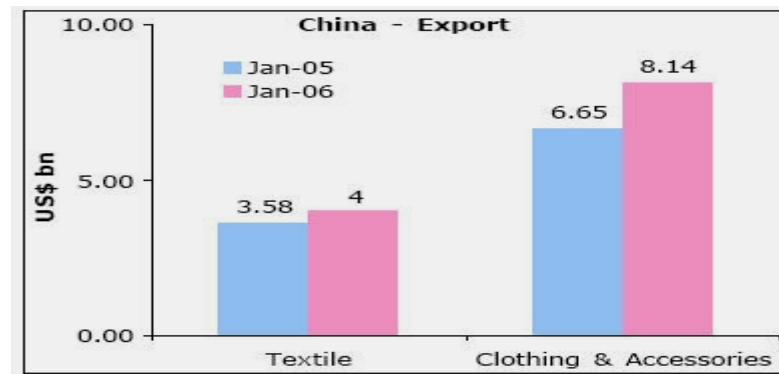
Exports of textile and apparel during December 2006 were valued at around US\$13.354 billion, up by 4.75% representing an increase of US\$605.5m from last month. Among them, yarn fabric and products were US\$4.44 billion, clothes and apparel attachment was US\$8.913billion. From January to December 2006, cumulative export of fabrics clothes were about US\$143.993 billion up by 25.2% year-on-year, yarn, fabric and products increased by 18.66% to US\$48.8bn, while the clothes and apparel attachment increased by 28.85% to US\$95.192bn, compared with the same period last year.⁶²⁶

⁶²⁴ China Industry Monitor: Textiles, Vol. 701.

⁶²⁵ <http://www.china-cotton.org/english/INDEX.htm> - China Cotton Association

⁶²⁶ **China Industry Monitor:** Textiles, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 702 February (2007)

Figure 24: Cotton Exports of China (January 2007)



China's exports of textiles, clothing and accessories in January 2007 grew 18.55% to US\$12.14 billion as compared to January 2006, according to statistics of China's General Administration of Customs. China's textile exports reached US\$4 billion by 11.6%, and clothing and accessories exports reached US\$8.14 billion, up by 22.3% in January 2007 over January 2006.⁶²⁷

6. Banking Industry

With the Chinese economy expected to grow at about 10.5% by 2007, more and more money will be invested in fixed asset formation. At the same time the country is on the verge of heavy investment. It is conducting two mega events, Olympic in 2008 and World Expo in 2010. Government is planning to invest more than US\$23 billion in preparation for Olympic game in 2008.⁶²⁸ All these activities will slow down without banks' intermediation in funding.

As the household savings deposit is less attractive as compared to market oriented instruments in terms of return, it will bring in more and more investment particularly, from household sector in 'Alternate Investment' avenues. Analysts believe Chinese investors will not cope with rising healthcare and retirement costs unless they generate higher long-term returns on personal assets. With its rapidly ageing population and falling fertility rate, China is facing a potential pension's crisis in 10 years' time, according to experts. Due to this reason households have started investing in stock market and mutual funds to cater to their future needs. As the banks' deposits growth will slow down and left with less money to support the credit need of industry. In absence of government intervention the scenario is expected to aggravate.

⁶²⁷ **China Industry Monitor:** Textiles, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 703 March (2007)

⁶²⁸ **China Industry Monitor:** Banking, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 702 February (2007)

According to People's Bank of China, China's money supply continued to grow in February 2007. By the end of February, the broad measure of the money supply, M2, which covers cash in circulation and all deposits, went up 17.8% YoY to 35.9 trillion Yuan. Statistics released by the Central bank reported that newly added RMB-denominated deposits in February amounted to 527.1 billion Yuan, 92.9 billion Yuan more than the February 2006. The narrow measure of the money supply, or M1, was 12.6 trillion Yuan, up 21%. M1 is an antecedent index for a country's economic performance, reflecting the change in the amount of money in the hands of residents and enterprises. On the other hand, M2 shows the demand of the whole of society and indicates possible inflation. Bank figures also indicated that the outstanding renminbi-dominated deposits rose 16% year-on-year by the end of February to 34.5 trillion Yuan. The outstanding renminbi-dominated loans amounted to 23.5 trillion Yuan in February, a rise of 17.2%.⁶²⁹

6.1. Money Laundering in China

Accelerating the pace of cracking down on rampant money laundering in China, the government passed the legislation on Anti Money Laundering (AML) to come into force from January 1, 2007. The objective of money laundering is to legitimize income originating from illegal resources or businesses.

Money laundering has been recognized as one of the most common transactional crimes world over. If International Monetary Fund's 2001's survey is to be believed, then money laundering was the world's largest industry accounting for about 2 to 5% of global gross domestic product. According to UN estimates anything between US\$100bn to US\$1trln in "dirty" money goes through international banking system every year, and Asia contributes a significant portion of this.⁶³⁰

China has continuously used a source of money laundering since it adopted open door policy in 1980s and further a market economic system in the 1990s. These developments have led to increasing foreign capital investment, so called foreign "hot" money in China therefore greater scope for money laundering. Set up under central bank in 2004, China Anti-Money Laundering Monitoring and Analysis Centre, suspected about 683 money laundering cases by the end of year 2005. This involved nearly 137.8bn Yuan and US\$1bn. Overall, last year PBOC

⁶²⁹ **China Industry Monitor:** Banking, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 74 April (2007)

⁶³⁰ **China Industry Monitor:** Banking, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 612 December (2006)

and the State Administration of Foreign Exchange handed over 2790 and 405 suspected cases respectively to police. The amount involved in this was 32.7bn Yuan and US\$1.24bn respectively.⁶³¹

The reasons for rampant money laundering in China can be categorized under three heads:

Firstly, the privileges under the policy of “One Country, Two Systems,” allows companies in mainland China region to take advantages of Hong Kong Special Administrative Region (HKSAR) branches or financial institutions to directly launder their dirty money.

Secondly, there has been tremendous growth in the number of illegal underground banks involved in money laundering inside China.

Finally, the “profiteers and launderers” relationship. Some of public employees maintain relationships with launderers to hide their wealth collected through illegal means like corruption, bribe.

First of all AML had become a necessity for China in order to safeguard its national interests as well as the interests of the masses. There is a linkage between China’s global image and the way AML performs which will also determine the economic stability to some extent.

Secondly, it is also important for safeguarding the credibility of financial institutions and the financial stability in the country. Financial institutions are the most obvious used vehicle for money laundering as they are involved in mobilising funds. Therefore, financial institutions were exposed to great operational risk due to existence of money laundering.

Thirdly, since the opening of economy and gradual reforms economic crimes have also gone up which left the government with no other option but to crack down on money laundering. As the Chinese economy was getting more globalised crimes like smuggling, tax evasion, tax rebate cheating, financial frauds, market manipulation, insider trading were growing very rapidly and there was a need to curb them.

Finally, AML is one good method for prevention of other criminal acts like drug trafficking. China has witnessed great increase in international narcotics and organized crimes in the recent past. It is widely believed that these crimes are backed by financial support, which is a result of nothing but money laundering.

Financial institutions in China are bound to get affected with the recent legislation on money laundering as they play a unique role in the national payment system and the transactions

⁶³¹ Ibid.

involving transfers of financial assets. They are now entrusted with responsibility of monitoring suspicious cash flows for criminal assets. Further, financial institutions will also be required to control risk in order to maintain public image and to secure business growth. AML will also enforce statutory duties on financial institutions that will encompass all dimensions of a bank's business with its clients, right from the initiation of a service contractual relationship with the client till the conclusion of the service contract.

Going forward the implementation of anti-money laundering systems will become very critical for financial institutions. As per estimates, almost 600 financial institutions received administrative penalties from PBOC and were subsequently ordered to pay fines amounting to RMB56.26m⁶³² due to non-compliance with anti-money laundering regulations.

6.2 Opening of Banking Sector

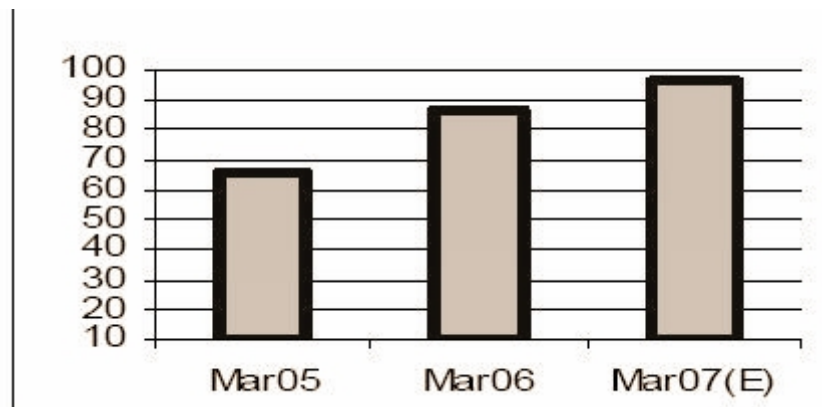
In line with its commitments to the WTO, China opened its banking sector to the fullest extent on December 11, 2006. Like any other event, this too has its own set of pros and cons attached to it. While one view maintains an optimistic attitude saying this will pioneer reforms and sophisticated systems in the Chinese banking sector, bringing it to international standards, another sees it as an opportunity for foreign encroachment upon the domestic banking industry to gain control over it. However, the question remains – Can the local players sustain the increased global competition? Or will China's domestic banks be wiped out by their foreign counterparts?

6.2.1. Advantages of Foreign Banks

Keeping in view China's opening of the banking sector in December 2006, foreign banks were already on an expansion mode since the last couple of years. Banks such as ABN Amro, Bank of East Asia, Citigroup and HSBC have been investing heavily in mainland China. These banks have expanded their branch networks, and aggressively targeted wealthy clients with private, foreign currency banking services. By the end of June 2006, there were 71 foreign banks in China with 183 branches. In Shanghai, which is China's commercial capital, foreign banks hold 13% of total banking assets. The liberalization of the banking sector will provide a huge impetus to this already well established business of foreign banks, helping them to spread their wings further.

⁶³² Ibid.

Figure 25: Number of Foreign Banks & Branches in Shanghai⁶³³



Most of the Chinese lenders have confined themselves to the traditional narrow banking approach – accepting deposits and granting loans. They have not redesigned existing products or introduced new products in order to keep abreast with the global financial developments. However, as China’s economy is growing, and the Chinese consumer is becoming more matured, demand for such innovative products and services is on the rise. The unavailability of the same with the local lenders is bringing in customer dissatisfaction.

Foreign banks, armed with the latest technology and in a position to offer the latest products and services, can capitalize on this weakness of Chinese banks to win customer loyalty. They can concentrate on the bigger cities on the Chinese mainland and introduce universal banking services such as personal financial advisors, foreign-currency investment products and core banking solutions.

6.2.2. Advantage of Local Banks

Foreign banks, though huge on a global scale, have limited investments in China. In contrast, the Chinese banks are huge, dwarfing their foreign counterparts’ Chinese subsidiaries. The biggest state-run commercial bank, Industrial and Commercial Bank of China has 18,000 branches and deposits totaling some US\$700 billion.⁶³⁴ The other big Chinese banks, although smaller, operate on a similarly grand scale. This allows the Chinese banks to reap the economies of size by incurring lower cost of operations, and thereby pushing up margins.

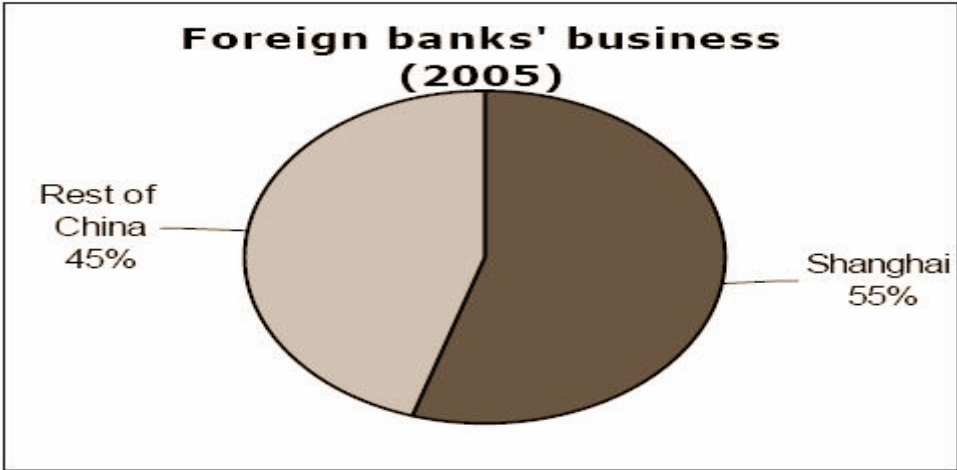
⁶³³ Shanghai Banking Regulatory Bureau - <http://www.sbacn.org>

⁶³⁴ **China Industry Monitor:** Banking, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 701 January (2007)

Most of the foreign banks' business is concentrated in Beijing and Shanghai. They have targeted only the elite business community Chinese consumers. 55% of the total foreign banking business and 30% of the total foreign bank outlets are located in Shanghai.⁶³⁵

Foreign banks operating in China will have to incorporate within the country, to offer bank cards and mass-market banking services in Renminbi. Overseas lenders who don't incorporate locally must set aside two times as much capital, or 200m Yuan, as those that do, according to rules released November 15, 2006 by the Central Bank of China. They also can't issue bank cards and can take only large deposits, limiting their ability to amass funds and grow through lending. The process of incorporation requires compliance of legal and legislative procedures, which require a considerable amount of time. This serves as a major hurdle for foreign banks desirous of operating in China, thereby bolstering the ability of local players to withstand competition.

Figure 26: Foreign Banks' Business⁶³⁶



Foreign banks don't pose a significant threat to Chinese ones in the short term. No matter how many foreign banks pour in with the liberalized market, they will continue to lag behind the local players in terms of branch coverage and client-base in the immediate future. The yet stringent legal norms enhance the profitability of Chinese banks. In addition to this, local banks enjoy the trust of customers, who will be unwilling to shift their business overnight with the new foreign counterparts.⁶³⁷

⁶³⁵ Ibid.

⁶³⁶ Federal Reserve Bank of San Francisco - <http://www.frbsf.org/>

⁶³⁷ China Industry Monitor: Banking, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 701 January (2007)

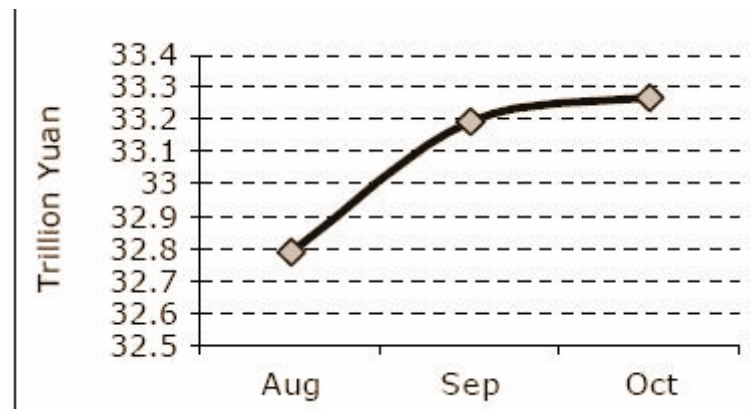
However, Chinese banks do not enjoy the same competitiveness in the long run. The future of banking will shift from corporate to retail. Foreign banks, with their sophisticated systems and more customer-oriented approach, will seem attractive for the new generation Chinese customers. Chinese banks ought to revamp their operations and come at par with international standards to survive global competition in the long run. Understanding the consumer and utilising advanced technology to offer the latest products and services will be crucial. Further, the risk management policies too need to be improved and banks must resort to prudent credit sanctioning guidelines.

6.3. Industry Performance

China's banking system has undergone major changes since the last two decades. China's banking industry has remained in government's hands, though banks have gained more autonomy. China's accession to WTO will lead to a significant opening of this industry to foreign participation.

The growth of Broad Money (M2) increased slightly, while the growth of Narrow Money was on upswing in the month of November 2006. The Broad Money stood at 33.27 trillion Yuan, which was an increase of 17.1% year-on-year basis, while the rise was only 0.3% from the month of October. Narrow Money (M1) reached 11.84 trillion Yuan and increased 16.3% year-on-year basis and a rise of 0.6% from the month of October. The major factor that contributed in the growth was continued and large increase of corporate demand deposits in the month of October06.

Figure 27: Broad Money Growth (2006)⁶³⁸



China's banking system has undergone major changes since the last two decades; banks are now functioning more like banks than before. Nevertheless, China's banking industry has remained in the government's hands even though banks have gained more autonomy. China's accession to WTO will lead to a significant opening of this industry to foreign participation.

On the back of China's overheated economic growth, both broad and narrow money has grown rapidly towards the end of 2006. However, due to hike in interest rates two times in 2006, the rate of money supply growth seems to have cooled down a bit. At the end of November 2006, broad money (M2) has accounted for RMB33.75 trillion, an increase of 16.8% YOY, down by 30 basis points from October 2006. The rapid growth of narrow money, however, remains unabated, with RMB12.16 trillion, representing an increase of 16.8% YOY, up by 50 basis points from October 2006.⁶³⁹ This continued growth has been seen mainly due to large increase in corporate deposits and faster cash injection.

In the following years, China economy is expected to continue its steady performance for the first half of the current year. With GDP expectation of 10.5%, the banking industry seems to be bullish. In addition to this with the opening up of Chinese banking industry to foreign players in accordance with WTO agreement, the bank is well poised to enter into strategic alliance with foreign players to tap the global market on a wider scale. On the macro front the central bank raised the lending rates by 27 basis points to cool off the fast growing economy, but left deposit rates unchanged. This will improve the interest spread for banks. With the induction of advanced technology in its operations, not only the product quality will improve, but also the operations are expected to be more efficient, thereby boosting the margins.

⁶³⁸ People's Bank of China - <http://www.pbc.gov.cn/english/>

⁶³⁹ **China Industry Monitor**: Banking, Cyngus Bussiness Consulting & Research Knowledge Partner for Profitable Growth, Vol. 702 February (2007)

7. Defense Industry

7.1. Outlook to the Defense Industry

Since the early 1980s, a prominent and consistent conclusion of Western research on China's defense-industrial complex has been that China's defense R&D and production capabilities are rife with weaknesses and limitations.⁶⁴⁰ In this study, we call into question this conventional wisdom. Our research found that certain Chinese defense enterprises are designing and producing a wide range of increasingly advanced weapons that, in the short term, are relevant to the Chinese military's ability to prosecute a possible conflict over Taiwan but also to China's long-term military presence in Asia. This study puts forward an alternative approach to assessing China's defense-industrial capabilities: From the vantage point of 2005, it is time to shift the focus of research to the gradual improvements in and the future potential of China's defense-industrial complex.

The recent progress in China's defense-industry modernization can be explained by four mutually reinforcing considerations.

First, the government has consistently devoted more funds to weapon acquisition. From 1990 to 2003, the official defense-budget allocation for military equipment grew from 5 billion RMB to 64.8 billion RMB.⁶⁴¹ These increases are about twice the rate of growth of the official defense budget. Also, the share of the budget devoted to equipment increased from 16.3 to 34 percent in this time period. For the period 1997–2003, according to official Chinese budget figures, the amount of funding for equipment grew 153 percent, more than for the other two categories in the official defense budget. Such defense spending is bound to positively affect output; these increases likely contributed to the pace at which new systems have come online in recent years. However, the benefits of such increased spending are limited unless defense enterprises actually improve their research, development, and production capabilities.

Second, the gradual development and commercialization of some defense enterprises during the transition in China's economy over the past 25 years have improved their research, development, and production capabilities. The robust and rational commercial business operations of select defense enterprises allowed the accumulation of "spin-on" benefits in some defense sectors. Defense enterprises with the greatest exposure to international markets have

⁶⁴⁰ Bates Gill, "Chinese Military-Technical Development: The Record for Western Assessments", 1979–1999," in James C. Mulvenon and Andrew N. D. Yang, eds., *Seeking Truth from Facts: A Retrospective on Chinese Military Studies in the Post-Mao Era*, Santa Monica, Calif.: RAND Corporation, CF-160-CAPP, 2001.

⁶⁴¹ Evan S. Medeiros; Roger Cliff; Keith Crane; James C. Mulvenon, "A New Direction for China's Defense Industry" Library of Congress Cataloging in Publication Data: RAND Corporation, 2005.

been especially effective at improving their R&D and production capabilities, through both partnerships and competition with foreign firms.⁶⁴²

Third, the defense industry in the past decade has had consistent access to limited amounts of foreign military equipment and technical assistance, especially from Russia and Israel. This access has assisted the efforts of some defense sectors to copy-produce weapon systems, to integrate advanced technologies into China's production lines, and to raise the technical expertise of Chinese personnel involved in defense production.

Fourth, in past decades, Beijing largely avoided implementing the type of fundamental reforms, such as rationalization and consolidation, which were needed to revitalize the defense industry. However, beginning in spring 1998, China's leadership adopted a new series of policies to revamp the structure and operations of the defense procurement system and to reform the operations of defense enterprises. At a minimum, these reforms importantly signaled recognition of the depth of the problems in China's defense-industrial system. More importantly, these policies initiated institutional changes in the management of China's defense industry in ways that outstripped past efforts in both scope and depth. Specifically, China's leaders aimed to inject into China's defense-industrial system the principles of "competition, evaluation, supervision and encouragement," known as the "Four Mechanisms"

China's defense industry now has the potential to become more competitive with the defense industries of the world's advanced military powers in key sectors within a moderate (10–20 years) amount of time. Indeed, our analysis of their R&D and production capabilities suggests that several defense sectors are already overcoming long-standing weaknesses. To be sure, the prevailing data set related to defense-industrial capabilities is still limited, and current progress has been mixed within defense sectors and uneven across them.

Some of the current weaknesses of China's defense industry could be further ameliorated in the medium term (10–20 years), assuming China does not deviate from its present course of reform of the defense-industrial system and government investment in and, importantly, a continued political commitment to defense procurement. If the government continues to push for open contracting of defense projects and takes a tough line on cost overruns, efficiency gains, the quality of production capabilities, and the degree of innovation should continue to improve. In some sectors, this could occur fairly rapidly.

⁶⁴² Bates Gill: *ibid.*

Even though such reforms are gathering speed, they will not happen overnight. Time is needed to train new employees into skilled defense-industry engineers and technicians. It will also take time to change management behavior and stimulate innovation, even after new management incentive systems are implemented. Such behaviors will be critical indicators of the pace of reform and the future direction of China's defense-industrial capabilities.

7.2. Defense Expenditures

Pursuant to the National Defense Law and the Budget Law, and guided by the principle of coordinated development of national defense and the economy, the Chinese government decides on the size and use of defense expenditure in an appropriate way to meet the demands of national defense in keeping with China's economic development.

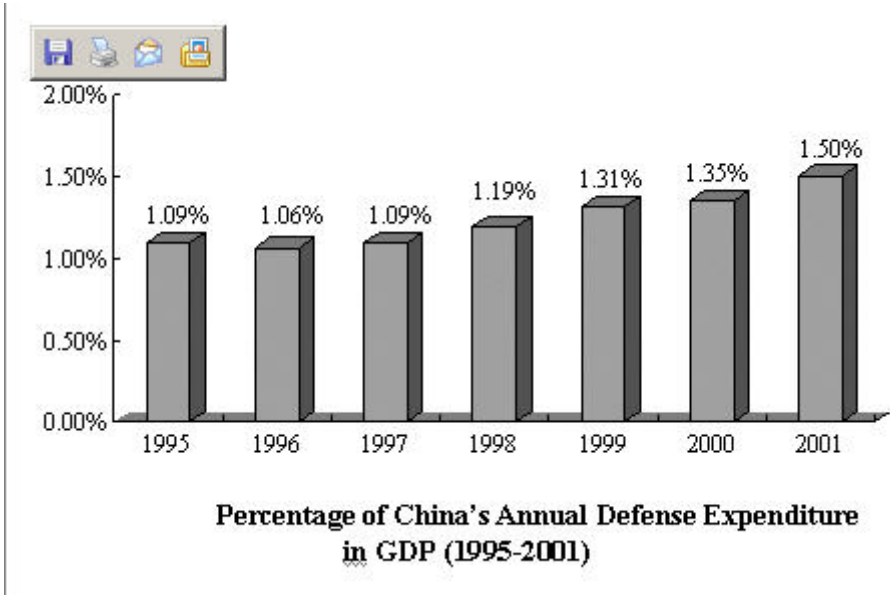
China's defense expenditure mainly comprises expenses for personnel, training and maintenance, and equipment. Personnel expenses mainly cover salaries, insurance, food, clothing, and welfare benefits for officers, non-commissioned officers and enlisted men as well as for civilian employees. Training and maintenance expenses cover troop training, institutional education, construction and maintenance of installations and facilities, and other expenses on routine consumables. The equipment expenses mainly cover research on, experimentation with, and procurement, maintenance, transportation and storage of weaponry and equipment. The defense expenditure covers not only the active forces, but also the militia and reserve forces. Also covered by the defense expenditure are costs to support part of the retired officers, education of servicemen's children and the national economic development, as well as other social expenses.

Since the early 1990s, to safeguard its sovereignty, security and unity, and to keep pace with the global revolution in military affairs, China has gradually increased its defense expenditure on the basis of its economic development.⁶⁴³ This increase, however, is compensatory in nature, and is designed to enhance the originally weak defense foundation. It is a moderate increase in step with China's national economic development. In the 1980s, China began to shift the focus of its work to economic development. At that time, it was decided that national defense should be both subordinated to and serve the country's overall economic development. As a result, national defense received a low input, and was in a state of self-preservation. From 1979 to 1989, the average annual increase of defense expenditure was 1.23

⁶⁴³ China's National Defense in 2006, issued by the Information Office of the State Council People's Republic of China December 29, 2006. <http://www.fas.org/nuke/guide/china/doctrine/wp2006.html#8> accessed in April 2007.

percent. However, the defense expenditure actually registered an average annual decrease of 5.83 percent, given the 7.49 percent average annual increase of the consumer price index in the same period. From 1990 to 2005, the average annual increase in defense expenditure was 15.36 percent. As the average annual increase of the consumer price index during the same period was 5.22 percent, the actual average increase in defense expenditure was 9.64 percent.⁶⁴⁴

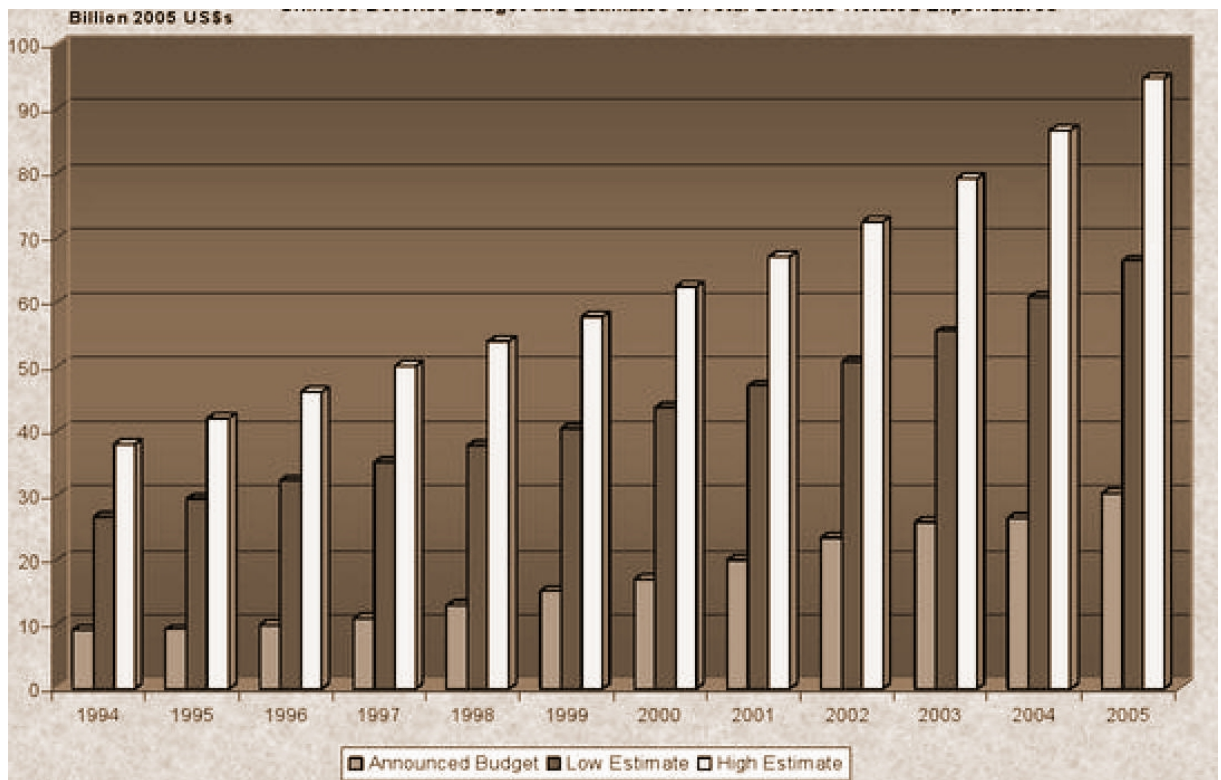
Figure 28: Percentage of China’s Annual Defense Expenditure in GDP (1995-2001)



China’s GDP in 2004 and 2005 was RMB 15,987.8 billion and RMB 18,308.5 billion, respectively, with a growth rate of 10.1 percent in 2004 and of 10.2 percent in 2005. The state financial expenditure was RMB 2,848.689 billion in 2004 and RMB 3,393.028 billion in 2005, up 15.57 percent and 19.11 percent respectively over the previous year. China’s defense expenditure in 2004 and 2005 was RMB 220.001 billion and RMB 247.496 billion, respectively, with growth rates of 15.31 percent and 12.50 percent. In the past two years, the share of China’s annual defense expenditure in its GDP and in the state financial expenditure in the same period has decreased, being 1.40 percent and 7.74 percent respectively in 2003, 1.38 percent and 7.72 percent in 2004, and 1.35 percent and 7.29 percent in 2005. Its defense budget for 2006 is RMB 283.829 billion.⁶⁴⁵

⁶⁴⁴ Evan S. Medeiros; Roger Cliff; Keith Crane; James C. Mulvenon: Ibid.
⁶⁴⁵ China’s National Defense in 2006: Ibid.

Figure 29: Chinese Defense Budget and Estimates of Total Defense Related Expenditures⁶⁴⁶

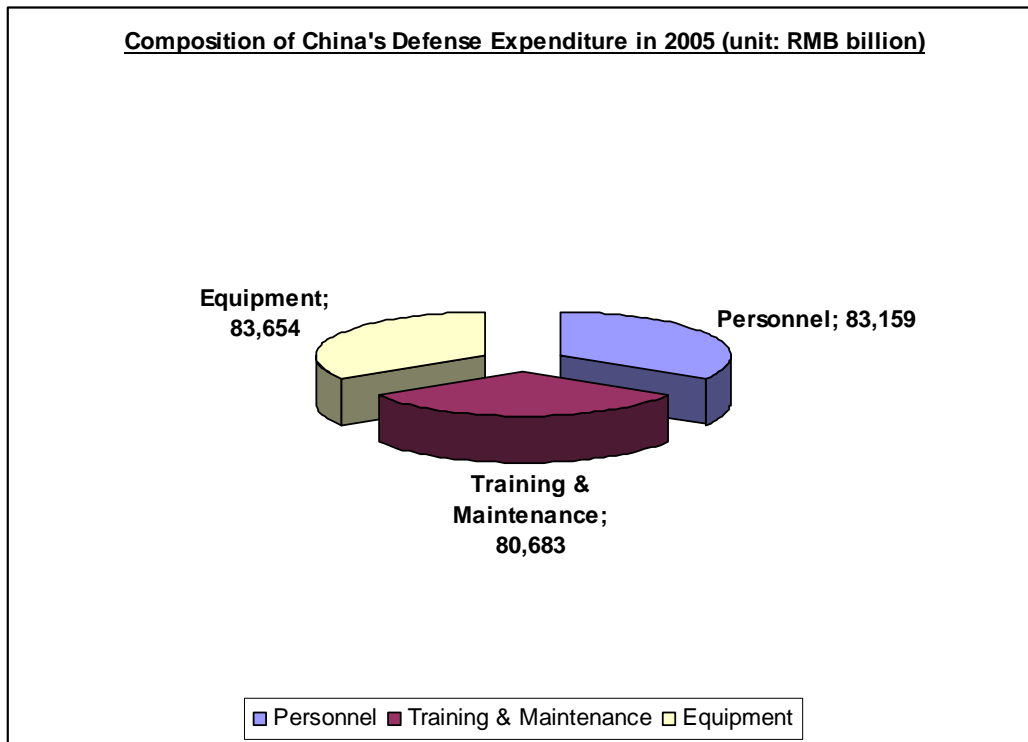


The increased part of China's defense expenditure is primarily used for the following purposes: (1) Increasing salaries and allowances of military personnel and improving their living conditions. Along with the growth of China's economy and the steady improvement of the people's life, the salaries and allowances of military personnel and the pensions of retired officers are increased accordingly. The insurance, medical, housing and other benefits are also increased. Subsidies are being increased, too, to compensate for regional and post differences, and the living conditions of the troops stationed in hardship areas are being improved. (2) Increasing investment in weaponry and equipment and infrastructure. The PLA is accelerating its informationization drive, increasing the expenses on procurement and maintenance of weaponry and equipment, upgrading the military infrastructure, and increasing input for improving the facilities for border and coastal defense troops. (3) Supporting the training of military personnel. The PLA is increasing input into education and training through both military educational institutions and regular institutions of higher learning. It is also increasing subsidies for professionals with outstanding performance and incentives for experts, and increasing the budget for the employment of contract civilians. (4) Compensating for price rise. As the prices of oil, building materials and staple and non-staple foodstuffs rise, the PLA accordingly increases the

⁶⁴⁶The School of Hawaiian, Asian and Pacific Studies - <http://www.shaps.hawaii.edu/images/2006/cmp-2006-fig3.png>

expenses on military petroleum, oils and lubricants and defense engineering, and raises the boarding subsidies. (5) Increasing expenses for international cooperation in non-traditional security fields.

Figure 30: China's Defense Expenditure in 2005⁶⁴⁷



Both the total amount and per-serviceman share of China's defense expenditure is low compared with those of some other countries, particularly major powers. In 2005, China's defense expenditure equaled 6.19 percent of that of the United States, 52.95 percent of that of the United Kingdom, 71.45 percent of that of France and 67.52 percent of that of Japan. China's defense expenses per serviceman averaged RMB 107,607 amounting to 3.74 percent of that of the United States and 7.07 percent of that of Japan.

China practices a strict system of financial appropriation of defense funds. The PLA's budgeting is based on the defense development strategy, military building objectives and annual military tasks set by the state. Budgeting units at each level carry out studies to decide on their budget items, make calculations of their requests for funds and then report to the next-higher authorities. The General Logistics Department, working with the relevant departments of other general headquarters/departments, analyzes, calculates and verifies the annual budget requests submitted by all the military area commands, the Navy, Air Force and Second Artillery Force,

⁶⁴⁷ China's National Defense in 2006: Ibid.

and draws up the defense budget. After being reviewed and approved by the CMC, the defense budget is submitted to the Ministry of Finance. The latter, on the basis of medium- and long-term fiscal plans and the estimated revenue of the year, puts forward a plan for military expenditure appropriations after consultation with the General Logistics Department, and then incorporates it into the annual financial budget draft of the central government. Upon approval by the State Council, the annual financial budget is submitted to the Budget Work Committee of the NPC Standing Committee and the Finance and Economic Committee of the NPC for review before it is submitted to the NPC for review. After the budget of the central government is approved by the NPC, the Ministry of Finance informs in writing the General Logistics Department of the approved defense budget. The defense budget is then implemented down to troops at different levels through prescribed procedures.

Financial departments are instituted at the General Logistics Department, military area commands, Navy, Air Force and Second Artillery Force, and units at the levels of corps, division (brigade) and regiment. These departments are responsible for the appropriation, management and supervision of the defense funds. The auditing offices of the state and the PLA conduct strict supervision of the defense budget.

7.3. Future Prospects of Defense Industry

China's emerging IT sector, for example, is at the forefront of such trends; yet, it is atypical in many ways. Although not an officially designated part of China's defense-industrial complex, it is the most innovative and economically dynamic producer of equipment for China's military. China's IT enterprises do not suffer from many of the structural weaknesses and burdens that have hindered development of modern military equipment in China's traditional defense sectors. Rather, they are situated in dynamic locales with privileged access to pools of high-tech labor, capital, and foreign technology. And although they are primarily (and exclusively, in most instances) oriented toward domestic and international commercial markets, the PLA has been able to effectively leverage certain production capabilities to improve the military's C4I capabilities a critical element of the PLA's modernization efforts. As China reaps the benefits of being the fastest-growing large market for IT equipment and consolidates its position as the global IT workshop, the Chinese military will continue to be an important, if indirect, beneficiary.⁶⁴⁸

⁶⁴⁸ Evan A. Feigenbaum, "China's Techno-Warriors" **National Security and Strategic Competition from the Nuclear to the Information Age**, Stanford university Press: (2003), California.

Unlike the IT industry, China's shipbuilding industry has been burdened with many of the trappings of the centrally planned economy of the past. Nonetheless, the industry has gradually flourished since Deng's reform and openness policies were introduced. It has rapidly expanded exports and has gained increasing access to foreign shipbuilding equipment and technical expertise as a consequence. As its commercial shipbuilding capabilities have expanded and improved, naval production has benefited, as well. China's shipbuilding industry now produces a wide range of increasingly sophisticated naval platforms, using modern design methods, production techniques, and management practices as reflected in the serial production of several new platforms in the past five years. These improvements are likely to continue in the future. Yet, Chinese defense enterprises (both inside and outside the shipbuilding sector) still lack the ability to build some critical naval subsystems, limiting the overall war fighting capabilities of Chinese-produced naval vessels.

China's missile sector has historically been one of the brightest stars in China's defense industry. The technological progress that had been slow and steady since the 1980s appears to have accelerated in the past five years. Missile-production enterprises continued to produce new and increasingly advanced ballistic and cruise missiles including serial production of new types of SRBMs. China may soon begin fielding land attack cruise missiles, modern long-range surface-to-air missiles, fire-and-forget air-to-air missiles, and anti-radiation missiles. China's ability to produce and deploy such systems in a timely manner will serve as an indicator of continued reform of the missile sector until recently, the relative progress of the IT, shipbuilding, and missile sectors could be contrasted sharply with the failures of China's aviation industry. For years, this sector suffered under the weight of a large, bloated, technologically unsophisticated, and highly inefficient collection of R&D institutes and factories that failed to produce modern military aircraft in a timely manner. Those military fixed-wing aircraft that were produced were mainly improved versions of 1950s-era technology.⁶⁴⁹ In recent years, limited signs of progress have begun to emerge in this industry. China's first indigenously designed and produced combat aircraft (JH-7) recently entered service, and China is on the verge of producing a domestically developed fourth-generation aircraft (J-10/F-10), albeit with substantial foreign design assistance. China is also expected to begin producing its first operational turbofan engines, possibly ending its dependence on imported engines to power the modern combat aircraft it produces.

⁶⁴⁹ Evan A. Fiegenbaum; Ibid.

Important gaps in China's aviation design and production capabilities remain, however. China has not yet mastered serial production of complex aviation platforms, such as fourth-generation fighters. In addition, China is still unable to produce heavy bombers or large transport aircraft, and it has yet to field an indigenously designed helicopter. Although China has begun production of fourth-generation fighter aircraft, the United States has begun fielding fifth-generation fighters. Most importantly, critical structural weaknesses remain in China's aviation sector, inhibiting R&D advances. Thus, although China's aviation industry may be narrowing the gap with the world's most-advanced nations, it is unlikely to achieve parity with those nations in the foreseeable future.

Overall, relative to other countries, the Chinese defense industry's most acute weaknesses are not its lack of basic capabilities or institutions, which take years or even decades to build from scratch. Rather, many of the most severe shortcomings are in the incentives presented to the sectors and their component enterprises. These could shift in the medium term as the sectors become exposed to market-based pressures and/or the central government increases pressures for greater efficiency and quality.

In other words, China's defense industry now has the potential to become more competitive in some technologies with the defense industries of the world's advanced military powers in the next two decades. Indeed, our analysis of various indicators suggests that key defense sectors are already overcoming long-standing weaknesses. To be sure, the prevailing data set on defense-industry operations is still limited, and current progress has been mixed within defense sectors and uneven across them.

8. Economy Industry

8.1. Outlook

The GDP was expected to grow by 10%, but the growth rate achieved in the third quarter (July – September 2006) was 10.4% indicating the over heating of the economy. The Chinese economy is on the spree of cooling down, as there is drop in its three key figures indicating economic performance. Gross domestic product (GDP), industrial output and investment in fixed assets, all experienced slow growth by the end of September, compared with their dramatic boost earlier this year (2006-2007). Over the same period, bank loan growth also declined. This clearly indicates that the central government's macro-control efforts have worked and the overheated economy is temporarily recovering at a reasonable pace.

The huge stock pile of forex reserves of US\$1 trillion is also raising eyebrows for many economists, as a reserve of US\$600 billion-US\$700 billion is enough for the economy to guard against financial risks. It is expected that with growth in the per capita income, the divide between the urban and rural income will widen. Incomes in the rural regions are expected to grow by 6.1% this year and 6% next year, while the urban income shall grow by 10.5% this year and 10% next year.

Moreover, Yuan is expected to take a hit, if China goes in for a revaluation. The pressure to revalue Yuan has increased considerably and it is expected that US will enforce punitive duties on Chinese imports, if it does not revalue any time soon.

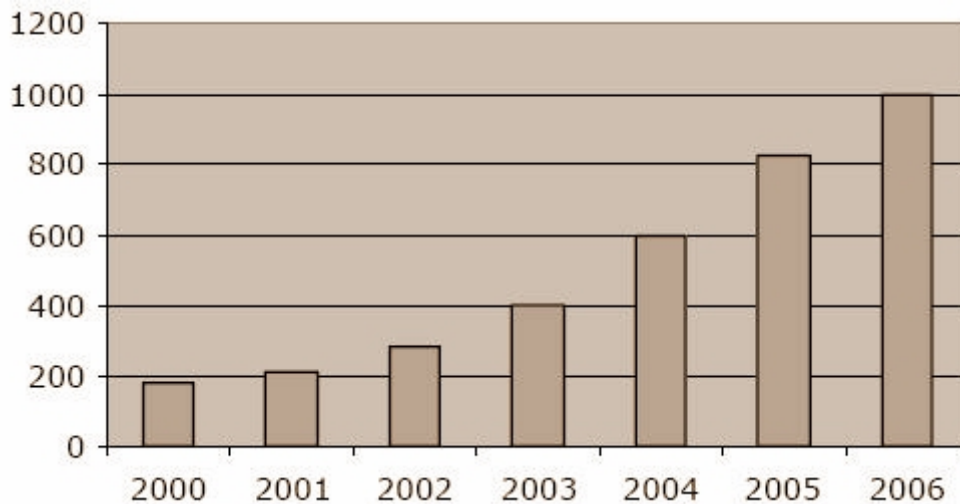
Finally, in order to ensure that the economy grows as a result of its consumption rather than investment, the government has already formulated prudent, fiscal and monetary policy for the year 2007.

As official data flash up staggering US\$1 trillion of foreign exchange reserves,⁶⁵⁰ the economists are debating whether the huge stockpile is a blessing or a burden and what to do with it. The huge forex reserves are a reflection of China's economic achievements, since reforms began in 1980s, but the concern is whether the excessive, fast-growing stash will endanger currency stability and liquidity.

The rapid increase in forex reserves could lead to speculation in the appreciation of the Chinese Source: Central Bank of China currency, Yuan or Renminbi (RMB). On one hand, these huge reserves are also becoming a target of international critics, as the undervalued yuan gives Chinese products a price advantage in international markets and hurts manufacturers from other countries; but on the other hand, various economists argue that the rapidly growing Chinese economy requires huge reserves in order to protect itself against financial risks created by speculators and possible financial crisis.

⁶⁵⁰ **China Industry Monitor:** Chinese Economy, Cyngus Bussiness Consulting & Research Knowledge Partner For Profitable Growth, Vol. 612, December 2006 - www.cygnusindia.com

Figure 31: Forex Reserves US\$bn, Year End⁶⁵¹



The forex reserves have increased tremendously from zero to US\$1 trillion since 1980s. In fact during 2004-2006, the reserves rose by more than US\$200 billion in each year. This massive hoard is the result of its large current-account surplus, significant inward foreign direct investment, and big inflows of speculative capital over the past couple of years.

China's foreign trade is expected to hit US\$1.7 trillion, showing an increase of more than 20% in the exports and imports volume over last year.

The foreign trade maintained rapid growth during January-November 2006, with the imports and exports volume reaching US\$1.27 trillion, a year-on-year increase of 24.3%. This is mainly due to dramatic increase in exports of machinery and electric products and high-tech products during the past months. Imports of primary products grew quickly this year as a result of robust domestic demand and high prices in the international markets.

The flows of foreign money into China had pushed the Yuan, but China has resisted this, forcing the central bank to buy up the surplus foreign currency. The growth in reserves has slowed in recent months, but it is still averaging a hefty US\$16 billion a month. It is expected to appreciate gently to 7.8 to the dollar by the end of the year, 7.73 in six months' time and about 4.5% higher at 7.56 in a year's time.

According to the 11th five year program of the Ministry of Commerce, China has set the goal to achieve foreign trade volume at US\$2.3 trillion in 2010, with a balance between imports and exports and the maintenance of growth rate at 10% annually.⁶⁵² This can be achieved by

⁶⁵¹ Central Bank of China.

⁶⁵² **China Industry Monitor:** Chinese Economy, Vol.612. December 2006.

implementing a free float exchange rate system and lifting the foreign exchange restrictions. Further, it is important for the government to take initiatives in the following areas:

- Adoption of free float - China could set free its exchange rate or it could relax restrictions on capital outflows and allow private citizens to hold foreign assets. It should maintain its prudent monetary and fiscal policies in face of anticipated heated investment, excessive bank loans and an expanding trade surplus. Moreover, it should also consider raising the benchmark deposit and lending rate in the next year for curbing the inflationary pressures.

- Investment - According to the deputy governor of the central bank, the reserves can be invested in state-owned banks, especially listed ones, as this would preserve and increase the value of the reserves. Moreover, it can also be utilized for infrastructure investment, which would yield a much higher return than American bonds.

- Hedging - Moreover, part of the reserves can also be used to buy oil, gold, silver and other rare metals as a hedge against dollar risks. The stockpiling oil would push up prices, yet absorb only a tiny proportion of the sums at China's disposal. Buying the equivalent of six-month oil consumption, as has been suggested, would take only 8% of total reserves at current prices, but the extra oil bought would amount to three times the growth in global oil demand this year.

According to the National Bureau of Statistics (NBS), the growth in the first three quarters (January – September 2006) was 10.7%, down 0.2 percentage points from the first half of the year. China's gross domestic product (GDP) grew by 10.4% in the third quarter of 2006, down 0.9 percentage points from the second quarter. The industrial sector reported growth of 13%, compared with 4.9% for the agricultural sector and 9.5% for the services sector. Moreover, the fixed asset investment totaled 7.19 trillion Yuan (US\$910 billion) in the first nine months, up 27.3% from the same period last year, but 2.5 percentage points down from the first quarter.⁶⁵³

According to the Ministry of Commerce, China's trade surplus is expected to total US\$150 billion during the year 2006-2007 from the last year's record of US\$109.8 billion. This is mainly due to dramatic increase in exports of machinery and electric products and high-tech products during the past months. Imports of primary products grew quickly this year as a result of robust domestic demand and high prices in the international markets. Moreover, world's manufacturing industry's transfer to China is another cause for an increase in the trade surplus.

⁶⁵³ Ibid.

China had prevented birth of 400m people due to its family planning policy. Formulated in the early 1970s, China's family planning policy encourages late marriage and late childbearing, and limits most urban couples to one child and most rural couples to two. This policy has stopped the growth in the population and has contributed to the socio-economic development of the country. China will work to keep its mainland population below 1.37 billion by 2010.

According to a study by professors of university of Nottingham,⁶⁵⁴ if the current growth rate continues, China will overtake the United States to become the world's largest economy by 2038. China's GDP (gross domestic product) would overtake that of Japan by 2017 or 2018 and Germany's by next year. China had pursued a gradual, pragmatic approach to reform, taking maximum advantage of foreign investment to build its exports and selectively importing science and technology to stimulate its own domestic development. This model had proved highly successful and was an example for other developing nations to follow. The government had adopted a series of strategies to deal with these problems, and there were different views on how successful Beijing would be. Under a pessimistic scenario, growth could slow, causing high unemployment, with corruption and inequality provoking social unrest amidst an energy crisis or financial crisis, in turn leading to an unstable, polarised and stagnant society. But under an optimistic scenario, the high growth economy would continue, with science and technology resolving the problems of energy and resource shortages, leading to a much improved quality of life for China's 1.3 billion people and big reductions in poverty and inequality. Under such a scenario, China could become a real superpower in 30 years time.

8.2. Foreign Direct Investment

China's imports and exports volume is expected to grow by more than 20% over the year 2005-2006 and is expected to touch US\$1.7 trillion. China's foreign trade maintained rapid growth in the first nine months, with the imports and exports volume reaching US\$1.27 trillion, a year-on-year increase of 24.3%. Moreover, exports totaled US\$691.2 billion, up 26.5% from the same period last year, and imports reached US\$581.4 billion, up 21.7%.⁶⁵⁵ According to the 11th five year program of the Ministry of Commerce, China has set the goal to keep foreign trade volume at US\$2.3 trillion in 2010, with a balance between imports and exports and the growth rate will be maintained at 10% annually.

According to the Ministry of Commerce, China has attracted US\$665 billion foreign funds as of the end of September 2006. In fact, it has been the biggest recipient of Foreign Direct

⁶⁵⁴ <http://www.nottingham.edu.cn/>

⁶⁵⁵ Ibid.

Investment (FDI) among the developing countries for 15 straight years.⁶⁵⁶ These foreign investors come from about 200 countries and regions worldwide and include 480 of the global top 500 corporations. Moreover, in order to meet the demand of China's national development and industrial structure adjustment, the Ministry of Commerce and the National Development and Reform Commission are adjusting investment guidance for foreign investors, so as to encourage more investments in the high-tech, advanced manufacturing, energy-saving and environmental protection, modern agriculture and service industry.

According to the China Customs Bureau, the value of China's foreign trade will reach a record US\$1,758 billion. Foreign trade has grown by more than US\$1,200 billion since China entered the WTO, when the value of foreign trade was just US\$509.6 billion. In 2002, the total value of China's foreign trade grew by more than US\$110 billion, or 21.8%. The increase was over US\$200 billion in 2003 and has been over US\$300 billion every year since.⁶⁵⁷

Between 2001 and 2003, China went from being the world's sixth largest trading power to third largest behind US and Germany. The proportionate value of China's foreign trade on a world scale has increased from 3.9% in 2001 to above 7.5% in 2006. The enormous growth in China's foreign trade is based on the improvement of national industry. China has reduced import tariffs several times since its accession to the WTO, expanded the opening of the domestic market and promoted the growth of imports.

China's monthly trade surplus stood at US\$23.37 billion in November 2006, slightly dropping from October's US\$23.83 billion. The November figure has brought the aggregate surplus to a new high of US\$157 billion in the first 11 months of 2006, a year-on-year increase of US\$66 billion. Exports reached US\$875 billion, up 27.5%, which was 2.2 percentage points lower than the rise during November 2005. Imports amounted to US\$718 billion, up 20.5%, which was 3.4 percentage points higher than November 2005 figures.⁶⁵⁸

China's foreign exchange reserves hit US\$1.0387 trillion at the end of November 2006. This was triggered by China's ballooning trade surplus. China's stockpile of forex reserves, the world's largest, stood at US\$1.0096 trillion at the end of October 2006.⁶⁵⁹ China's massive

⁶⁵⁶ Ted C. Fishman, "Çin, Inc. Dünyanın Yeni Süper Gücünün Yükselişi ve Hem Dünya'ya Hem de Amerika'ya Meydan Okuyuşu", Tercüme Edenler: Güneş Tokcan, Nalan Başkal Ünver, İstanbul Klan Yayınları (2005)

⁶⁵⁷ Ibid.

⁶⁵⁸ **China Industry Monitor**: Chinese Economy, Cyngus Bussiness Consulting & Research Knowledge Partner For Profitable Growth, Vol. 701, January 2007 - www.cygnusindia.com

⁶⁵⁹ **China Industry Monitor**: Chinese Economy, Cyngus Bussiness Consulting & Research Knowledge Partner For Profitable Growth, Vol. 702, February 2007 - www.cygnusindia.com

foreign exchange reserves are mainly the result of a sharp surplus increase in goods trade. The hefty rise in goods trade surplus is due to China's improving manufacturing capabilities and the country's booming exports supported by a robust global economy. Its foreign exchange reserves reached US\$1.066 trillion by the end of December 31, 2006. Surplus in foreign direct investment (FDI) under the capital account decreased slightly as Chinese enterprises sped up overseas investment.⁶⁶⁰

China's new foreign exchange investment arm is expected to focus on strategic investments in energy and resources as well as emerging market assets, which could have significant implications for asset allocation on the global market, US treasuries and potentially the US dollar. China's parliament announced that it will set up the State Foreign Investment Corp (SFIC) to manage and diversify part of the country's huge foreign exchange reserves. The new body, which will report directly to the State Council, is likely to be operational by the end of 2007. The consensus is that it will start with at least US\$200 billion worth of assets under management. The investment mandate for the SFIC is likely to involve overseas strategic investment in crucial sectors of national interest, such as energy, and also in international equity and bond markets to enhance long-term returns. In the near-term, shifts in the investment portfolio of China's forex assets are likely to take place gradually, as it would not be in the country's interest to cause a significant sell-off in the US treasury market. But the medium-to-long-term implications on international capital flows could be more significant and complicated. One particular concern, in the context of international capital flows, is the issue of the 'recycling' of China's current account surplus, which according to IMF forecasts would sustain at annual levels of US\$200 billion-US\$275 billion over the next five years.⁶⁶¹ The incremental accumulation of China's forex assets will likely be channeled less into US treasuries and other US assets directly. However, capital will not necessarily flow into non-dollar assets instead, as a large portion of the SFIC's strategic and portfolio targets are still likely to be denominated in US dollars. China's foreign exchange reserves hit US\$1.066 trillion at the end of 2006, up from US\$818.9 billion the year before.

China's plan to set up a separate foreign exchange investment firm will not affect the nation's US dollar assets. The investment firm will not be a unit of any other government department and will be aimed at ensuring the continued growth in value of the nation's foreign

⁶⁶⁰ **China Industry Monitor:** Chinese Economy, Cyngus Bussiness Consulting & Research Knowledge Partner For Profitable Growth, Vol. 703, March 2007 - www.cygnusindia.com

⁶⁶¹ **China Industry Monitor:** Chinese Economy, Cyngus Bussiness Consulting & Research Knowledge Partner For Profitable Growth, Vol. 704, April 2007 - www.cygnusindia.com

exchange holdings. China does not disclose the exact details of its foreign exchange holdings but the dollar is widely known to be a major component.

D. CONCLUSION

In conclusion we have tried to explain the pragmatist aspect of Chinese political culture and its' influences over Hong Kong and put forth the results of taking Hong Kong back by the help of the pragmatist policy.

We had seeked the realist China's situaiton and tried find the answer: According to it's realist policy why would China want to achieve a predominant position in the region? For realists, “a state’s freedom to choose whether to seek great-power status is in reality tightly constrained by structural factors.” More important, “eligible states that fail to attain great-power status are predictably punished.” China is seen as such a state that is aiming to become a major power in the Asia-Pacific region.

From the liberal perspective, both China and its trading partners have common interests in maintaining stability and prosperity in the post-Cold War world, and they should seek to maximize their absolute gains through international cooperation. Today, China is beginning to matter as much for the rest of the world as Japan, the EU or the US.” The problem is that it has never been easy for the international system to accommodate newly emerging powers. By the way, it is been expected that the rise of China may cause instability or military conflict, so that the outside world must seek to draw China into the international community peacefully and accommodate China and itself into the current system.

Internationally, the rise of Chinese nationalism has coincided with a presumption in the international community that nationalism has assumed an irrational and dangerous quality that might distort a state’s true interests and threaten other states in the late twentieth century. The rise of Chinese nationalism is seen as “a potent force in a country that is striving to shake off its image as the sick man of Asia and regain ancient glory. To be sure, pragmatic leaders have displayed a consistently real politic worldview. Nevertheless, their preferred ends have predominantly remained the defense of their own political power and the preservation of China’s territorial integrity. They have played up a history of painful Chinese weakness in the face of Western imperialism, territorial division, unequal treaties, invasion, anti-Chinese racism, and social chaos, because eliminating “the century of shame and humiliation” is at the heart of a principal claim to CCP legitimacy. The regime’s legitimization has always been based on its ability to defend China’s national independence against foreign enemies.

In the Chapter II, my research tried to know the differences in Chinese administrative system by the famous great leader Mao and the reforms that he made. Also the economy policies and the results of the Great Leap Forward were investigated and it appears that this process was a Great Leap Backward for China in the end. The radical changes both in the political and economic system had been applied in Deng era and i also tried the brought up the foreign relations of China with the Russia, USA, ASEAN, Africa and European Union.

In Chapter III, my research was about the structural and the sectoral analysis over Chinese economy including the Coal Industry, Natural Gas Industry and Current Natural Gas Policies and also Prospects for Chinese Natural Gas Resources. The role of Petroleum & Oil in Chinese economy, Nuclear Reactors and Power Prospects, usage of electricity and renewable energy in Chinese economic system. The economy of the People's Republic of China is the fourth largest in the world when measured by nominal GDP. Its economic output for 2006 was \$2.68 trillion USD. Its per capita GDP in 2006 was approximately US \$2,000 (US \$7,600 with PPP), still low by world standards (110th of 183 nations in 2005), but rising rapidly. As of 2005, 70% of China's GDP is in the private sector. The smaller public sector is dominated by about 200 large state enterprises concentrated mostly in utilities, heavy industries, and energy resources.

Since 1978 the People's Republic of China (PRC) government has been reforming its economy from a Soviet-style centrally planned economy to a more market-oriented economy but still within the political framework, provided by the Communist Party of China. This system has been called "Socialism with Chinese characteristics" and is one type of mixed economy. These reforms started since 1978 has helped lift millions of people out of poverty, bringing the poverty rate down from 53% of population in 1981 to 8% by 2001.

To this end the authorities have switched to a system of household responsibility in agriculture in place of the old collectivization, increased the authority of local officials and plant managers in industry, permitted a wide variety of small-scale enterprise in services and light manufacturing, and opened the economy to increased foreign trade and foreign investment. The government has emphasized raising personal income and consumption and introducing new management systems to help increase productivity. The government also has focused on foreign trade as a major vehicle for economic growth. While the accuracy of official PRC figures remains the subject of much debate, Chinese officials claim the result has been a tenfold increase in GDP since 1978. Some international economists believe that Chinese economic growth has been in fact understated during much of the 1990s and early 2000s, failing to fully factor in the growth driven by private enterprises.

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