CHINA'S INTERNAL DILEMMAS
ROUNDTABLE: CHINA'S INTERNAL DILEMMAS AND IMPLICATIONS FOR THE UNITED STATES

HEARING

BEFORE THE

U.S.-CHINA ECONOMIC AND SECURITY

REVIEW COMMISSION

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

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FEBRUARY 25, 2011

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UNITED STATES-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION

WASHINGTON : 2011

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U.S.-CHINA ECONOMIC & SECURITY REVIEW COMMISSION

WILLIAM A. REINSCH, CHAIRMAN
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March 11, 2011

The Honorable Daniel Inouye
President Pro Tempore of the Senate, Washington, D.C. 20510
The Honorable John A. Boehner
Speaker of the House of Representatives, Washington, D.C. 20515

DEAR SENATOR INOUYE AND SPEAKER BOEHNER:

We are pleased to notify you of our February 25, 2011 public hearing and roundtable on *"China's Internal Dilemmas."* The Floyd D. Spence National Defense Authorization Act (amended by Pub. L. No. 109-108, section 635(a)) provides the basis for this hearing and roundtable.

At the hearing and roundtable, the Commissioners heard from the following participants: Dr. Elizabeth Economy, Dr. Martin K. Whyte, Dr. Murray Scott Tanner, Dr. Yukon Huang, Dr. Steven Dunaway, and Mr. James Mann. The subjects covered included the social, economic, and political roots of protest in China and the Chinese Communist Party's response; the major challenges to stability in China; and implications for the United States.

We note that the full transcript of the hearing and roundtable will be posted to the Commission's website at www.uscc.gov when completed. The prepared statements and supporting documents submitted by the witnesses are now posted on the Commission's website. Members and the staff of the Commission are available to provide more detailed briefings. We hope these materials will be helpful to the Congress as it continues its assessment of U.S.-China relations and their impact on U.S. security.

The Commission will examine in greater depth these issues, and the other issues enumerated in its statutory mandate, in its 2011 Annual Report that will be submitted to Congress in November 2011. Should you have any questions regarding this hearing or any other issue related to China, please do not hesitate to have your staff contact our Congressional Liaison, Jonathan Weston, at 202-624-1487 or jweston@uscc.gov.

Sincerely yours,

William A. Reinsch
Chairman

Daniel M. Slane
Vice Chairman

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FRIDAY, FEBRUARY 25, 2011

CHINA'S INTERNAL DILEMMAS

ROUNDTABLE: CHINA'S INTERNAL DILEMMAS AND IMPLICATIONS FOR THE UNITED STATES

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- Mr. James Mann, Foreign Policy Institute Author-in-Residence, Johns Hopkins University, SAIS, Washington, DC

- Dr. Yukon Huang, Senior Associate, Carnegie Endowment for International Peace, Washington, DC
- Dr. Steven Dunaway, Adjunct Senior Fellow for International Economics, Council on Foreign Relations, Washington, DC
- Dr. Martin K. Whyte, Professor of Sociology, Harvard University, Cambridge, MA
- Dr. Murray Scot Tanner, China Security Analyst, CNA, Alexandria, VA

CHINA'S INTERNAL DILEMMAS
ROUNDTABLE: CHINA'S INTERNAL DILEMMAS AND IMPLICATIONS FOR THE UNITED STATES

FRIDAY, FEBRUARY 25, 2011

U.S.-CHINA ECONOMIC AND SECURITY REVIEW COMMISSION
Washington, DC

The Commission met in Room 562 (Hearing) and Room 116 (Roundtable) Dirksen Senate Office Building, Washington, D.C., at 8:49 a.m., Chairman William A. Reinsch (Hearing Co-Chair), Daniel M. Slane, Vice Chairman, and Commissioner Robin Cleveland (Hearing Co-Chair), presiding.

OPENING STATEMENT OF CHAIRMAN WILLIAM A. REINSCH
HEARING CO-CHAIR

CHAIRMAN REINSCH: Let's bring this hearing to order, please. Good morning. Welcome to today's hearing on "China's Internal Dilemmas."

As this year's Chairman, I want to thank you all for joining us today. We appreciate your participation, and we encourage all of our guests in the audience to attend other hearings throughout the year.

Today we're going to do something that's a little bit different format-wise. The morning is going to be devoted to a hearing in the traditional format. We have two panels of witnesses that you'll be hearing about shortly, but then we're going to break after that and go downstairs to a different room, 116, in this building, for a roundtable discussion whose participants will be most of our witnesses along with other outside experts and the members of the Commission.

This session is also open to the public so those of you that are in the audience that want to join us, we're happy to have you do so. Regrettably, we cannot offer you lunch, but grab something on the way down. For our witnesses and participants at the table, we can offer you lunch. So I will be encouraging everybody to hurry downstairs after this part is over so we can move on to that phase.

This is an experiment for the Commission. It's an attempt to get more of an interactive dialogue between our experts and ourselves and get out of the formality of the hearing process. We'll see how it works. Maybe it will; maybe it won't.

The hearing and the roundtable today will examine the social, economic and political roots of protest in China, and the Chinese Communist Party's response, the major challenges to stability in China, and the implications for the United States.

This is a particularly interesting issue for me and has been since I was in graduate school because I think Chinese economic progress, in particular, which is extraordinary, needs to be viewed in the context of their domestic challenges and the government's response to those challenges, and particularly whether there are inherent contradictions in their system of governance that effectively doom them to failure in dealing with these challenges, or whether they'll be able to surmount the challenges and continue to move in the direction that they're going.

So while most of what we do at the Commission focuses specifically on the bilateral relationship and various aspects of it, this hearing is an attempt to look at what's going on internally and to talk about the ability of the Party and the government to deal with that, and then to see if we can get a better understanding of how that then affects the bilateral relationship.

We have a group of witnesses this morning who are experts in what is going on there and I think are going to provide us with some very insightful comments on the questions I've just raised.

I'll ask our panelists to limit their opening statements to seven minutes each, please. A complete version of your testimony will be included in the hearing record automatically regardless of what you say. So you're already a prisoner of your written word.

For those of you who are new to our hearings, we're a bipartisan Commission composed of 12 members, six of whom are selected by the Majority Leader and Minority Leaders of the Senate and six selected by the Speaker and Minority Leader of the House.

Commissioners serve two-year terms. Congress has given our Commission the responsibility to monitor and investigate the national security implications of bilateral trade and economic relations between the United States and China. We fulfill our mandate by conducting hearings and undertaking related research as well as sponsoring independent research.

We also travel to Asia and receive briefings from other U.S. government agencies and departments. We produce an annual report and provide recommendations to Congress for legislative and policy change.

This is our second hearing this year. In the future, we will examine China's national security policy, China's investment policy, and China's foreign policy, among other things. Our next hearing will be on March 10.

Finally, let me remind Commissioners we don't have auxiliary microphones this morning for a variety of reasons, so the only microphones are the ones that are installed. You must push to talk. If you don't push the little button to talk, our wonderful stenographer will interrupt you and tell

you to do so. So please try to remember to push to talk, and I'll do the same.

Let me now turn it over to the Co-Chair for the hearing, Commissioner Cleveland.

[The statement follows:]

Good Morning. Welcome to today's hearing on "China's Internal Dilemmas." As this year's Chairman I want to thank you all for joining us today. We appreciate your attendance and we encourage you to attend our other hearings throughout the year.

The hearing and roundtable will examine the social, economic, and political roots of protest in China and the Chinese Communist Party's response; the major challenges to stability in China; and implications for the United States. I would ask our excellent panelists to limit their opening statements to seven minutes, please. A complete version of the submitted testimony will be included in the hearing record.

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This is the second hearing for 2011; we will also examine China's national security policy, China's investment policy and Chinese foreign policy.

I now turn the microphone over to my hearing co-chair, Commissioner Cleveland.

OPENING STATEMENT OF COMMISSIONER ROBIN CLEVELAND
HEARING CO-CHAIR

HEARING CO-CHAIR CLEVELAND: Thank you.

I share virtually all of your concerns and associate myself with your remarks. China's made impressive economic strides during the past 30 years, and, in particularly, I have been impressed by the fact that they've lifted probably 300 plus million people out of poverty, but significant challenges remain, including growing income inequality, corruption, environmental issues, housing, education, access to health care.

And what we are hopeful to address today is how citizen dissatisfaction with those issues is influencing and shaping Chinese government policy.

With the news of political unrest in the Middle East, how the Chinese government has responded with censorship and policy decisions gives us some indication of their view of their own security, and I'm hopeful that the witnesses will address events in the Middle--how the Middle East is translating into policy choices in China.

At today's hearing, we have the opportunity to explore whether any of the challenges faced by Chinese society and economy have the potential to

challenge the Chinese government's legitimacy.

I think Bill has reviewed the procedures. I've got all these written orders from the staff as to how we should describe what happens, but you've covered that. So let's turn to the witnesses. Are you going to do the introduction?

[The statement follows:]

I want to thank everybody for being here today. I would especially like to thank Senator Ben Nelson and his staff for helping us secure today's hearing venue.

This hearing is focused on analyzing and understanding the internal problems in China that jeopardize the control by the central government and the Chinese Communist Party, and the implications for the United States. The topic is particularly timely.

China has made significant economic strides during the past thirty years, leading to the rapid development of its national infrastructure, expansion of industry, and higher standards of living. For the Chinese government, political legitimacy is linked with economic growth. Significant challenges remain, however. Growing income inequality, migrant labor pressures, and corruption, among other problems, are signs of China's growing citizen dissatisfaction.

News of political unrest in the Middle East has been heavily censored in China, hinting at Chinese government insecurity and concern over domestic threats to its legitimacy. At today's hearing we will have an opportunity to explore whether any of the challenges faced by China's society and economy have the potential to challenge Chinese government legitimacy.

Today we will try something a little different. The two formal hearing panels will be followed by a roundtable discussion in the afternoon. Chairman Reinsch will moderate. We ask all our witnesses and members of the audience to join us for the roundtable in Room 116 of the Dirksen Senate Office Building after Panel II concludes.

The transcript of today's hearing and the panelists' written testimony will be posted on our website and will be used in the preparation of our annual report. The Commission will take all views into account when it later formulates its own recommendations to the Congress. We appreciate the work our distinguished witnesses have put into preparing their statements, and we thank them for being here to testify.

CHAIRMAN REINSCH: Yes, thank you.

The first panel consists of three very distinguished experts. Dr. Elizabeth Economy is C.V. Starr Senior Fellow and Director for Asia Studies at the Council on Foreign Relations.

Dr. Economy has published widely on both Chinese domestic and foreign policy. Her most recent book is The River Runs Black: The Environmental Challenge to China's Future.

She's been with us before, and we're delighted to have her back with us again.

Next is Dr. Martin Whyte, Professor of Sociology at Harvard University. His primary research and teaching specialties are comparative sociology, sociology of the family, and sociology of development, the sociological study of contemporary China, and the study of post-Communist transitions.

Welcome to you, too, Dr. Whyte.

And finally, we have Dr. Murray Scot Tanner, China Security Analyst at the Center for Naval Analysis.

Dr. Tanner has published widely on Chinese and East Asian politics and

security issues and is an expert on internal security, social unrest, policing, and intelligence in China.

Welcome to you, too, Dr. Tanner.

I think we'll proceed in that order from right to left, or left to right, depending on which way you're facing. So, Dr. Economy, we'll begin with you.

Thank you.

PANEL I: ROOTS OF PROTEST AND THE PARTY RESPONSE

STATEMENT OF DR. ELIZABETH ECONOMY
C.V. STARR SENIOR FELLOW AND DIRECTOR, ASIA STUDIES, COUNCIL ON FOREIGN RELATIONS, NEW YORK, NEW YORK

DR. ECONOMY: Thank you very much. Let me begin by thanking the members of the Commission for the opportunity to testify before you this morning on this very important and timely issue of the roots of protest in China and how the Communist Party is responding to this protest.

I'd like to make just four brief points concerning the nature of the challenge. First, the roots of protest in China rest in the systemic weakness of the governance system: a lack of transparency, official accountability and the rule of law.

Second, the nature of protest is evolving in important ways. Over the past several decades, protest has been primarily rural-based with the exception of workers in some urban factories, but today we are seeing the emergence of urban middle class protests that has both different purpose and different strategy and challenges the government in different ways.

Third, much as people predicted a decade ago, the Internet has become a potent weapon in the world of Chinese protest. In fact, I would argue it is becoming a virtual political system.

And, finally, while the regime has been quite effective at keeping protests isolated and preventing them from crossing boundaries, it is clear that the Communist Party is enormously concerned about its ability to maintain stability but has yet to develop a set of tools that does more than address the symptoms of the challenge.

So, first, the fundamental roots of protest rest within the system of governance. Without robust and transparent political institutions, it is difficult for public grievances to be addressed in a timely and judicious manner.

The result is that disputes that might otherwise remain manageable often flare up into much more serious, potentially violent, large-scale protests.

So in the arena that I've studied most closely, the environment, what often happens is that people try to work through the legal system, maybe for one or two years or even more, in order to get redress for the pollution problems they're suffering, for example, crop loss or dead fish or serious health issues.

When they can't get redress, they may stage a small protest in front of

the polluting factory, but then you get escalation when the factory managers or workers try to disperse the protests, often using some level of force. At that point, you'll find the entire village will become engaged in this protest, and indeed it may spread to many more villages surrounding this protest. Before you know it, you have thousands of people smashing buildings and setting police cars on fire.

From my perspective, one of the most telling aspects of social unrest in China is the degree to which a small incident that affects only a few people can transform into a large-scale violent protest.

To me, this suggests a serious sense of dislocation, perhaps powerlessness and alienation, from the political system.

The second important issue is the emergence of urban unrest. While many of the 90 to 100,000 odd protests every year--and I think maybe Scot will give us the best numbers that are out there--are in rural areas, we're now seeing urban, educated, middle-class Chinese protests, primarily around social issues such as the environment.

We've had protests against a PX plant in Xiamen, the maglev train in Shanghai, and perhaps the source of greatest urban unrest, incinerators throughout coastal China.

What is particularly interesting is that urban residents are often protesting against something that has yet to happen rather than against some injustice that has been perpetrated against them. So in this way, they are influencing the policy decision-making process at the local level. This could have profound implications for the evolution of China's political system over time.

A third important aspect of social unrest is the rise of the Internet. Typically, when we think about the Internet in China we often think about a medium that amplifies nationalistic voices, which it certainly does. However, it has also become a medium through which people live political lives that they can't otherwise experience.

The Internet has become very important in terms of promoting transparency. This is certainly true in the environment, but also a year ago or so, Beijing had put out some statistics on housing prices to try to say that housing prices hadn't actually increased as significantly as many people believed, but just within a few weeks, a real estate association based in Beijing put out an entirely different set of statistics, a much higher number than the official number.

You also have people who will post videos of their dealings with corrupt or petty bureaucrats online. This allows people all over the country to connect in a very new way to gain transparency and to understand that their experiences are not unique.

The Internet has also become a system of justice, maybe vigilante justice, but when wrongdoings are perpetrated by corrupt officials, Chinese citizens can take their case to the Internet.

There have been a number of cases where political cover-ups have been unmasked because of the Internet, or where justice has been served because tens of thousands of Chinese demand it over the Internet. It's akin to having a virtual national watchdog on local corruption.

And finally the Internet has been used on numerous occasions to organize protests. One of the most interesting cases was in Jilin in July of 2010, in which a protest over a planned incinerator spread from a village to a nearby urban area. They were all concerned about the toxins. Villagers were also concerned about a planned highway coming through.

But then young people came in and used Twitter and cameras to spread the word about the protests even though they themselves were not directly affected by the incinerator. This is interesting in that it's a kind of political activism for the sake of political activism, not simply because these people are directly affected.

My fourth and final point is about the government response and the depth of the challenge. Again, the Chinese government has been very effective at putting out the fires of protest and adapting to new forms of protest, such as urban and Internet protests by responding to worker demands for higher wages, ad responding to middle class desires for quality of life, while at the same time monitoring the Internet, shutting down Web sites, and harassing and detaining dissidents. The government has had a very effective tool box in terms of managing this mounting social unrest.

But I think the level of concern they express publicly, the mounting resources they invest in public security, by some accounts equal to the amount that they're investing in national security, the overreaction to any perceived challenge, all suggest, I think, an insecurity born of a real fear.

I don't think we can predict with any accuracy when or even whether these protests might produce a genuine "Jasmine Revolution," but we can take our cue from the Chinese leadership itself and acknowledge that it is a real and present danger for them.

Thank you.

[The statement follows:]

Elizabeth Economy
C.V. Starr Senior Fellow and Director, Asia Studies
Council on Foreign Relations

Testimony before the U.S.-China Economic and Security Review Commission on February 25, 2011

"China's Internal Dilemmas"

Roots of Protest and the Party Response

Introduction

The roots of protest in China rest in the systemic weakness of the country's governance structure. A lack of transparency, official accountability, and the rule of law make it difficult for public grievances to be effectively addressed and encourage issues such as inflation, forced relocation, environmental pollution, and corruption to transform from otherwise manageable disputes to large-scale protests. As a result, the Chinese government has contended with an estimated more than 90,000 protests annually, in each of the past three years.[1]

[1] John Garnaut, "China Insider Sees Revolution Brewing," *The Sydney Morning Herald* (February 27, 2010).

Moreover, the nature of protest in China is evolving. Traditionally, most protest has been rural-based. In the past few years, however, the urban middle-class has demonstrated a new-found willingness to advance its interests through protest. In addition, the Internet has become a virtual political system with individual complaints able to go viral in a matter of minutes, gaining widespread popular support across gender, age, profession and provincial boundaries.

The government response to this endemic social unrest is multi-faceted and case dependent. Arrests of corrupt local officials are often accompanied by arrests of protest leaders. Particularly vocal protestors may be detained or put under house arrest without prior warning or specific cause. Broad-based middle class protest has generally been met with warnings to protest leaders but also a degree of responsiveness to the demands. In response to Internet-based protests, the Chinese government deploys both Internet police to monitor traffic and insert government opinion, as well as the full range of technical solutions to shut down websites or blogs that the Party views as particularly destabilizing. The Party has also used public security forces to harass online activists.

The Nature of Protest

Chinese protest is typically rooted in a failure of the political system to protect the rights of the people, whether the issue at hand is related to land, environment, labor, or general official corruption.

Land disputes are particularly common; they are reportedly responsible for up to 65 percent of all protests.[2] In some instances, local officials expropriate land illegally; in others, they fail to compensate citizens adequately. In one case in July 2010 for example, officials in Gangkou, Jiangxi Province, offered to relocate villagers away from a heavily polluted site that had sickened them but provided only minimal compensation. When police beat two female petitioners into a coma, thousands of angry citizens used bricks and stones to smash windows and overturn police cars.[3] In urban areas, forced eviction has become increasingly common as local officials seek to develop older residential areas into more profitable office space and expensive apartment complexes. In Shanghai, a group of women housing activists were repeatedly detained—some as many as almost 100 times—as a result of their efforts to stave off eviction in the run-up to the 2010 Shanghai Expo.[4]

The environment is also an issue that provokes substantial social unrest. Rates of environmental degradation and pollution in China top world charts. For the Chinese people, the failure of local officials and factory managers to enforce environmental regulations translates into crop loss, poisoned fish and livestock, and serious public health concerns. During the summer of 2010, for example, thousands of villagers in Guangxi province protested against a plan by a heavily-polluting aluminum company to build a new highway. The plant had ruined their drinking water and caused their crops to suffer. When the factory brought in workers armed with sticks, villagers from nearby towns came to support the villagers. Three migrant workers were killed, and a number of villagers wounded. According to one report, as many as 10,000 villagers were involved.[5]

Labor issues are also an increasingly common source of protest in coastal China. Labor shortages and better-educated workers contributed to a rash of strikes during the summer of 2010, with workers calling for higher wages and improved working conditions. Local officials and plant managers generally met these calls with raises and promises to improve living conditions.

Most challenging for the government, however, is the pervasive sense of unfairness within Chinese society. As a result, seemingly small incidents flare up to engage thousands of people. For example, a mourning ceremony for a small boy who died in a hospital in Jiangsu (where another child had recently died from the same treatment) garnered thousands of people and turned violent when police and other security forces massed.[6] A

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[2] "Rural Land Disputes Lead Unrest in China," *China Daily* (November 6, 2010).
[3] Qing Gu, "Ten Thousand Villagers Protest in Southeast China," *The Epoch Times* (July 5, 2010).
[4] "China Silences Women Housing Rights Activists Ahead of Expo 2010," *Amnesty International (April 30, 2010).* Accessed at http://www.amnesty.org/en/news-and-updates/china-silences-women-housing-rights-activists-ahead-expo-2010-2010-04-30.
[5] Yilian Chen, "Thousands Protesting in Southern China Violently Suppressed," *The Epoch Times* (July 2010).
[6] Zhuang Pinghui, "Mourning for Boy Erupts Into Violence," *South China Morning Post* (December 7, 2010).

dispute over a motorcycle parking issue in Sichuan similarly engaged thousands in violent protest with police after the couple was beaten by local officials. [7]

While the Chinese government has been relatively adept at "putting out the fires" of traditional rural-based protest, in the past few years, a new form of protest rooted in urban areas has also emerged. These protests are significant because they represent an effort to change the outcome of the policy process, thereby preventing an injustice, rather than being primarily a response to an injustice already committed. In May 2007, for example, in Xiamen, the local government agreed to site a large petrochemical plant near the city center, in contravention of Chinese regulations.[8] Local university professors and students rallied between 7,000-20,000 people for a weekend-long peaceful protest and successfully staved off the development of the plant. At the next site proposed, a similar set of protests occurred and the plant was once again relocated, this time to a poorer region with weaker political capacity. Protests there were ignored.

A Virtual Political System

No aspect of contemporary Chinese life has the potential to be as politically transformative as the Internet. There are 450 million Internet users in China[9] with the capacity to inform themselves, organize, and protest online. In effect, the Internet has become a virtual political system.

To date, the Internet in China has often been associated with providing an arena for expressions of Chinese nationalism. Over the past decade, Internet nationalism has been associated with a number of perceived challenges to China's sovereignty or dignity, such as the EP-3 incident over the South China Sea in 2001. Nationalism has also been expressed via anti-Japanese protests and boycotts of Japanese stores and products in 2005, anti-CNN and western media protests during the Lhasa riots in 2008, and most recently during the flare-up between Japan and China during September and October of 2010. In the last instance, a number of Chinese Internet sites were filled with anti-Japanese postings, and QQ instant messaging was used to organize protests.[10]

Yet expressions of nationalism occupy only one small corner of Internet life. The Internet has begun to play a critical role in building transparency and enhancing the flow of information throughout Chinese society. A Baidu webpage scientifically ranks Internet searches based on their frequency. In 2010, the most powerful and widespread roots of discontent were unaffordable urban real estate followed by inflation (specifically rising commodity and food prices). While the government may try to downplay the challenge of inflation or report specious numbers, postings by concerned citizens ensure that information is available from a number of sources. As one posting on a Chinese website noted, "As a whole, food prices have risen 10.3 percent since this time last year. The price increases, however, are not uniform across the board. The price of wheat has risen 15.1 percent, the price of meat 10.9 percent, eggs 20.2 percent, water 11.1 percent, vegetables have risen 2 percent and fruits have shot up over 34.8 percent."[11] In response to such concerns, in January 2011, Beijing announced an increase in the minimum wage by almost 21 percent, while Guangdong had earlier raised the minimum wage by about 19 percent. [12]

In other cases, environmental activists post pollution maps online that detail which factories have yet to address their pollution problems. Rankings of some municipal environmental practices are now also being posted online, much to the chagrin of many local officials.

The Internet has also become a means of trying to ensure a degree of official accountability and the rule

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[7] "Beating by City Authorities Causes Angry Masses to Smash Police Station, Throw Bricks, and Overturn Police Car," *Ming Pao* (August 5, 2010). Accessed at http://www.sinonet.net/news/china/2010-08-05/89716.html.

[8] Edward Cody, "Text Messaging Giving Voice to Chinese," *The Washington Post* (June 28, 2007).

[9] Wang Qian, "450 Million Chinese Use Internet," *China Daily* (December 31, 2010).

[10] Kathrin Hille, "The Big Screening," *Financial Times* (November 17, 2010).

[11] "National Bureau of Statistics: CPI Up 4.9% From January of Last Year, Food Prices Up 10.3%" *Chinese National Radio* (February 15, 2011) Accessed at http://www.cnr.cn/gundong/201102/t20110215_507676871.html.

[12] Elaine Kurtenbach, "China Ups Minimum Wage as Inflation Persists," *Associated Press* (January 27, 2011) Accessed at http://www.chinapost.com.tw/china/china-business/2011/01/27/289231/China-ups.htm.

of law. In one case, a journalist sought by police on trumped-up charges of slander took his case to the Internet. Of the 33,000 people polled, 86 percent said they believed he was innocent. The Chinese newspaper *The Economic Observer* then launched a broadside against the police, condemning their attempt to threaten a "media professional." The authorities subsequently dropped the charges against the journalist.[13]

The most infamous case to date involves a young man, Li Qiming, in Hebei province who killed a young woman and injured another while driving drunk. He fled the scene of the accident, in the process shouting, "My father is Li Gang! Try to get me, I dare you!" The incident instantly went viral on the Chinese web, with "My father is Li Gang" becoming synonymous with government corruption and the privileged lives of officials' children. Despite the father's efforts to protect his son by apologizing on television and paying the family of the victim to drop its suit, Li Qimin was sentenced to six years in jail.

At the same time, the Internet can move beyond virtual justice to rally people in physical protest. As the blogger Qiu Xiubin writes: "When the interests of the people go unanswered long term, the people light up in fury-like sparks on brushwood. The Internet is an exhaust pipe, already spewing much public indignation. But if the people's realistic means of making claims are hindered, in the end we slip out of the make-believe world that is the Internet and hit the streets."[14]

In July of 2010, for example, bloggers provided first hand accounts of a large-scale pollution disaster in Jilin Province, contradicting official reports. Thousands of people ignored government officials, angrily accusing them of a cover-up and rushing to buy bottled water. In Guangzhou, in late 2009, a protest against a planned incinerator began with peasants living near the proposed site. However, they were soon joined by nearby workers and apartment dwellers. Some young activists used Twitter to spread the word and posted pictures on the Internet. While they were not directly affected by the plant, they wanted to use modern technology to spread the word and "show a protest in real time." With the engagement of the middle class and the use of the Internet, local officials soon promised not to pursue the project until an environmental impact assessment had been completed.[15]

The social network site Twitter, despite being blocked in China, has also become a particularly politicized Internet venue. According to the popular netizen Michael Anti, Twitter is the most important political organizing force in China today.[16] He notes that more than 1.4 million yuan was raised for the beleaguered NGO Gongmeng (Open Constitution Initiative) via Twitter. He also points to the uncensored discussion held between the Dalai Lama and Chinese citizens in May 2010 as an example of the political influence that twitter can exert. According to Anti, the people who participated stopped referring to the Dalai Lama as Dalai and now call him by the more respectful Dalai Lama. Anti reports that there are over 100,000 active users, and he anticipates that there will be 500,000 or more within the next two to three years.

Anti's claim of the importance of Twitter as a political force is supported by others. A poll of 1,000 Twitter users in China found that of the top twenty reasons why people access the site, almost a third of them are political: "to know the truth and open the horizon"; "no censor here, this is the taste of freedom that I enjoy"; "it allows me to keep my independent citizen conscious"; "feel that as a party member I should learn more about this world"; "it is an inevitable choice for a journalism student".[17] Moreover, according to the media critic Hu Yong, as Beijing has moved to strengthen its censorship efforts, Twitter has become more political in its orientation. He sees Twitter as particularly important because it brings together opinion leaders from around the world to sit at a virtual table. There public intellectuals, rights advocates, veterans of civil rights movements, and exiled dissidents can all

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[13] The following is taken from Elizabeth C. Economy, "Nobel Peace Laureate Liu Xiaobo and the Future of Political Reform in China," Testimony before the Congressional-Executive Commission on China on November 9, 2010.
[14] Don Weinland, "China: Increasing Trend in Mass Incidents," *Global Voices Online* (February 14, 2010). Accessed at http://globalvoicesonline.org/2010/02/14/china-increasing-trend-in-mass-incidents.
[15] Malcolm Moore, "China's Middle Class Rise Up In Environmental Protest," *The Daily Telegraph* (November 23, 2009).
[16] The following is taken from Elizabeth C. Economy, "Nobel Peace Laureate Liu Xiaobo and the Future of Political Reform in China," Testimony before the Congressional-Executive Commission on China on November 9, 2010.
[17] Oiwan Lam, "China: Survey on Chinese Twitter users," *Global Voices Online* (February 1, 2010). Accessed at http://globalvoicesonline.org/2010/02/01/china-survey-on-twitter-users.

converse simultaneously.[18] Recent calls for a "Jasmine Revolution" in China began with a Twitter post.

The Chinese Government Response

The Chinese government has managed through a range of incentives and coercive means to keep protests isolated and prevent unrest from directly challenging Party control. Responding to workers' needs for wage increases and improved living conditions, addressing middle-class concerns over quality of life issues, aggressively monitoring and responding to web-based protest, detaining and arresting protest and potential protest leaders, and dramatically increasing government expenditures for public security have all enabled the regime to keep social discontent from boiling over in a manner that threatens the stability of the country.

Yet the threat to stability remains. Central Party School official Gao Xinmin raised several issues concerning the challenge posed by the Internet in an off-the-record speech that was later made public on the web: "Against a backdrop of a diversity of social values, new media have already become collection and distribution centers for thought, culture and information, and tools for the amplification of public opinion in society. They are a direct challenge to the Party's thought leadership and to traditional methods of channeling public opinion. Traditional thought and education originates at the upper levels, with the representatives of organizations, but in the Internet age, anyone can voice their views and influence others. Many factual instances of mass incidents are pushed by waves of public opinion online, and in many cases careless remarks from leaders precipitate a backlash of public opinion."

In the wake of the protests throughout the Middle East, moreover, China faced its own calls for change. A Twitter posting called for a set of protests to be held in major Chinese cities on February 20th—a "Jasmine revolution." While the protests largely fizzled, the government's reaction was instructive as thousands of police were mobilized, prominent dissidents were arrested, and edicts were issued to keep university students from leaving campuses. Only the day before, President Hu Jintao had delivered yet another speech on the need to control society more effectively through means such as a national database to cover every Chinese, more effective use of the Internet, socialist education, improving the Party's leadership, etcetera.

Outside China, analysts often portray the country as a model for other developing countries to emulate—a uniquely successful authoritarian regime. Yet it is evident that the Chinese leadership itself is not confident about its continued ability to manage the pervasive social unrest and discontent it confronts. Unless the Party is prepared to address the fundamental roots of such unrest—the lack of transparency, official accountability and the rule of law—pressure from below is only likely to grow, with new forms of protest from the urban, middle class and the Internet making Party control even more tenuous.

CHAIRMAN REINSCH: Thank you.
Dr. Whyte.

STATEMENT OF DR. MARTIN K. WHYTE
PROFESSOR OF SOCIOLOGY, HARVARD UNIVERSITY
CAMBRIDGE, MASSASSCHUSETTS

DR. WHYTE: All right. I also would like to thank you for inviting me to talk here today, and to start out, let me reference Monty Python, "now for something completely different."

I don't disagree with what my colleague Liz Economy has said, and I presume with Dr. Tanner, but I've been studying something different, which many people feel is an important reason to fear that China might become unstable, and that's the rising income inequality and other distributive

[18]Yong Hu, "The Revolt of China's Twittering Classes," *Project Syndicate* (October 14, 2010). Accessed at www.project-syndicate.org/commentary/hu2/English.

justice issues that many people see.

Many Chinese say that China for two decades now has been above the "danger zone" into high inequality, and that an increasing number of people are angry, feeling that the structure of inequality in their society is unfair, and that the benefits of the reforms are being monopolized by the rich and powerful.

Colleagues and I have been conducting a program of research for more than ten years to find out how ordinary Chinese think about patterns of inequality today? We've conducted three surveys, and I'm going to mainly be talking about the first national survey we did in 2004, summarized in my recent book, Myth of the Social Volcano, if you're interested in going to Amazon.

This was a national survey. We've done a five-year follow-up which I won't be talking about much, but I can address it in the Q&A. Basically we find that there's very little evidence for what I call a "social volcano" due to rising anger about increased inequality, either in 2004 or in 2009.

We're able in this study to replicate questions that have been used in our own society and in Eastern European post-socialist societies so we can compare Chinese views on inequality issues and the chances of getting ahead with views of their counterparts in other societies.

So just a few key findings. One, it is the case that most Chinese think that income gaps in their country are too large. 72 percent said so. Well, it turns out that in almost every society, a majority of people say that. 65 percent of Americans say that. Well, that's a little bit lower than in China, but in almost every other country that we looked at, higher percentages said that.

In Eastern Europe, 85 to 95 percent of the people surveyed said, yes, there's too much income inequality. A more key fact is we asked people why do you think some people are rich and why do you think some people are poor?

In response to these questions, Chinese respondents in our surveys are off the charts in terms of their interpretation that it's mostly differences in ability, hard work, talent, education, and so forth. It's not corruption, dishonesty, unfairness.

They recognize that those latter factors play a role, but when they look around them, they see mainly differences based upon merit. So they see the system of inequality in which they live as characterized more by distributive justice rather than distributive injustice.

We also asked them, well, do you think the government should do more to reduce inequality and redistribute from the rich to the poor? Here Chinese are kind of in the middle. They're not particularly desirous for the government to do more to limit inequality, particularly in regard to a question about whether the government should place maximum income limits on people?

Chinese agree with income limits more than Americans do, but Americans are off the chart in the other direction, as we all know, given our famous individualism and distrust of government intervention.

But in most other societies except the U.S. and China, there are larger

proportions who say, yes, the government should do more to limit inequality.

We also asked about what people thought their chances were for getting ahead, and how well they've been doing compared with five years earlier. On these questions, Chinese are again off the charts. In 2004, more than 60 percent said their families were doing better than they were five years earlier. And they predicted that five years in the future, again, over 60 percent thought they would be doing better. In our most recent survey in 2009, the figures have gone up. 75 percent now think their families will be doing better five years from now. No other country we compared China with comes close to those levels of optimism.

So, in general, we don't find clear evidence for the assumed large anger about the unfairness of the current patterns of inequality. So the question is why are there all these protests in China that Liz has been talking about and that Scot will also be talking about?

If people think it's so fair, why are they going to the streets? Well, as I look at the research that my colleagues and many others have been doing on social protests, it seems to me such protests are almost always sparked by procedural injustices--unfairness of local governments, abuses of power, people not able to get redress when they're mistreated, and so forth, and by fear about whether they're going to be able to maintain their property or their future careers.

It's not anger about some people being much richer than they are. Okay. So there's an entire, in my view, misplaced focus on rising inequality. In any society, the important issue is not inequality; it's inequity. If the inequalities are large, but you think they're fair, then you're not going to be upset, and that seems to be the case in China, and, incidentally, as you may know, that seems to be the case in America.

The Paul Krugmans of the world gnash their teeth because they can't understand why Americans aren't more angry about inequality. Anyway, let me not get into talking about America, but finish talking about China.

So if people aren't upset about inequality, why am I here today, and what has my research got to do with the themes of this hearing? Okay. Well, I have two basic responses that I want to use to conclude:

The first is that it seems to me that people's satisfaction with current patterns of inequality, and their very substantial optimism about their chances of getting ahead despite the existence of corruption and dishonesty and unfairness, and the fact that they look around them and see many other people getting ahead and doing better, all of these things, it seems to me, provide a source of legitimacy for the system and its leaders and a counterweight to the dissatisfactions they have in other realms.

In my prepared statement, I use the familiar distinction between distributive justice and procedural injustice. So I think many Chinese say the distributive justice situation is satisfactory, but in terms of procedural injustice, they may feel their society is in lousy shape. But the whole system is not seen as corrupt and in need of being overthrown. At least I don't see the evidence of that.

So I think there's a reservoir of support for the system, and the

leaders are very adept at taking credit for that, and in regard to the procedural injustice problems, they're also very adept at placing blame on those local guys and deflecting blame from the central leadership.

A final point is that we've all heard about Hu Jintao and his harmonious society campaigns, and many of us thought this was just public relations slogans or telling people to behave. But, in fact, they've done major things to redistribute to the poor, and particularly to relieve burdens from people in the countryside.

My time is running out, but in my prepared statement I present figures from our two surveys on medical insurance coverage, and there's been a dramatic increase nationwide and particularly in the countryside.

Now, rural people are more likely to have medical insurance than urban people for the first time probably in recorded history. So I think that changes also provide some increased acceptance of the status quo. In contrast could Mubarak or Gaddafi point to these kinds of major changes designed to improve the lot of the poor? I think the Chinese leadership is doing everything they can to convince the population that they should be allowed to continue their dictatorship.

Thank you.

[The statement follows:]

February 25, 2011
Martin K. Whyte
Professor of Sociology, Harvard University
"Testimony before the U.S.-China Economic and Security Review Committee"
"China's Internal Dilemmas"

Chinese society in the last three decades has been characterized not only by robust and sustained economic growth, but also by a rising tide of social protest activity. Especially in view of recent events in Tunisia and Egypt, it makes sense to ask whether China might face a similar challenge to the dictatorial rule of the Chinese Communist Party (CCP). In these prepared remarks I focus mainly on one potential threat to China's political stability: anger about inequality issues. Do Chinese citizens feel that the rising inequalities produced by post-1978 market reforms have made their society so unfair that CCP rule should no longer be tolerated? Based upon more than a decade of research on Chinese opinions on these issues, including three rounds of surveys I directed (in Beijing in 2000, and with national samples in 2004 and again in 2009), my answer to this question is a resounding "no!" Whatever other popular grievances Chinese citizens have--and they are considerable--most accept the more unequal post-socialist order in which they now live as more fair than unfair, and as providing ample chances for the industrious and ambitious to raise their living standards and improve the lot of their families, as Chinese families have done for centuries. I contend that for the most part current patterns of inequality constitute more a source of stability rather than instability for the regime.

Myth and Reality of Chinese Popular Attitudes Regarding Current Inequalities

My recent book reporting results of the 2004 China national survey, *Myth of the Social Volcano*,[19] challenges the widespread belief, within China and among many foreign analysts, that citizen anger over rising inequality increasingly threatens CCP rule. What are the basic elements of the social volcano scenario? They start with the accurate observation that income and many other inequalities have increased markedly since China's reforms were launched in 1978. In terms of the Gini coefficient conventionally used to measure income inequality, China went from an estimated Gini of .28 or less as the reforms were launched to .47 in 2007—in other words, inequality of incomes across China has almost doubled in the post-Mao era.[20] This trend, it is argued, is resented by most

[19] Stanford, CA: Stanford University Press, 2010.

[20] See chart at the end of this document of Gini trends for China and selected comparison countries. A Gini of 0 indicates everyone has equal incomes; a Gini of 1

Chinese, who perceive that the powerful and already rich and connected are monopolizing most of the new opportunities and wealth created by market reforms. In other words, it is assumed that Chinese citizens view current inequalities in terms of rampant distributive injustice. It is also assumed that many Chinese harbor nostalgia for the greater equality that they perceive existed in the socialist era. Another element of the social volcano scenario is an assumption that anger about distributive injustice is most common among groups, and in locales, that have been left behind by China's rising prosperity—for example, among farmers, migrants, the urban unemployed, and residents of interior provinces. Rising anger about distributive injustice issues is seen as a primary cause of the rising social turbulence and protest activity that have characterized China in recent years.

Except for the initial observation that income gaps have increased in the reform era, all elements of this social volcano scenario are at best oversimplifications, and at worst dead wrong. Let me illustrate my contrarian conclusion through selected findings from our 2004 national survey (the detailed evidence behind the findings cited here can be found in *Myth of the Social Volcano*), with briefer mention of the results of our five year follow-up survey in 2009. The 2004 survey resulted in interviews with a nationally representative sample of 3267 Chinese adults residing in 23 of China's 31 provincial units, respondents who were selected through a procedure called spatial probability sampling[21] (with a response rate of approximately 75%). The 2009 survey followed the same design and sampling frame and resulted in 2967 completed interviews, a response rate of 69%.[22] The availability of prior surveys in other countries on these issues makes it possible to place the views of Chinese citizens in comparative perspective.

How do Chinese citizens perceive the heightened inequalities within which they now live? A substantial majority (72%) of 2004 survey respondents said that national income gaps are excessive (75% in 2009). While this is modestly higher than the percentage of Americans who voiced this view in a 1991 survey (65%), it is about the same as the percentage of West Germans, British, and Japanese who felt income gaps were excessive in that same 1991 survey project, and much lower than the share of residents of most other post-socialist societies who think income gaps in their societies are excessive (85-96%, in surveys conducted in Bulgaria, Russia, Hungary, the Czech Republic, and the former East Germany between 1995 and 2006). Furthermore, when asked whether the income gaps within their work organization and within their neighborhood are excessive, only about 1/3 said yes, with the most common response being that such local inequalities are about right. Perceptions that national income gaps are too large are common around the world, and Chinese citizens do not stand out as especially angry about such gaps, despite the sharp increase in income inequality in the PRC. And most Chinese do not view the inequalities in their immediate environments as unreasonable.

Perhaps the most striking pattern of responses in our 2004 survey concerns questions about why some people are rich while others are poor, questions developed in the International Social Justice Project (ISJP) surveys carried out in Eastern Europe and selected advanced capitalist countries between 1991 and 2006 which we replicated in our Chinese surveys. These questions present respondents with a list of possible explanations for why some people are poor and a similar list of reasons why some people are rich and ask them to say, for each listed reason, how relatively important or unimportant it is. The two lists mix together explanations stressing individual merit (e.g. talent and hard work, or their absence) and reasons stressing societal unfairness (e.g. unequal opportunities, dishonesty, unfairness in the economic system). In response to this set of questions, Chinese respondents rate talent, hard work, and education as much more important in explaining poverty versus wealth than various kinds of societal unfairness, and their pattern of responses is strikingly different and more "meritocractic" than found in any ISJP country, whether East European or advanced capitalist. For example, over 61% of Chinese respondents felt lack of ability was an important or very important reason why some people are poor, with the comparable

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(multiplied by 100 in the chart) means total inequality, with one person or family monopolizing all of the income.

[21] Spatial probability sampling involves using maps and population density estimates to randomly select sampling sites with probability proportional to population size, and then to interview one randomly selected adult within each household located within a designated perimeter around each sampled physical point.

[22] Both surveys were conducted by an international team of social scientists which included Albert Park, Pierre Landry, Wang Feng, Jieming Chen, Chen Juan, and Chunping Han, with the surveys administered by our PRC colleagues, Shen Mingming, Yang Ming, Yan Jie, and the staff of the Research Center for Contemporary China at Peking University. Primary funding for the 2004 survey was provided by the Smith Richardson Foundation and for the 2009 survey by the Harvard China Fund and the Smith Richardson Foundation. The funders of the surveys are not responsible for the views offered here.

figures from other ISJP countries ranging from 26% in Japan (1991) to 37% in the former West Germany (2006). On the other side of the coin, only 17% of Chinese respondents felt that dishonesty was an important or very important reason why some people are rich, with the comparable figure for other ISJP countries ranging from 28% in Japan to 82% in Bulgaria (1996).

It is apparent that most Chinese we interviewed do not view the current patterns of inequality as stacked against them and preventing them from getting ahead, a view reinforced by how they responded when asked to assess the (dubious) statement, "hard work is always rewarded." Overall, more than 61% of 2004 China respondents (66% in 2009) said they agreed or strongly agreed with this statement, whereas the comparable figures from the ISJP surveys ranged from only 3% (Bulgaria again, 1996) to 47% in the former West Germany. How can such relatively favorable and optimistic appraisals be squared with our knowledge that cases of official corruption in China elicit widespread popular condemnation in informal conversations as well as on the Internet?

China's record of sustained economic growth, job creation, and poverty reduction for more than three decades likely discourages Chinese citizens from seeing pursuit of individual and family prosperity as a zero-sum game, in which corrupt officials and business owners profit at the expense of everyone else. Chinese are not unaware of or unconcerned about the unfair routes that have propelled some new Chinese millionaires and billionaires to their current affluence. However, as they look around them in their daily lives and immediate communities, they see ample opportunities and many examples of ordinary people without special connections who have risen from poverty to enjoy much more comfortable and prosperous lives. Indeed, substantial majorities of respondents in both the 2004 (64%) and 2009 surveys (75%) said their families were better off than they had been five years earlier, and these experiences reinforce optimism about the future. Close to 62% of our interviewees in 2004 said they expected their family's standard of living to improve over the coming five years, and in the 2009 survey even more respondents (73%) voiced this expectation. Furthermore, in the 2009 survey more than 82% of our respondents said that on average their neighbors were better off than five years earlier. Even if they are not prospering, most Chinese see others in their immediate environment who are doing so.

In other words, Chinese popular acceptance of current and enlarged inequalities is fostered by widespread perceptions by the people we interviewed that they and many of their neighbors are better off today than a few years ago and that they can expect things to continue to improve--despite obvious imperfections and unfairness in China's current political economy. One can thus readily understand the obsessive concern China's leaders have with keeping the growth engine going, since by doing so they hope to avoid widespread popular anger about distributive injustice issues. Is there some magical growth target, such as the widely quoted 8%, that must be maintained in order to keep China's distributive injustice social volcano dormant? It is hard to be sure, since China has relatively effectively and rapidly dealt with threats to its growth engine (after the Tiananmen massacre and foreign sanctions in 1989, the Asian financial crisis in 1997, and the global financial crisis in 2008-2010), so the reform era has yet to witness a sustained period of lower or negative economic growth.[23]

Views on distributive justice versus injustice involve not simply perceptions of current patterns of inequality, but preferences for a more fair social order. Do many Chinese citizens harbor nostalgia for the perceived greater equality of the Mao era, and do they think the government should be playing a more active role in fostering equality and redistributing from the rich to the poor? Our surveys contain detailed questions to tap views on preferences for equality and on government efforts to foster a more egalitarian society. In regard to these issues, the dominant attitude of Chinese survey respondents is more a liberal welfare state orientation than a preference for radical redistribution, much less a return to socialism. Only about 1/3 or less of our 2004 survey respondents favored equality as a general principle of distribution, systematic redistribution from the rich to the poor, or placing limits on maximum incomes. However, substantial majorities of Chinese respondents, ranging from 62% to 81%, expressed support for providing extra help to the disadvantaged and for the government providing minimum income guarantees and jobs for the jobless. In these regards Chinese citizens voice views that are broadly in the middle of the pack compared to citizens in ISJP surveys in other countries. For example, on the question of whether there should be a maximum income limit imposed by the government, the proportion in favor in China (34%) is similar to Japan (33%) and slightly lower than the proportion in England (38%) and Russia (40%). It is much

[23] When in 2008 we planned and applied for funding to conduct our follow-up survey in 2009, we expected China to suffer a sustained dip in economic growth as a result of the global financial crisis due to the importance to China of export-oriented manufacturing. However, the impact on China was less severe and prolonged than we anticipated.

higher than the figure in the United States (17%) while being much lower than in Hungary (61%) and the former East Germany (59%). There is no evidence in these findings for an especially pronounced desire, much less nostalgia, for greater social equality.[24]

In sum, rather than Chinese society being a social volcano about to explode in anger about distributive injustice issues, it appears from our survey results that most Chinese citizens view current inequalities as relatively fair and as providing ample opportunities for ordinary individuals and families to get ahead. Chinese on most counts view the current system as more fair than do their counterparts in other post-socialist countries in Eastern Europe. Compared to their counterparts in advanced capitalist countries, they express views that are similar or at times even more favorable. Thus our survey data lead to an ironic conclusion. In China lifelong communist bureaucrats are doing a better job legitimating the ideas, incentives, and differentials of their increasingly capitalistic society than the leaders of more democratic and even well established and wealthy capitalist societies. Although these conclusions are based mainly on results of our 2004 survey, and we are only in the preliminary stages of analyzing the follow-up survey we carried out in 2009, in general there is no sign of any rising anger about distributive injustice issues over this five year time interval. In general terms the 2009 survey respondents gave responses about distributive justice issues that were at least as favorable, and sometimes more so, than their 2004 predecessors. Five years later, the idea that China faces a distributive injustice social volcano remains a myth.

An Exception That Proves the Rule

Do our survey respondents approve of current patterns of inequality in all respects? No, they do not. There are a variety of features of current inequality patterns that respondents disliked. For example, about 56 % disapproved (and only 21% approved) of the practice of individuals in official positions receiving special treatment, while more disapproved than approved of state enterprises laying off employees in the effort to become more efficient. However, the most systematic disapproval of current patterns of inequality concerned China's institutionalized discrimination against its rural citizens and rural migrants. We had to design our own questions about this particular axis of inequality, since countries included in the ISJP surveys lack any counterpart to China's system of discrimination based upon the household registration (*hukou*) of the place where you were born. In response to our questions on this issue, from 58-77% of respondents in our 2004 survey disapproved of denying migrants urban household registrations, access to certain urban jobs, access to urban social benefits, and access to urban public schools for their children. In fact, urbanites were as likely as those with agricultural *hukou* or even more so to express disapproval of these persisting discriminatory practices.[25]

So China's entrenched structures of rural-urban inequality, and institutionalized discrimination based not on merit but on where you were born through the *hukou* system, are widely condemned by our survey respondents. However, it is important to note that this is not an inequality that market reforms have introduced. Instead it is a legacy of Mao's system of socialism, which effectively made Chinese villagers into "socialist serfs," bound to the soil. One could argue that this is one current inequality that has not been widened by market reforms, since Mao-era controls prevented villagers from becoming migrants and joining the "floating population" in pursuit of better opportunities outside their places of birth. However nasty the discrimination suffered by China's 130 million + migrants today, they have at least escaped the confines of their village and a life of agricultural toil in their quest for better opportunities elsewhere, as Chinese villagers had done for centuries before Mao's socialism closed the doors to rural-urban migration. Chinese analysts and even Chinese leaders have increasingly recognized that discrimination based upon the *hukou* system is an anachronistic and unjust legacy of the socialist era, but they have not yet found a way to dismantle this system without courting the social instability that they fear.[26]

Even if Chinese accept most other features of current inequality patterns, does this condemnation of institutionalized rural-urban inequality and the social injustice it generates constitute a threat to China's political stability? Will China's villagers and urban migrants rise up to collectively challenge a system that permits such

[24] For more evidence on this specific point, see my paper, "Do Chinese citizens want the government to do more to promote equality?" available at http://www.wjh.harvard.edu/soc/faculty/whyte/Publications/Whyte_Do_Chinese_Citizens_Want_the_Govt_to_do_More.pdf

[25] In almost all cases rural migrants living and working even for extended periods in cities retain their status as holders of agricultural and outsider *hukou*.

[26] For further analysis of this issue, see the conference volume I edited, *One Country, Two Societies: Rural-Urban Inequality in Contemporary China*, Cambridge, MA: Harvard University Press, 2010.

unfairness to persist? On this question again my response is negative. Everything we know about inequality and feelings of injustice in societies around the world indicates that feelings of unfairness are not generated automatically by objective inequalities, but are the product of subjective evaluations of fairness and unfairness. And those subjective evaluations involve relative expectations and comparative reference groups. In America as much as in China, if individuals feel that they are being deprived of opportunities and benefits that are being unfairly enjoyed by less deserving members of their reference groups, they are likely to be incensed. I may covet the nicer office down the hall of a colleague, but I don't get very angry about the outrageous wealth being accumulated by Bill Gates, Bruce Springsteen, or Tom Brady. China's urban migrants, who bear the brunt of rampant discrimination rooted in the *hukou* system, for the most part compare themselves with other migrants and with relatives and neighbors back in the village, and not with holders of urban *hukou*. And in our surveys it is striking that migrants, and even farmers, report more improvements in their families' standards of living compared to five years earlier than urban residents, and similarly greater optimism about continued income gains in the future. So in spite of the pervasive discrimination that they experience, China's urban migrants and villagers remain fairly optimistic about their lives and future prospects, sentiments not likely to foster major challenges to the regime.

Social Contours of Distributive Injustice Feelings

Even if most Chinese are not particularly angry about current and rising inequalities, are there some pockets of concentrated anger about these issues? The social volcano scenario summarized earlier assumes that relative "losers" in the reform era are most likely to have strong feelings of distributive injustice. However, our survey results indicate that this assumption is also incorrect. Several patterns emerge when we look for variations in distributive injustice feelings.[27] There is no social group or geographic locale in which we find systematically more negative feelings regarding distributive justice issues across the board. However, there are nonetheless some tendencies for the attitudes of particular groups to differ from others across several inequality domains. These patterns do not coincide with the expectation that "losers" are angry while "winners" accept the status quo. The most consistent pattern in our 2004 survey results is the most unexpected. Across several measures, Chinese farmers (who remain at the bottom of any plausible occupational status hierarchy) tend to have more favorable attitudes, and less desire for the government to intervene to promote greater equality, than any urban social group. Within urban areas it is particularly the well-educated (seen by most as reform-era "winners" rather than "losers") who have somewhat more critical attitudes toward current inequalities and greater desires for government redistribution than their less-educated peers. There is also some tendency for the middle-aged, in contrast with both youths and the elderly, to have more critical attitudes on these issues. Most other objective background characteristics, such as family income, ethnicity, and CCP membership, are not good predictors of respondent attitudes on inequality issues. We do find, however, that subjective measures are better predictors. Respondents who say that their families are doing better than they were five years earlier and better than their neighbors tend to have favorable opinions about current inequalities, while those who have been experiencing financial difficulty or mistreatment by local officials tend to have more critical opinions.

I do not have time here to try to explain these complex findings, but in general they point to several clear conclusions. First, it is dangerous and misleading to try to guess people's attitudes from their objective status characteristics, since in China (unlike the patterns found in most other societies), some low status groups are more satisfied with current inequalities than the groups that have derived more benefit from market reforms. Second, our findings suggest that the patterns of inequality in the prior socialist era are not viewed with nostalgia by most Chinese, and for some groups (particularly China's villagers, still the majority of the population) market reforms with their associated increased inequalities may be seen as tantamount to "liberation" from the distributive injustices of Mao-era socialism. A third and more general point is that our results remind us that the terms "inequality" and "inequity" are not synonymous. What matters in terms of popular feelings of distributive justice or injustice are perceptions of inequity, not objective inequality. If income gaps widen but most people feel that the widened gaps are fair (as appears to be the case in our surveys), then feelings of inequity and injustice will not be generated. Contrary to some public statements in China, there is no Gini coefficient "danger line" above which further widening of income gaps inevitably produces political turbulence.

[27] See also my article (with Chunping Han), "Social Contours of Distributive Injustice Feelings in Contemporary China," in D. Davis and F. Wang, eds., *Creating Wealth and Poverty in Post-Socialist China*, Stanford, CA: Stanford University Press, 2009.

Distributive Injustice and Procedural Injustice?

Do our findings suggest that most Chinese citizens feel the social order in which they now live is fair in all respects? If they are so satisfied with the status quo, how can we explain the rising tide of social protests that have erupted in recent years? My answer to these questions turns on the fact that our survey work in China has been focused narrowly on distributive injustice issues, and not on social justice and injustice in other realms. Justice theorists tell us that there are distinct domains that can affect citizen attitudes, and this literature makes a basic distinction between distributive justice and procedural justice concerns. Procedural justice refers to things such as how much control people feel they have over their own lives and over the decision-makers who affect them, whether they feel vulnerable to arbitrary abuses of power, and whether they perceive that they have effective recourse when their rights have been violated by individuals in authority. In the growing body of research on social protest activity in China in recent years, it seems to me that almost always the sparks that set off popular anger and public protests are abuses of power and other procedural injustice issues, rather than distributive injustice complaints. Of course, drawing a clear line between these two types of social injustice can be difficult, since usually protestors are not only less powerful but also poorer than the targets of their anger. However, by my reading protest targets tend to be local officials, employers, and other powerful figures, rather than individuals who are simply very rich. The fact that our survey indicates that most individuals accept current patterns of inequality does not tell us whether they feel that they are being treated fairly by the powers that be. But when we asked 2004 respondents whether they or any member of their family had received unfair treatment by local officials in the previous three years, a striking 27% responded affirmatively. Although we lack comparable figures from surveys in other societies, this finding suggests that such official mistreatment is a surprisingly common occurrence. We may hazard a generalization that many Chinese feel they now live in a society characterized by distributive justice but fairly widespread procedural injustice.

Using surveys to systematically explore procedural justice issues, especially for a foreign researcher, is much more difficult and sensitive than inquiring about distributive injustice issues.[28] Since we don't have systematic data on procedural justice attitudes, experiences, and grievances, it is hard to know how serious these issues are and whether they are growing over time. However, if China's political stability faces threats in coming years due to popular anger about injustice incidents, the anger thus generated is likely to focus mainly on the arbitrary and arrogant behavior of those in power and not on those who have risen to previously unimaginable wealth.

Conclusion: Some Breathing Space and Some Reality to "Social Harmony"?

If many Chinese citizens feel that they are living in a society with inequality patterns that are relatively fair, but at the same time in a society that is rife with abuses of power and unfair treatment by authority figures, does that mean that my chosen topic for today, Chinese popular attitudes toward distributive justice issues, is irrelevant to whether China might become politically unstable? In this instance my response is "not necessarily," and I say that for two main reasons.

First, even if our survey-based assessment that most Chinese approve of current inequalities does not directly tell us anything about how those same citizens feel about other social justice issues, our findings do suggest they may have sufficient tolerance of continued CCP rule to offset and temper anger stemming from procedural injustices (or for that matter from other hot-button issues, such as rising inflation or international threats to China's national pride). In other words, the relative gratitude and optimism that average Chinese citizens display about their ability to get ahead and improve the lives of their families are likely lead to a degree of satisfaction with the status quo and a reluctance to mount challenges to the system that will continue to provide the CCP with some "breathing room," making a "social volcano" less likely. CCP leaders have also proved very adept at taking credit for wise guidance of the economy and the improved living standards of ordinary Chinese citizens, while being perhaps even more obsessed with deflecting blame for procedural abuses onto local officials and bosses rather than on the system itself (and its top leaders). As a result, China displays a "trust differential" that is common in many

[28] When we began our research on popular attitudes about rising inequality, we were often told that distributive justice issues were too politically sensitive to the authorities in China to make systematic survey research possible on the topic, and indeed no such systematic surveys had been carried out in China prior to ours. Our 2000 survey in Beijing was a pilot effort designed in large part in order to test this claim and to convince potential funders of a China national survey that a distributive justice survey was feasible under Chinese political constraints.

authoritarian regimes (although not in Tunisia and Egypt recently). Many citizens get angry at arbitrary and unfair actions of local authorities while having more faith in the central leadership, to whom they direct complaints and appeals in the hope that "grandpa" Wen Jiaobao or other top leaders will intervene and set things right. Whatever the indignities and abuses they experience in their daily lives, the acceptance and optimism associated in the popular imagination with the current combination of robust growth and market-based inequalities likely reduce the likelihood that Chinese citizens in large numbers will view the current system overall as unfair and corrupt and its top leaders as indifferent or inept.

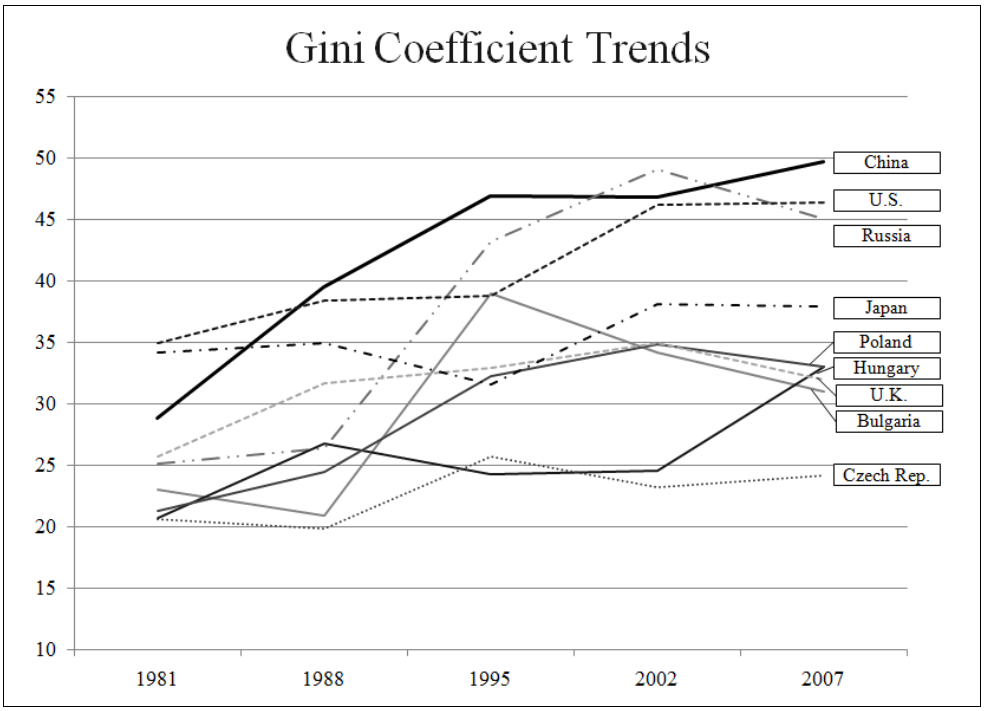
A second factor that makes anger about procedural justice issues unlikely to produce fundamental challenges to CCP rule is that the current social order is not static, and that many Chinese see recent changes that seem designed to make CCP leader Hu Jintao's "harmonious society" more than simply a public relations slogan. However much Chinese may joke about this slogan (with references to "river crabs," a homophone in Chinese for "harmonious"—*hexie*), some fairly dramatic changes have been taking place at the grass roots over the past decade. It may well be the case that CCP leaders have taken these measures only out of an exaggerated fear that growing inequalities may provoke mass protest incidents that could threaten their rule. Whatever the case, our surveys contain indicators of new efforts to alleviate poverty and give better lives to the poor, especially in rural areas, reforms of the sort that our survey questions indicate most Chinese would welcome. For example, in the 1990s, many localities in rural China experienced protest activities and conflicts with local leaders over the rising burden of the extra local taxes and fees they had to pay.[29] In response to this turbulence, the national leadership implemented tough new regulations and financial reforms designed to limit such excess local payments. In our 2004 survey we asked respondents what had happened to the local taxes and fees that they paid, and fully 70% told us that such fees had gone down compared to three years earlier, a marked and presumably appreciated change. In more recent times, central authorities have implemented other measures with the same intent, such as eliminating the grain tax paid by farmers and tuition fees for compulsory schooling (grades 1-9).

Perhaps the most dramatic change our surveys document is the effort to rebuild China's medical insurance safety net. In the late Mao era something like 90% of the population was covered by at least rudimentary medical insurance plans, but in the market reform era most medical care shifted to a pay-as-you-go basis, with about 90% of the population having no such coverage in the 1990s. In the first decade of the new millennium vigorous efforts were launched to revive and expand medical insurance coverage, particularly through a new network of village cooperative medical insurance plans. The second chart appended to this statement shows the dramatic change that occurred in insurance coverage in the five years between our two national surveys. In 2004 still only about 29% of our respondents overall had public medical insurance coverage, and these were overwhelmingly urban residents. By 2009 about 82% of all respondents had such insurance coverage overall, and villagers were actually more likely than urban residents (90% compared to 75%) to be covered (although, to be sure, the extent of coverage for medical costs is generally lower in rural than in urban plans). Moves are also underway in other realms, such as extending a system of minimum livelihood payments for the very poor (the *dibao* system) from urban to rural areas and to provide modest payments to elderly villagers who do not have a grown child (usually a son) to support them. While the sums involved in these eliminated fees and new welfare benefits may be modest, they reinforce a message that CCP leaders are only too anxious to convey—that the order of the day is no longer economic growth at top speed without regard for the human costs and the people left behind. Rather, the CCP wants their citizens to be persuaded that their leaders care about the welfare of the poor and are taking important new steps to spread the wealth and promote more equitable growth. Even though control over communications and the media is much looser today that it was in the Mao era, the CCP still has much more ability than the leaders in most societies to forcefully convey their message that official benevolence is constantly expanding opportunities for ordinary Chinese to improve their lives. The positive sentiments fostered by these recent changes (and the prominence given to them in the official media) likely augment the "breathing room" the CCP constantly seeks.

To conclude, our survey data indicate that most Chinese are not particularly angry about current patterns of inequality, don't bear extreme resentment toward the very rich, and don't want to return to the supposedly more equal social order of Mao's socialism. Instead most feel that current patterns are more fair than unfair, and some of China's most disadvantaged citizens (particularly farmers) voice such acceptance more than others. Whatever their complaints on other fronts, particularly regarding the procedural injustices that remain all too common, the substantial acceptance and optimism generated by China's continued economic growth, rising but more unequal

[29] See Thomas Bernstein and Xiaobo Lu, *Taxation without Representation in Contemporary Rural China*, Cambridge, UK: Cambridge University Press, 2003.

incomes, and recent anti-poverty measures promote stability rather than instability in China's political system.



Sources: China: 1981, World Bank; other years, China Household Income Project
Other countries: Available sources (contact author)

- Public health insurance coverage (%)

	2004	2009
Rural	15.4	89.6
Urban	50.8	75.2
Rural Migrants	9.2	56.1
Total	29.0	82.4
N	3250	2878

CHAIRMAN REINSCH: Thank you.
Dr. Tanner.

STATEMENT OF DR. MURRAY SCOT TANNER
ASIA SECURITY ANALYST, CHINA STUDIES DIVISION
CNA, ALEXANDRIA, VIRGINIA

DR. TANNER: I would like to begin by thanking the members of the Commission and especially today's co-chairs and the staff for kindly inviting me back again to testify before your Commission.

I would note, in particular, the honor of sharing this panel with two

colleagues, both connected with me from Michigan, from whom I've learned an enormous amount about these topics over the years.

I should note that my remarks today represent my own personal views and do not necessarily reflect the views of the CNA Corporation, any of its corporate officers, or its sponsors.

I've been asked today to testify about recent unrest trends in China, the institutional roots of those protests, and the response of China's law enforcement authorities. In doing so, I want to make five major points:

First, despite the historic success of Beijing's 30-year economic growth strategy, the available data from Chinese law enforcement sources indicate that unrest in China has continued rising for nearly two decades with little or no break.

Second, the core list of government and managerial abuses that spark the great majority of these protests has changed little over the past decade, notwithstanding innumerable directives and laws from Beijing to staunch them.

Third, this fact demonstrates that Beijing continues to struggle to find institutional responses that will check these abuses and predations by local officials, but over the past decade, it has been far more ambivalent in promoting some of the legal and political institutional reforms first inaugurated in the late 1980s and 1990s that once promised to strengthen citizen access, oversight, and influence.

Western analysts would be justified in asking themselves to what extent the promotion of political and legal structural reform can still be described as a major priority of the Chinese Communist Party anymore?

Fourth, shortly after the onset of the 2008 economic crisis, Chinese public security forces issued new regulations aimed at forging a more sophisticated response to unrest.

But, number five, as with previous efforts to develop a more effective police containment and management strategy for unrest, the question remains whether China's law enforcement forces can develop the discipline and professionalism necessary to carry out this new strategy and whether or not local Party authorities who command the police will let them?

Turning very briefly to recent unrest trends in China, according to Chinese law enforcement estimates on so-called "mass incidents"--that's their official term of art for a wide variety of social protests--China has seen an increase in social protests every year or nearly every year from 1993 to at least 2008. Numerous police analysts report that official mass incidents figures rose from a mere 8,700 in 1993, when these figures were first collected, to 74,000 in 2004, 87,000 in 2005, "more than 90,000" in 2006.

Official figures for the year 2007 are difficult to come by, but at least one analyst asserts that incidents may have declined slightly in number, but the number of people participating, quote, "increased dramatically"--closed quote.

Despite Chinese government efforts to keep protests down in the run-up to the 2008 Olympics, the spring and summer witnessed a series of high-profile and violent incidents. The one most noted in the United States was, of course, the March 14 riot in Lhasa, but for Chinese police, more attention

may have been paid to the large-scale protests in Weng'an, in Guizhou, in Menglian, Yunnan.

Protests appear to have spiked with the beginning of the financial crisis, soon after the Summer Games, and by the end of 2008, total mass incidents had reportedly risen to 120,000, despite the pre and post-Olympic security.

Nationwide, figures for 2009 and '10 are not yet available, though local data and reports by some prominent Chinese academics indicate protests climbed greatly in 2009 in the wake of the economic difficulties.

Many Chinese analysts placed primary blame on increasing protests on economic factors, most notably unemployment and China's increasingly unequal income distribution about which Dr. Whyte has just spoken.

But China has witnessed increases in unrest during years in which China's economy was growing and producing jobs at historically high rates above ten percent. My contention is that the persistent increase in protests over the past 18 years is rooted more in the failure of the system to provide citizens with accessible, effective political institutions that allow the redress of grievances of the type that spark most protests.

Data from police sources indicate that the list of grievances that spark the largest number of protests has changed little over the last decade, including illegal land seizures, forced evictions and demolitions, withheld wages and pensions, air and water pollution, and refusal of local authorities to honor citizen petitions.

Over the last decade, Party and state leaders have issued numerous speeches, directives, regulations and laws repeatedly demanding an end to each of these abuses, and yet the fact remains that all police data indicates that these still remain the major forces for unrest.

Faced with this gap between citizen demands and the ineffectiveness of Party and government institutional responses, the Party and government have felt they have little choice but to rely on their public security forces, to contain, manage, and if need be suppress social protests.

In December 2008, three months after the economic crisis, the Ministry of Public Security issued new regulations superseding the ones in 2007. They largely continued the same direction of--pardon me--issued in 2000--they largely continued the trend of the previous regulations to try to develop a more sophisticated strategy for preventing, containing and managing popular unrest.

My time is short, but I will briefly summarize a couple of the points in them:

One, and top of the list, police need to try to avoid causing protests to spin out of control by the ham-handed and inappropriate use of police violence.

There's a greater emphasis on intelligence and monitoring of citizen activists.

Police are encouraged to secure government buildings and facilities against being taken over.

Sometimes act as go-betweens between protesters.

And deploy police quickly when faced with certain, especially

sensitive, types of protests, including illegal organizations and so-called "evil cults."

I would simply note in closing that the major dilemma for this has always been do China's police have the professionalism and self-discipline necessary to carry out a much more sophisticated strategy for dealing with unrest, and recent incidents, as I mentioned in my statement there, raise serious doubts about that prospect.

Thank you very much.

[The statement follows:]

Murray Scot Tanner, Ph.D.
Unrest in China and the Chinese State's Institutional Responses

I would like to begin by thanking the Commission and its staff for their kind invitation to testify before today's panel. I should note that my remarks today represent my own personal views, and do not necessarily reflect the views of CNA, any of its corporate officers, or its sponsors.

I have been asked today to testify about recent unrest trends in China, the institutional roots of these protests, and the response of China's law enforcement authorities. In doing so, I want to make five major points:

- Despite the historic success of Beijing's 30-year economic growth strategy, the available data from Chinese law enforcement sources indicates that unrest in China has continued rising for nearly two decades with little or no break.
- The list of government and managerial abuses that spark the great majority of these protests has changed little over the past decade, notwithstanding innumerable directives and laws from Beijing to stanch them.
- Beijing continues to struggle to find institutional responses that will check these abuses and predations by local officials. But over the past decade it has been far more ambivalent in promoting some of the legal and political institutional reforms first inaugurated in the late 1980s and 1990s that once promised to strengthen citizen access, oversight, and influence. Western analysts would be justified in asking themselves to what extent the promotion of political or legal structural reform can still be described as major priority of the Chinese Communist Party.
- Shortly after the onset of the 2008 economic crisis, China's public security forces issued new regulations aimed at forging a more sophisticated response to unrest.
- As with previous efforts to develop more effective police containment and management of unrest, the question remains whether China's law enforcement forces can develop the discipline and professionalism to carry out the new strategy—and whether or not local Party authorities will let them.

Recent trends in unrest in China

China's leaders have expressed growing concern over social unrest over the past two-to-three years since the late 2008 onset of the global financial crisis and economic downturn. According to Chinese law enforcement estimates on so-called "mass incidents"—their official term for a wide variety of group social protests—China has seen an increase in social protests every year—or nearly every year—from 1993 to the late 2000s. Numerous police analysts report that official mass incident figures rose from 74,000 in 2004, to 87,000 in 2005, and to "more than 90,000" in 2006. Official figures for the year 2007, and at least one analyst asserts that incidents declined slightly that year, though the number of persons participating "increased dramatically."

Despite Chinese government efforts to keep protests down in the run-up to the 2008 Olympics, the spring and summer witnessed several high profile or violent incidents. While most Americans focused on the March 14 riot in Lhasa, Tibet, Chinese police were also fixated on major incidents such as those in Weng'an, Guizhou, and Menglian, Yunnan. Protest numbers apparently spiked with the onset of the financial crisis soon after the Summer Games,

and by the end of 2008, total mass incidents had reportedly risen to 120,000 despite the pre- and post-Olympic security. Nationwide figures for 2009 and 2010 are not yet available, although local data and reports by some prominent Chinese academics indicate protests climbed greatly in 2009 in the wake of economic difficulties.

The Institutional Factor

Many Chinese analysts place the primary blame for increasing protests on economic factors—most notably unemployment and China's increasingly unequal income distribution. But while it is certainly true that unrest statistics have spiked more quickly during major economic crises such as 1997 and 2008, China has witnessed increases in unrest during years in which China's economy was growing and producing jobs at historically high rates well above ten per cent per year.

My contention is that this persistent increase in unrest over the past 18 years is rooted much more in the failure of the system to provide citizens with accessible, effective, and reasonably autonomous legal and political institutions that can allow citizens to seek redress of the grievances that most commonly spark incidents of protest. Data from police analysts indicates that list of grievances that spark protest incidents has changed little over the past decade, and includes illegal land seizures, forced evictions and demolitions, withheld wages and pensions (often accompanied by unannounced factory closures), illegal pollution of air, water and farmland, and the refusal of local authorities to accept or honor citizen petitions.

This does not mean that the Chinese leadership has not tried to defuse unrest by promoting policy responses to protestor demands. To the contrary—over the past decade Party and state leaders have issued numerous speeches, directives, regulations and laws, repeatedly demanding an end to illegal land seizures, evictions and demolitions, pollution, withheld wages and other labor contract violations, and abuses of China's petition system. But the Party's preference has been to apply various forms of top-down pressure, monitoring, and promotion incentive systems to prod local Party and government officials to obey these regulations, end their predations, and be more responsive to popular complaints. The fact that Party leaders have repeatedly had to re-issue orders calling for an end to these abuses, while these abuses remain leading causes of unrest, demonstrates the inadequacy of these implementation and enforcement institutions. At the same time, I think that Beijing has been far more ambivalent over the past decade in promoting many of the legal and political institutional reforms that were first inaugurated in the late 1980s and 1990s, and which once promised to strengthen citizen access, oversight, and influence. Prominent among these were elections for village committees, significantly more autonomous courts and procurators, and a more assertive and critical National People's Congress.

Police Response Strategies

Faced with this gap between citizen demands and the ineffectiveness of the Party and government's institutional responses, the Party and government have felt they have little choice but to rely upon public security forces to contain, manage, and if need be to suppress social protest.

In December 2008—three months into the economic crisis—the Ministry of Public Security issued new regulations on how police should handle unrest, simultaneously revoking similar regulations it issued in 2000. These new regulations largely continue in the same direction as the 2000 regulations they replaced, and represent a further effort by security officials to develop an increasingly clear and sophisticated strategy for preventing, containing, and managing popular unrest. Among the most important objectives and procedures of this strategy endorsed by Public Security officials are the following:

- Avoid causing protests to spin out of control as the result of police mishandling.

- Emphasize forecasting and prevention. Strengthen police intelligence and social monitoring to foresee sources of social tension and potential unrest, and alert Party officials to head them off. This involves close monitoring, surveillance, and control of political activists and illegal groups.

- Insist on police obedience to local Communist Party leadership, and affirm the authority of local Party political officials to direct police in handling unrest.

- Secure Party, government, and military offices, broadcast facilities, and public squares against occupation.

- Encourage police to act as go-betweens and to "clear channels" (*shudao;* 疏导) between protestors and relevant managers or government officials.

- Deploy police forces quickly when faced with certain especially sensitive types of protest, including those led by illegal organizations, and especially what China calls "evil cults." In general, however, avoid arresting organizational protest leaders until a safe time, or after protests are dispersed.

- Exercise restraint in dispatching police forces to confront protestors. Show particular caution in using police weapons, or in plunging into crowds to arrest protest leaders.

- Notwithstanding these efforts to contain and defuse protests with minimum force, if protests degenerate into violence or constitute a major political threat, police should not hesitate to "decisively put down the incident according to law."

This counter-protest strategy demonstrates a good deal of political sophistication by emphasizing, whenever possible, the prevention of protests, the restrained use of force, and efforts to avoid enflaming onlookers who might choose to join the protestors, and by trying to drive subtle wedges between protest activists and larger groups of apolitical citizens.

Moreover, the 2008 regulations appear to contain some important changes from the 2000 regulations—the Ministry of Public Security seems to be trying to define a growing sphere of small-scale, low-confrontation, and less-broadly political protest incidents that small groups of police forces would monitor, but which large groups of police forces would not necessarily have to deploy to, contain and suppress. These incidents, for example, would include "rallies, marches, and demonstrations contained within a campus or work unit, in which there have not yet been any people injured, illegally detained, or any destruction of property, arson, or looting," that local police should not, in principle, be called upon to put down, but instead to monitor.

But effectively carrying out this strategy has always required that China greatly enhance the professionalism, personnel, and budgets of its security forces. Since police are under the leadership of local Party and government officials, it also requires that local authorities also be willing to take a more restrained, sophisticated, and responsive approach to unrest.

On whether and how much China's security forces are capable of carrying out this strategy, the evidence of the past several years is highly mixed. A particularly striking case was the fall 2008 Longnan, Gansu protest. Pictures of the protests made available on the internet depicted some police lines holding their positions and sealing-off streets despite evidence of being heavily stoned by protestors. But these photos also revealed numerous instances of police engaged in brutality against protestors—groups of officers kicking civilians on the ground, beating them with clubs, and hurling large chunks of broken concrete at persons apparently just out of camera view. So within the same incident, there appeared to be evidence both for and against the idea that China's police possessed the discipline needed to carry out a more sophisticated, restrained policing strategy.

The writings of Chinese police analysts have also long demonstrated a keen desire to avoid getting caught in the middle between an angry populace and government officials or enterprise managers who were committing unpopular, improper, or illegal actions. In January 2011, for example, police officials in Hunan province, the city of Wuhan, and some other localities announced a ban on police taking part in evictions, land seizures and "other activities that are not for police."[30] This is not, however, the first effort to prevent local Party and government misuse of police coercive powers in "non-police activities." Previous efforts have failed because local Party authorities have been able to invoke control over police budgets, personnel, and the need for loyalty to Party leadership to overcome police hesitancy to carry out these coercive actions.

Thank you for your attention

[30] Xinhua, "Hunan Forbids Public Security Organs from Participating in Forced Evictions. Instead, They Should Actively Try to Reconcile Disputes," (*Hunan yanjin gongan jiguan canyu zhengdi chaiqian. Yao jiji huajie jiufen*; "湖南严禁公安机关参与征地拆迁 要积极化解纠纷") 2011年01月1日 http://news.xinhuanet.com/legal/2011-01/11/c_12966922.htm.

CHAIRMAN REINSCH: Thank you very much, all three of you.

We're going to begin with Commissioner Cleveland, who has one specific question, sort of a factual question, and then we'll go down the list.

HEARING CO-CHAIR CLEVELAND: I'm interested in, Dr. Tanner and Dr. Whyte, how you collect your data? It's impressive, and given Dr. Economy's comments about transparency and access to information, in both cases, I'd be curious if you could sort of lay out for us how you did the surveys that you did, Dr. Whyte, and how you collect your information, and how valid do you consider, or what is the probability of error in terms of the data you're gathering?

DR. WHYTE: Well, I collaborate with a former Michigan student, who is now the director of a survey center at Peking University, and who's very well trained in survey methods, and we've been working together since his student days.

My colleagues on the panel all know him. We use a national probability survey of more than 3,000 adults selected through a complicated system called spatial probability sampling, which because you can't get good numbers on the ground means you actually use GPS machines to select physical points and sample people, so you get a good representative sample. Then we follow all the standard survey precautions of assuring people of confidentiality, that we're not coming from the government, and so forth. I don't go and interview people myself; we have special teams of Chinese interviewers.

HEARING CO-CHAIR CLEVELAND: That's really what I'm interested.

DR. WHYTE: Yes.

HEARING CO-CHAIR CLEVELAND: Are they face-to-face interviews? Are they--

DR. WHYTE: They're face-to-face interviews using basically the same methods used by well-trained survey operations--Gallup organization, and so forth--in our own society. So it's a very high quality sample, and the details--you can hear a lot more about it if you care to get my book. Previously there were no systematic surveys on this topic, and when we started, people told us this is still too sensitive. You can't ask this kind of question. The Chinese authorities won't allow it, but my colleague, and former student, is a very savvy person, and we've been able to carry it off.

DR. TANNER: I do hope that Co-Chairperson Cleveland will forgive me if I demure a little bit about the specific details for where I come up with numbers on Chinese police estimates of unrest, but simply that I will say that I exclusively use things that are cited by qualified Chinese law enforcement experts with access to government estimates.

But I want to take a second and say a little bit about these numbers because these numbers can take on too much of a life of their own.

Anybody who was here in town during, for example, the Million Man March, knows that estimates of protest number and size is one of the great mystic arts for law enforcement and Park officials.

And the Chinese police are no exception. They gather their data from local police authorities. The only thing I would note is that these are being cited by precisely the organization whose people are paid to keep these numbers down, and so when I see them consistently rising year in and year out, I take that point seriously.

But the fact that the data every year almost always seem to end in exactly three zeros leads me to expect that we are in the realm of estimate here.

[Laughter.]

CHAIRMAN REINSCH: Okay. Moving along, Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you, Mr. Chairman, and I want to thank all three panelists for very interesting testimony this morning. It's a cutting-edge issue, and a lot of it is based on feel, I know, but there are a lot of numbers out there, too.

I would like to welcome Dr. Economy back to the Commission. Nice to see you again. And also, Dr. Whyte, good to see you again after several years, after we went to undergraduate school together; I think it was two or three years ago we went.

[Laughter.]

COMMISSIONER D'AMATO: Good to see you again, Dr. Tanner.

DR. WHYTE: I'm still alive and so are you.

[Laughter.]

COMMISSIONER D'AMATO: Thank you all for your very, very interesting testimony. It's a question primarily for Dr. Economy, but either or both of you are welcome to comment on it, too.

And that is the question of who is winning here--the twitterers or the censorers--based on recent experience and what the real attitude of the Party is toward the Internet, given the large numbers that were cited about the number (some 100,000 people are participating in twittering, and maybe as many as half-a-million are coming in the near future on this venue), and your description of the Internet as a virtual political system and as a political force?

To me political force means the beginning of organizations, and what we saw in the Arab, in the Arab experience just recently was the kind of communication between the Tunisians, for example, and the Egyptians, which led to development of some kinds of quasi-organizations in Egypt, particularly, as a result of that dialogue. There was a lot of interest in China, apparently, in the so-called "Jasmine Revolution," which, quote, "fizzled," but there was some interest in change maybe beyond simply just twittering here.

And I have a question of what is the nature, if any, of organizational development as a result of the existence of the Internet and all of this action that we can discern in China; and, secondly, what is the actual reaction of the Party toward this phenomenon?

Obviously the presence of the Internet provides information to the regime, to the Party, about what's going on, and advanced warning, and people put up whatever positions they have on politics, and the regime can take action against those individuals, so it's almost like an intelligence

operation on the part of the Party to understand what's happening in the society.

But it can get out of control. I notice you quote a speech by the head of the Party school who just-- was his speech leaked or did he actually purposely put it out on the Internet to say we regard this as a direct challenge to our authority? They regard the Internet as a direct challenge to the Party's authority.

Is that the attitude and will that result in a renewed attempt to shut it down out of fear of what has just happened in terms of the reaction to the Egyptian results?

So the question is what is the scorecard between the two? Are there organizational implications that we can now discern here, and what will be the inevitable reaction of the Party to it? Small question.

DR. ECONOMY: That's an enormous question that's like worthy of an entire lecture, but let me just make a couple of points.

The Party's relationship to the Internet is very complicated, and you basically set out the sides of it. The Party wants to use the Internet to engage with the populace as a transmission vehicle from the Party to the people. For example, they have Internet police who will inject opinions like "Don't worry, inflation is not as bad as you think," but obviously not say that they're working for the government.

The Party leadership at one point had set up a kind of Internet chat. Wen Jiabao went online, and had 90,000 people write to him, asking him questions. There was supposed to be a kind of formal Internet, the Zhongnanhai Express. It was supposed to be an avenue via the Internet through which you could communicate with Party leaders, but apparently is not operational. So the government is interested in finding out what the people are thinking and they want the opportunity to tell the people what they think the people should be thinking.

Also, of course, it is, as you suggest, a mechanism for identifying troublemakers and going after them, which they're reasonably successful at. They move pretty efficiently.

Having said that, the opportunity for people to organize via the Internet is clear. The protests are organized via the Internet--there is no doubt about it--and via instant messaging and via microblogging. It has happened in Xiamen. It has happened elsewhere. These things move very quickly--too quickly for public security to shut it down as it's going out.

I think who's winning the war back and forth is very difficult to tell. I think its cat and mouse game. As the government develops new techniques, people find ways to work around them. It's a constant kind of hide-and-seek for the Internet activists.

One of the interesting things in terms of formal organization via the Internet that hasn't happened very successfully is formal organizations within civil society, non-governmental organizations, they often are not those that are engaged in the protests.

So, for example, there's a very big difference in the environmental arena between people who work on the environment as an NGO activist and people who protest on environmental issues.

Usually, NGO activists are not partaking in the street protests. So the formal institutional infrastructure for protests that could exist doesn't necessarily translate onto the Internet system. Rather those NGOs would be working to promote transparency or the rule of law. They tend to work more toward pushing the boundaries of the political system somewhat within the system.

I don't know whether I've answered all of your questions, but you can come back to me.

COMMISSIONER D'AMATO: I will. Dr. Whyte, do you have any comment on it?

DR. WHYTE: Well, in general, China is sometimes interpreted as if it's now just another authoritarian country, but I would say it's still got enough Leninism in it to make a difference. I haven't done a systematic study of attempts to control the Internet in China compared to Egypt or wherever, but it seems to me the resources and the degree of organization and the degree of loyalty that leaders can still depend upon are substantially greater in China.

So I think Leninism still makes a difference. Now sometimes it hasn't worked as you know. In 1999, with the Falun Gong protest, 10,000 people showed up for a sit-in in Beijing. This was organized mainly by cell phones, and the public security was authorities were apparently completely caught flat-footed. They had no idea.

But with 1989 and with 1999, I assume they're learning and trying to figure out ways to combat this. It seems to me it's still just a much stronger political system than some of the ones that are collapsing in the Middle East.

COMMISSIONER D'AMATO: Dr. Tanner.

DR. TANNER: Thank you.

I would associate myself with the views of my colleagues on this. One point in particular that I think Dr. Economy made that is very well put, this is a mutual learning game where each side goes back and forth and tries to get the upper hand on the other. The police are trying to learn the new techniques that are used by twitterers and protesters, and the ability of society to adapt with counter-techniques is remarkable in some cases.

In fact, I can't imagine that any of us who have studied this topic haven't at times just sat back and chuckled at the cleverness with which some of the people who organize these protests are able to get around monitoring, either by using euphemisms such as, hey, at five o'clock, we're all going to go for a walk, and that "walk" is 30,000 down the streets of Xiamen or something like that.

Or the simple structural advantage that the Chinese language has more homonyms. Mandarin has more homonyms, I suspect, than any other language in the world, and homonyms are frequently used to get around the censorers automated control of particular words.

The police don't necessarily think they're winning this. Neither do high-level leaders, and we saw a fairly dramatic example of that just this last week. General Secretary Hu Jintao gave a major address that is actually rather mind-numbing to read, but it's on the topic of social management,

but if you slog through the verbiage and decode the language, one of the things that he's very concerned about is the loss of control over what he calls the "virtual society."

And he's very worried about this, and there have been police speeches and directives that have come forth on this since then so they do not necessarily think that they are winning this.

COMMISSIONER D'AMATO: Thank you.

Just one quick follow-up, if I may, Mr. Chairman.

CHAIRMAN REINSCH: Quick.

COMMISSIONER D'AMATO: The reason I say this is I've got a nine-year-old Tibetan boy at home who spends a lot of his time in virtual reality along with his friends, and you wonder when they're going to get to actual social reality. They spend their time on iPads and so on and so forth.

Is the younger generation in China addicted yet to these machines and the Internet the same way our society is? And that would portend perhaps even more of a problem for the regime in the future than they currently face with more mature twitterers.

DR. TANNER: They are indeed addicted among the young, and what is the current running number for Internet users in China? 500 million, 450 million or something like that?

DR. WHYTE: More than the American population!

DR. TANNER: Yes, yes. But there's another point that I think is critical here. This is not something that's limited to the young. My dear, saintly, 80-year-old father doesn't have the foggiest idea what Twitter or a text message is, and I've given up trying to explain to him.

But my 70 and 80-year-old Chinese academic colleagues are fiends for these technologies, and just live on them, and so this is--text messaging--I wish we had a text specialist here. I believe the Chinese text message more than any other people in the world. Check me on that fact.

But, yes, they use it very consistently, and that means, getting back to Elizabeth's point, that when you have complaints and protests among people of middle class and older age, they have a level of sophistication for this type of technology, for organization, that I don't think you see in American society.

COMMISSIONER D'AMATO: Thank you.

DR. WHYTE: Can I just add one footnote? It would be a mistake to view each Internet user as a potential social protester. We had a measure in our surveys of Internet access, and we didn't find that people with Internet access had more critical attitudes about inequality than others we interviewed.

Most people go on the Internet in China, as in other societies, for all kinds of reasons, and highly nationalistic citizens who want to bash the foreigners and stand up for China's rights, also go on the Internet. So it's a complicated picture. You just can't equate growing Internet use with greater likelihood that the system is going to collapse.

CHAIRMAN REINSCH: Okay. Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Thank you and thank you to some of my good colleagues who are here testifying, and also to Dr. Whyte, I actually

do have your book. I haven't read it, but I have it.

I think it's interesting that you're all from the University of Michigan and all interested in protests.

[Laughter.]

COMMISSIONER BLUMENTHAL: I had a follow-on question to Commissioner D'Amato's, which is, well, really three questions. One is are you seeing some kind of profile of leaders of organizations that's different than say you saw five, six years ago? So are you seeing real leadership in the protests? And who are these people, and without naming them here and getting them in trouble, but just a generic profile?

Are they younger, older, that sort of thing? Are they tied with religious organizations? We certainly know about Liu Xiaobo, but what's making them tick?

The other one is, are they better organized, period? The numbers I think are telling, but they don't tell too much. I understand the answer to the question on the NGOs themselves are not necessarily participating, but are there what I would call real civil society outside of the state that's actually getting more organized, outside of state NGOs, and so forth, and protesting?

The third question is this juncture between the fact that there is a lot of inequality, but people don't seem to care about that. They care about procedural injustice and things that don't have necessarily to do with material well-being. You mentioned the Leninism of the Chinese government. Do you think there's a danger that they are misdiagnosing the problem so they look at very material indicators of well-being where people really are starting to care about many other things besides income inequality?

And, I'm especially interested in the comment you made that incomes and people's feeling that their incomes are going up, yet protests continue. So, again, there's this question of misdiagnosis, particularly if you come from a Marxist-Leninist point of view in China.

That's for all three of you.

DR. ECONOMY: Okay. I'll take a crack at one or two, and then we can all sort of mix and mingle.

I think in terms of is there a kind of online organized community; right? Is that not--

COMMISSIONER BLUMENTHAL: Well, not even necessarily online, just getting, are the protests themselves getting more organized and less spontaneous? Are the leaders--

DR. ECONOMY: To date, most protests, for example, the most recent sort of Twitter--beginning of this Jasmine Revolution were to be held in nine different cities or more throughout the country. I think most protests are still highly local, and so they can be organized in the sense that there's a university professor and college students who start the protest, or there are, interestingly enough, in some of these incinerator cases, they are wealthy urban residents who commission research and find out that to say, "This is the level of toxin that's going to be emitted," and then they organize protests.

The protest organizers vary depending on the situation, and sometimes I think there is no organizer. In some of those cases it's just a moment of injustice that erupts, and people just gather, and then violence explodes.

So the nature of the protests and the degree to which it's organized varies very much.

It is interesting that there is more of a community now. For example, all the major bloggers, major tweeters, they know each other. They collaborate. You can have online petitions that engage a certain sector of society.

Human rights lawyers, and people from different parts of what's called the intellectual elite or activist intellectual elite will sign on to these petitions in support of other kinds of intellectual activist elites.

So there is very much an awareness in a certain strata of society of what each is doing and a desire to be supportive in that context. There is a loose form of organization, and Michael Anti--I cite him in my testimony as one of the sort of leading bloggers.

He said something interesting--to the point that Scot made about the Chinese language--and that is that 140 characters for a tweet goes a lot further in Chinese than it does in English. You can say a lot more and you can do a lot more with 140 characters.

Let me just say in terms of misdiagnosing the problem, it's an interesting question. They're misdiagnosing the problem. They know what the problem is but they can't really address it because to address it would result in some pretty fundamental political change, and they're not willing to do that.

COMMISSIONER BLUMENTHAL: I'm running out of time, but are there splits that you detect in the leadership about how to address it?

DR. ECONOMY: Well, of course, the classic, at this point, is Premier Wen Jiabao and his series of speeches over the past six to nine months. Apparently there's going to be another major speech talking about the necessity of being more responsive to people, the necessity of pushing forward with political reform, and "I will not bend despite the harsh winds against me, and this kind of talk.

Whether or not that goes or takes you anywhere, many Chinese and Chinese intellectuals are quite skeptical. They think this is sort of the last gasp and a desire to preserve his reputation.

But there are probably at least one or two people within the incoming Standing Committee of the Politburo that have experimented in the past with some interesting political reforms and may push for something a little bit different once they're in the Standing Committee.

COMMISSIONER BLUMENTHAL: My time is up so I'll talk to you off line. Thanks a lot. No, no, it's my fault; I asked too many questions.

CHAIRMAN REINSCH: We have may have time for a second round depending upon whether we can keep within our limits.

Commissioner Fiedler.

COMMISSIONER FIEDLER: Dr. Whyte, a quick question. Do you know of anybody who's measured people's fear of the repressive machinery in

China?

DR. WHYTE: No, that is a topic that would be too sensitive to do this kind of survey research about. But what I would say is that compared to the Mao era, it's extraordinarily improved, with much less fear affecting daily lives.

But I also have had talks with Chinese, and this echoes the point that Scot made earlier, who said that there was an optimism earlier in the reform period that things, even on the political front were going to continue to loosen, the Party was going to gradually loosen controls further--and then in the last decade or so, that hasn't happened.

And there is some tightening up. There are more arrests of people who try to go to bat to protect local villages and so forth, and so there is still that fuzzy line. It's still a Leninist system. There are no guarantees.

COMMISSIONER FIEDLER: Thank you.

So some years ago, there was a great deal of faith put in rule of law changes and the Chinese government letting lawyers represent people, and now it appears as if lawyers are the targets. They're getting arrested much more frequently. That reinforces your earlier point.

The repressive, the mechanics of repression, Dr. Tanner, do you find U.S. company involvement in any aspects of that? What are we complicit about in this repressive machine?

DR. TANNER: I would be hard-pressed to name a specific case right now of, I assume that what you're trying to get at--

COMMISSIONER FIEDLER: Are they fully--

DR. TANNER: --are U.S. firms finding ways of violating the post-Tiananmen--

COMMISSIONER FIEDLER: No, no. Those post-Tiananmen things are cattle prods and unsophisticated torture devices. Are they, is their indigenous innovation sufficiently developed that they can do all of their Internet policing by themselves?

DR. TANNER: No, I'm not an expert on Internet management, but no, my understanding is that they purchase at least a fair amount of their technology from U.S. firms. I believe Cisco is one of the more famous cases.

COMMISSIONER FIEDLER: Liz, let me come back to you on the activist question. If we're going to analyze their repressive strategy, superficially, at least, from what I read in the newspapers, and my experience in studying strikes, one of the first things they do, and they do very effectively, is tag the leadership. They prevent leadership from developing.

Your earlier comments about environmental activists--and we had this exchange the last time you were here--they only go so far. But the only dichotomy or the only options are not going to the street protest but organizing in various cities to pressure people, growing an organization.

So size of organization, leadership, and spread of organizations, all seem to me to be retarded in China; is that a fair?

DR. ECONOMY: Yes, of course, it's fair. You probably know that within the laws and regulations on NGOs, there's a stricture against having branches of an NGO throughout different provinces. So it's a good way of maintaining--

COMMISSIONER FIEDLER: Maintaining control.

DR. ECONOMY: Yes.

COMMISSIONER FIEDLER: Your survey, Dr. Whyte, sort of hinges on--this is sort of my reading of what you said--hinges on economic progress. In other words, I don't care if somebody else is getting rich as long as I'm doing better.

What happens when they run against the wall economically as every country? I'm just flabbergasted that people think that there's an upward trend here that goes on forever. What happens when they run up against the wall?

DR. WHYTE: Well, unfortunately, I'm not very good at futurology, and so far they've done an extraordinarily good job--

COMMISSIONER FIEDLER: Well, no, no, I'm not asking futurology. So what I'm saying, I'm trying to get the measure--

DR. WHYTE: It's--

COMMISSIONER FIEDLER: Let me finish.

DR. WHYTE: Okay.

COMMISSIONER FIEDLER: Those people who are optimistic, did we measure at all at what point they no longer become optimistic? In other words, when you're, in your questioning.

DR. WHYTE: When I applied for funds in 2008 for the new survey, my assumption was that the Chinese growth engine was going to go in the toilet because of the collapse of export orders, but by the end of 2009, when we did our new survey, employment was up again and growth was steaming ahead. China was crowing about how it had been affected much less by the global financial crisis than other countries.

So until a sharp drop in growth happens, I can't say how Chinese would react. But certainly a logical conclusion from the work we're doing is that maintaining that growth engine is absolutely essential to--

COMMISSIONER FIEDLER: Necessary.

DR. WHYTE: --to keeping people satisfied and--

COMMISSIONER FIEDLER: Thank you.

DR. WHYTE: And not--

COMMISSIONER FIEDLER: Just one quick. Anybody know any studies for Tunisia, Egypt and Libya?

DR. WHYTE: Well, I haven't studied those countries, but certainly--

COMMISSIONER FIEDLER: No, no, no. I know that.

DR. WHYTE: The unemployment rate, for instance, is much higher in those countries, and I gather the inflation rate is much higher in those countries.

COMMISSIONER FIEDLER: I'm trying to grapple with the unpredictability of it and the implications for China's unpredictability, is why I was asking the sort of empirical question of whether anybody studied it and thought everything was fat, dumb and happy in any one of those three countries? Or near bursting out?

DR. ECONOMY: I would say based on my colleagues' work, at least on Egypt, I don't think anybody anticipated what just happened. Whatever the situation with unemployment or inflation, I think people felt as though, yes,

there was dissatisfaction with President Mubarak, but to see this kind of explosion, to see him fall so quickly like that, I don't think any of my colleagues certainly predicted that.

It would be really interesting to go back now and do the survey with inflation rising, with all of these concerns about the Chinese economy and see if you get the same results. I just think it can be very sort of temporally specific.

DR. WHYTE: I would point out that in 1989, there was something like 20 percent plus inflation. That was a major contributor to the dissatisfaction that in particular made it likely that urban ordinary citizens would come out to support the students in 1989.

And at the moment at least the figures may not be accurate, but it's much more modest inflation in China at the moment.

DR. TANNER: If I may, following up on that, first of all, I think it's fairly clear that even though as far as their official figures are concerned, unrest has continued going up, almost every single year for the last 18.

They see dramatic spikes when the economy turns down. On the two occasions when the economy has turned down, 2008, and in the Asian financial crisis, 1997 to 2000, so to the extent that they are very concerned that if they don't generate a lot of jobs and continued high rates of growth, they're going to face higher employment, they have a very strong empirical basis for that concern.

Secondly, I think we really should be modest about our ability to forecast when anger might burst forth suddenly and all that. There's every good reason to assume that given the growth record, the increase in global power that the Chinese government has brought to its people in the last couple of decades, that this is a government that enjoys fairly strong popular support.

That said, I don't think we would have anticipated the level of anger we've seen in the Middle East in recent years, and I recall very clearly in 1989, when I had the misfortune of being at Beijing University throughout the entire spring, and to the massacre in 1989, and going into the beginning of those protests, the absolute universal conclusion of every China watcher in China and in the West was that this was an apathetic society, not interested in protests, not interested in politics, that the kids in the universities only wanted to pass their TOEFL exam and get to the United States, worried about a job.

And General Secretary Hu Yaobong died, and like that--so I think we need to be modest about our ability to forecast when these things might suddenly break forth and show us some underlying feelings that we didn't realize were there.

CHAIRMAN REINSCH: Thank you.

Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Mr. Chairman, and thank all of you for being here and your testimony which was very interesting. And I also want to thank the panelists who will be on later for their submitted testimony because that added to what we can talk about.

Dr. Whyte, the question I have for you is, can anger over inequities as

opposed to anger over inequality, can that be a basis for regime change?

I remember reading Crane Brinton's book, Anatomy of a Revolution many years ago, and the desertion, and all that. But I can't recall, is it inequality that drives these things? Is it inequities or just what? And that would be helpful to comment on that issue.

DR. WHYTE: Okay. First, it's not inequality but inequity. Okay. Inequality is an objective thing out there. What matters is what people feel about whether something is fair or unfair, and if people felt that they were in a society —maybe like Mobutu in Zaire for example—in which all of the gains were being monopolized by the top elite, then you could have very considerable anger building up. But that is not the situation in China today.

One certainly gets the sense in discussions of Libya these days--I don't know much about Libya, but--you know, Muammar Gaddafi and his very rich sons and their spending a million dollars for a New Year's celebration with Mariah Carey singing--if I were an ordinary Libyan, and I was looking at the quality of our roads and schools and so forth, I would be very angry, but, again, inequity is not the only issue.

There are all these other issues. There are not just procedural injustice issues, but inflation, threats to nationalistic pride, and so forth. So predicting when people are going to get angry enough to coalesce--there's another argument that in any society at any time there are enough angry people--the question is can they organize and get together and can they avoid being, you know, shut down before they mount a challenge?

COMMISSIONER MULLOY: If I could quote from another witness, and this would help the other two maybe respond, Dr. Yukon Huang from the Carnegie Endowment, who will testify on the next panel, he states in his testimony about China, quote:

"Currently civil unrest tends to be driven less by visions of regime change, but more by drawing attention to abuses that affect daily lives."

So that's very important for us to think about then. So the regime, he's saying is not threatened by all the incidents. It seems to be more they have--like you were saying--they still have confidence in this regime because it's delivering.

DR. WHYTE: Well, let me just give a few comments and then turn to my colleagues.

COMMISSIONER MULLOY: Good.

DR. WHYTE: First, we have a lot of survey evidence about what people think about their local leaders versus provincial and higher leaders, and all of those show that people have a lot more faith and trust in the central leadership, and that central leadership, of course, does everything they can to perpetuate that. So if you're angry, it's those bad guys down at the bottom.

Okay. So that is certainly true, but the other thing that my colleagues have already commented on, is that despite this, the top leadership is extraordinarily paranoid about the possibility of unrest, and so they engage often in ham-handed overreactions, for example arresting the Nobel Prize winner who circulated a relatively mild reformist petition . You would think that they should be much more confident. We're doing well, our economy is

growing, people are satisfied; we should allow protests. It's not a problem. It's not going to overthrow the system. But that's not the way they react.

They still react as if this is the Leninist system that's going to be thrown overboard if we don't hold the line, and they look at what happened in Eastern Europe, they look at what's happening now in the Middle East, and I think it's really a kind of paranoia.

There are Chinese researchers who say, "Why can't China's leaders allow normal protests?" You know, look at Madison, Wisconsin. Well, are those going to overthrow the system? I don't think so. But Chinese leaders' reactions are still very different.

COMMISSIONER MULLOY: Mr. Chairman, could they respond or —is my time is up.

CHAIRMAN REINSCH: Why don't we move on, and then we'll have another round.

COMMISSIONER MULLOY: Okay. Thank you.

CHAIRMAN REINSCH: Commissioner Wessel.

COMMISSIONER WESSEL: Thank you all.

This is extremely interesting. If I could get quick answers so that I can ask a number of questions.

[Laughter.]

COMMISSIONER WESSEL: Dr. Whyte, several years ago we had some discussion here at the Commission about survey research. Following up on Commissioner Cleveland's question, the ability to survey the public is somewhat limited, meaning that you have to have governmental approval, as I recall. There is, at some times the requirement that surveys, in fact, be passed by the government. Is that still the case? This was four or five years ago.

DR. WHYTE: It's a touchy issue. We rely on our colleagues to get approval. We don't go through the formal procedure. We don't have our--

COMMISSIONER WESSEL: But you're saying it's not like a Gallup poll where we could go out and give them money and they'd go out and do it. You have to get approval though; is that right?

DR. WHYTE: They get approval from within their university, and they operate--they've been doing this for years. There are no questions that we wanted to include that they said no, you can't ask these questions. We operate the same way as we would operate elsewhere--and we replicated questions that were asked in Eastern European surveys and the U.S. and elsewhere. It's not a real--

COMMISSIONER WESSEL: But you also said that there were some sensitive topics.

DR. WHYTE: Yes. I couldn't do a serious study of procedural injustice issues even today, I don't think, because you would have to ask a lot of questions that would be more sensitive. People thought our questions on equality would be too sensitive, but they didn't turn out to be.

COMMISSIONER WESSEL: Okay.

DR. WHYTE: There have been examples of past China surveys being in the field and upsetting the public security types they confiscate the questionnaires. They stop the study. Some Michigan studies had that

experience in the early 1990s. But we haven't had those experiences recently, but our colleagues in China are still very nervous and cautious.

COMMISSIONER WESSEL: I understand. I do work with a number of corporations, and, in fact, from an enterprise risk management standpoint, talking to one corporate leader earlier this week, the number one target for concern among this group was Egypt. Particularly looking at Gini coefficients and a number of other things in terms of inequality and those issues.

My question is, isn't everything directed from the leadership at containment of dissent in some ways, but that economic growth is the most important palliative as it applies to the public? As long as they get eight to ten percent growth, they're going to be able to get through a lot of these problems.

If that growth rate falters or if inflation starts to increase, that's when you have the real dissention that they may not be able to control. Could each of you three comment on that, whether that's a proper--

DR. WHYTE: Well, let me just mention that they're doing more than just trying to maintain growth. So part of my presentation was that his harmonious society stuff is actually producing changes.

COMMISSIONER WESSEL: No, no, no. I understand. I mean health care and education--

DR. WHYTE: In villages.

COMMISSIONER WESSEL: I agree.

DR. WHYTE: So those things are--

COMMISSIONER WESSEL: But you can't make those changes without the growth.

DR. WHYTE: Right, right.

COMMISSIONER WESSEL: Right, okay.

DR. WHYTE: Yes, right. So they have some advantage over us in trying to introduce universal health care.

DR. ECONOMY: But in terms of universal health care, Marty, what they're paying out at the village level is so negligible that it really doesn't constitute anything frankly worth discussing except that they're trying to deliver on a promise that they made a number of years ago. But to your point, I actually would make the argument that maybe economic growth is not enough.

You start to see middle class urban protests and while China has had eight to ten percent growth every year, more than that, in fact, for over two decades now and still, as Scot pointed out, the number of protests continues to rise. So something else is at work here

COMMISSIONER WESSEL: But those protests are somewhat containable, and just to ask, my recollection is that environmental activism, for example, in our country has been somewhat or mostly a function of economic prosperity; that when a town needs a plant, they're going to let it pollute.

It doesn't mean they're not concerned, but there's a little more willingness to accept it. But as income rises, you've seen more environmental activism.

DR. ECONOMY: The environmental protests, until recently, 99 percent in rural poor areas.

COMMISSIONER WESSEL: Right.

DR. ECONOMY: The point I was making at the outset was that it's different in urban areas because they're protesting things that they know are coming down the pike. They haven't actually sited the plant.

COMMISSIONER WESSEL: So, a threat.

DR. ECONOMY: Exactly. They have advanced knowledge, and they're saying "we won't have that." In rural areas, it's about things that have already happened and the people saying "we're sick." That's why they have all those cancer villages. So you've got to stop doing this.

There's a case to be made, that a certain point may come where people want their voice heard. I mean there is the whole idea about a hierarchy of values. We ought to be considering the possibility that even with growth, there will be significant pressure continuing on the government that may at some point produce really significant political change.

COMMISSIONER WESSEL: And the rapidity at which, meaning that without growth, does that accelerate that?

DR. ECONOMY: Absolutely. Yes.

COMMISSIONER WESSEL: Right. Okay.

DR. TANNER: If I may, the Chinese as far as growth and the management of economic growth are concerned, and its relationship to unrest, they've set themselves a very difficult problem on both ends, and there are short-term and long-term problems with this.

First of all, they sincerely seem to believe, and they say this time and again, that if the economic growth rate goes below about eight percent, they won't generate enough jobs to handle the young upcoming new graduating students and people entering the job market.

So you have that minimum figure of eight to ten percent, but, on the other end, as Dr. Whyte quite correctly pointed out, one of the pivotal forces in the 1989 protests, maybe the most pivotal factor, was inflation, which, as he correctly pointed out, was at, by the standards of developing countries, not horrifically high rates, 20, maybe 30 percent.

So on the one hand, if growth rates will go below about eight or ten percent, they think they're in trouble, but if the economy starts growing too fast and inflation starts taking over, that's been historically another source of unrest, and then there is the long-term issue, which is at a certain point, they're going to reach a level of average economic growth at which countries at very high levels of average income are almost universally democratic.

COMMISSIONER WESSEL: Thank you.

CHAIRMAN REINSCH: Thank you.

Commissioner Shea.

COMMISSIONER SHEA: Thank you all for your very, very interesting testimony. It's been a fascinating discussion. I was hoping if any of you can weigh in or talk about the so-called "ant tribe," these 20-somethings who are first-generation educated with a college degree, maybe at second or

third-tier colleges, who go to the big cities, looking for a good job, and find their expectations dashed.

Have you surveyed, for example, Dr. Whyte, those attitudes? If you can just explain a little bit about that, that cohort?

And also, this issue of the gender imbalance in China, which, as I understand it, is really imbalanced towards males, and, in fact, may be the greatest imbalance in the history of any country ever skewed towards males. Is this a source of potential instability?

DR. WHYTE: First, unfortunately any kind of general population survey won't have enough cases of a specific age group of a specific type so we don't have enough cases in our surveys to do a detailed analysis. But there is certainly existing journalistic and other writings about the "ant tribe" phenomenon.

I must say I myself find very puzzling Chinese government policy toward the rapid expansion of higher education. It would seem to me that this is a very worrisome policy. They're producing so many more university graduates than the economy is able to absorb so some graduates are ending up in sweatshop jobs that are well below their expectations.

People don't believe so much as they used to in the theory of revolution of rising expectations, but still it seems to me this is a potential pressure point of very disappointed and angry people who--

COMMISSIONER SHEA: Particularly, I'm having a vision of five 20-something-year-old guys in a 500-square-foot flat in Beijing with dashed expectations, well-educated, intelligent, and no prospect for marriage.

DR. WHYTE: Well, and we also found, again, on the inequality issue, that urban educated people are among the more critical, in fact.

You find much less criticism among peasants. Peasants are much more optimistic in our studies. So this segment is--even urban people who are not recent university graduates tend to have more critical attitudes in general.

On the sex ratio at birth question, it certainly is the case that there are about 20 percent excess males in recent times, but China historically had very high rates of excess males through female infanticide. Now, it's done more through prenatal self-selective abortions.

But I don't see that as there are some books that have been published saying societies that have this kind of imbalance, they become more warlike or whatever.

COMMISSIONER SHEA: Uh-huh. Right.

DR. WHYTE: I just don't think that's credible research.

COMMISSIONER SHEA: Okay. Dr. Economy or Dr. Tanner?

DR. ECONOMY: There's a lot of discussion about the gender imbalance and what it might produce in terms of sex trafficking and other kinds of social problems. I haven't seen then yet as a sort of potent mobilized force in some way.

It's interesting, though, that there are now experiments that are beginning in a number of provinces or scheduled to begin in a number of provinces to lessen the strictures of the one-child policy so, again, the government is very cognizant of this problem.

It's been the case that if two only-children marry, you can have two children. Now it's going to be if there's one only-child in the marriage, they can have two children. So I think this is going to start up in about five provinces. They're thinking this through and trying to redress it.

I recently learned, actually, the one-child policy was supposed to end, and it was never designed to go on indefinitely. It supposedly had a 30-year timeframe and they've reached that point now. So things may begin to improve in that regard but maybe not.

COMMISSIONER SHEA: Okay. Thank you.

CHAIRMAN REINSCH: Commissioner Slane.

VICE CHAIRMAN SLANE: Thanks for coming, and we really appreciate your testimony.

What concerns me the most is our deficit. Listening to you, and correct me if I'm wrong, it seems to me what the Chinese government fears the most, in terms of insurrection and rioting, is unemployment. And if that is the case, then changing from an export-driven economy to a domestic-consumption economy is going to be retarded dramatically by their fear of not being able to make the change in time and having all this unemployment.

I'd love to have your thoughts.

DR. TANNER: I think it is certainly true that for a large number of issues in the U.S.-China relationship, that fear of decrease in growth rate or a number of other factors that could feed into an increase in unrest is a powerful thought in the back of the mind of the Chinese, and it raises the stakes for them in negotiations over a number of issues, whether it's exchange rates or access to markets, things like that.

We need to be aware as we deal with the Chinese that they are thinking not just of the economic implications of this, but of some very serious potential social order. So, yes, that is a very serious concern for them behind a number of issues in our relationship.

DR. WHYTE: I would just say that my impression is certainly they're very concerned about trying to minimize the problem of unemployment, particularly for the urban population, but I think that in the actual experience of social protest demonstrations, groups of unemployed people going out and protesting is not a central part of the picture.

The other kinds of issues that we've been talking about are--at least I'm not aware of simply groups of unemployed being a major part of the social protest picture. But I defer to my colleagues on this.

DR. TANNER: It has been in the past. At least, again, if we take the Chinese law enforcement analysis at all seriously, in the wake of the 1997 to 2000 East Asian financial crisis and the problems in the Chinese economy, there is no question but that the overwhelming focus of unrest in the Chinese economy was in their rust belt regions where reform of the state-owned industrial systems was creating not only high levels of unemployment, but also people who had been relying on these factories for their pensions, getting them withheld, losing their benefits and things of that sort.

And the most dramatic statistic here is that, at least according to

Chinese police officials in I believe the year was 1999, of all the protests in China, one-sixth of them were taking place in one province, Liaoning, which is the industrial rust belt province of the northeast, a province very similar to my native upstate New York in its economic profile and its weather actually.

[Laughter.]

DR. ECONOMY: I would just point out that recently there's been a labor shortage by and large for factories in the coastal part of the country. It's not the case in the interior part of the country. We have seen a rash of worker strikes over the past summer for higher wages and better living conditions. These have been met pretty rapidly with a positive government and factory manager response.

So they are quite concerned about worker protests, and they've been very proactive in dealing with those.

CHAIRMAN REINSCH: Thank you.

Dr. Economy, you said something interesting awhile back that I'd like you to elaborate on which was that you made a distinction between the environmental NGOs and the protesters. Why don't the activists or the NGOs protest?

DR. ECONOMY: I think that they see their role differently, and in order to continue to push for change, and some of it is fairly radical change, they believe that if they were to become identified as a leader of a protest, their ability to push for things like reform in the rule of law or transparency would be sharply constrained. They're already oftentimes walking a fine line themselves. Also, and I think they're different kinds of people.

For example, I do have friends who are environmental activists who took to the streets when Hu Yaobong died. So it's not that in their youth they didn't protest. Many environmental activists and NGO heads came out of political reform tradition.

They were not experts in the environment. They became environmental activists in large part to push a political reform agenda. So I think that's deeply rooted in some of the environmental NGOs, but they choose just a different means of pursuing perhaps the same end.

CHAIRMAN REINSCH: Thank you.

Let me ask all of you, but perhaps start with Dr. Tanner, one of the questions that we've been kicking around is the "house of cards" phenomenon--the experience in Eastern Europe and possibly now in the Middle East where regimes that appear to be impregnable end up collapsing relatively quickly when certain combinations of events occur, to the surprise of everybody, at least at the time. Dr. Tanner, you had commented earlier on the difficulty of predicting any of these things.

So I appreciate that. I don't want you to violate your own principle, but one of the questions we can't help asking ourselves is what the odds are that China might be in this category?

Dr. Economy mentioned earlier something that has resonated with me for a long time, which is the capacity of little things to become big things very quickly. And with the kind of telecommunication system we have now, it's much easier. It happened years ago anyway, but now it happens

spectacularly easily, as several of you pointed out.

So when you throw that in the mix is this an outcome that has any degree of likelihood in China or is this really a different case from the other examples that I cited?

DR. TANNER: This seems a really good time to restate that my views today are my own and not those of CNA.

CHAIRMAN REINSCH: We'll respect that.

[Laughter.]

DR. TANNER: When I thought about what it would take for this sort of protest to turn into something serious, I start thinking about a number of factors that I don't see right now, and a couple of them that come to mind.

First of all, it would be, it would be supportive of nationwide protests to have nationwide organizational infrastructures to mobilize protesters across a wide variety of provinces, and the Chinese Communist Party and its security services have been extraordinarily good at preventing the rise of anything like that.

If we think back to the fact that--what is this--this is the 30th anniversary of the founding of Solidarity. There is no independent trade union in China.

Organizational base, not there. We're not seeing instances of an unwillingness of the security forces, be they the civilian police, the paramilitary People's Armed Police, or the People's Liberation Army, to demure from putting down protests. To turn the old statement on its head, sometimes all that's necessary for evil to fail is that bad men do nothing.

And in this case, we don't see any clear evidence of that, of a loss of willingness to confront protesters. Now, the police in China don't like being stuck between angry protesters and intransigent officials who are mistreating them. That's perfectly clear. That comes through loud and clear in their writings. But, no, there's no shortage of willingness to support that.

And lastly, I think Dr. Whyte made a very important point, that as far as we can tell from the available data, the Chinese have not yet transferred their anger at local officials in the local structure to a large-scale anger at the leadership and the system on its own.

I want to be very modest about my ability to assert that, but as far as that sort of evidence, I don't think we see that yet. So there are other points I can make, but I've taken too long. I'll leave it at that.

CHAIRMAN REINSCH: Thank you.

Dr. Whyte or Dr. Economy, do you want to comment as well?

DR. WHYTE: Sure. Just briefly. Obviously, from my comments, I'm also of the view that stability is likely to continue, and that this is rather a successful society in most respects despite all of its problems, but I also have times when I say, well, there are certain areas of weakness.

First, they still claim that they're pursuing socialism and nobody believes it anymore. Second, the leaders now are not people who are highly revered. So even if people think the government and the Party are doing a pretty good job in leading society, toward the particular individuals at the top--there's not the kind of reverence for them that there was for Deng or for Mao.

And we also don't know enough about the internal relationships among these people. Could there be a Gorbachev phenomenon? Maybe China will not experience that, but something happened in the Soviet Union because the particular individuals who took over were willing to take out pieces of the structure that kept them in power.

Gorbachev repealed the Brezhnev doctrine. Eastern Europe fell apart and so forth. And so there are imponderables here. I have a colleague at Harvard who after 1989 that said within five years Communist Party rule will be gone, but obviously that didn't happen. Party leaders pulled their act together, and they're doing a very vigilant job of trying to learn the lessons from '89, learn the lessons from Eastern Europe and learn the lessons from the Jasmine Revolution, wherever.

But, I certainly think it's going to continue to be a very tumultuous society, with more and more people making more and more demands, and the question is, will the people at the top be able to remain together and remain in control over it?

And the final thing has to do with what Scot has just mentioned--at the moment, the police and the army may be able to be called in, but in 1989, that was even problematic, as you know. Finally they had to resort to different troops than they first sent into the Square.

So, if there are major mass demonstrations of the kind we saw in 1989, will whatever future leaders of China really have the guts and nastiness and will the military have the discipline to be willing to take the kind of actions against their population which were deeply unpopular already in 1989? I don't know.

CHAIRMAN REINSCH: Dr. Economy, do you want to add anything?

DR. ECONOMY: I agree with pretty much everything that both Marty and Scot said. I would only add never say never. One of the things we don't know really is the extent to which this whole princeling and privileged elite, and the children of the elite--and how privileged and very, very wealthy many of them are becoming--how when those kinds of stories start to spread out throughout the country, what kind of resentment, a different kind from the one that Marty has been talking about, might breed.

I have an intern who used to work for Baidu and he was telling me that when he would write articles about local corruption, nothing would be censored. He could write about anything he wanted with no difficulty, and it would get posted.

The minute he tried writing a piece about when Hu Jintao visited an apartment complex where they were supposedly spending only like 77 yuan per month for the apartment, it produced this rash of commentary saying "This is a farce. You've got to be kidding me. There's no apartment for 77 yuan per month, and people were so happy to be living there," et cetera. That immediately got shut down.

So I think to Scot's point, criticism of the elite is not permitted and difficult to sort of get out, but it's there.

CHAIRMAN REINSCH: Okay. I think we'll go around again. If everybody can keep themselves to a question, that would be good.

Commissioner Cleveland.

HEARING CO-CHAIR CLEVELAND: I tend to see protests not on a global level that we've been talking about, but the factors that corrode daily life for individuals, and when Bill and I first started talking about this hearing, it really was interest in rural-urban cleavages and, as you describe in the book that we did get, Dr. Whyte, the three-tiered cast system, the hukou system, has created that you suggest that other scholars liken to apartheid and suggest that it denies large portions of the population access to basic services.

I'm interested in how you all see the hukou system as a factor and pressure on the Party since it affects the things we've been talking about--unemployment, growth, and inflation--because it limits labor mobility. And then what's your assessment of the likelihood of reform of that system, understanding that it's a local district issue in terms of enforcement and change?

Even the World Bank, not usually on the cutting edge of policy, has just put out a report on Chongqing talking about the urgency for reform of the hukou system if these urban/rural issues are going to be mitigated and pressures for change addressed.

DR. WHYTE: Well, let me just mention, since this question comes from another book that I edited recently, that I think you have a paradox here. Most people, in China and outside, agree that the foremost social cleavage in China today is the rural/urban gap, not an income or class cleavage, and that the hukou system is basic to this and produces extraordinary distributive injustice if you're born in a village, you just don't have the opportunities that people have if they're born in the city.

This cleavage was a product of socialism of the Mao era. It really was a system of socialist serfdom; rural people could not leave. Now they can leave, but they're still second-class citizens even if they're living and working in the cities.

Chinese leaders now recognize that this system has to be somehow reformed and gotten rid of, but they can't figure out how to do it without exacerbating their fears of masses of people coming into the cities and making demands on public services increasing crime and causing other problems.

However, the paradox is that this unjust cleavage is not likely to be a major factor producing political instability because, in fact, villagers and migrants do not compare themselves with and get angry and envious toward urban people for the most part. They compare themselves with people back in the village or with other migrants, and in our surveys, they're more satisfied and optimistic than urban people are, despite their low status and experiences of discrimination.

Urban people are suffering from layoffs and unemployment and so forth, but for a villager who started at the bottom and was held in this kind of socialist serfdom, things are looking a lot better now even if they're still pretty much at the bottom. And so discrimination against rural people and migrants is the most unfair feature of current inequalities, but it's not likely to produce the "social volcano" kinds of explosions from peasants or from most migrants. Migrants do join protests of against specific abuses by their

employers, but not protests against the hukou system itself so far as I can tell.

DR. TANNER: I, on that particular set of issues, I don't have anything to add to Dr. Whyte's fascinating data and analysis.

I would add one aspect, though, of this system that shows some signs of creating some social anger within China's cities, and that is actually not among the people on the lower end of the spectrum, but from the people who are already established in the city. We occasionally see cases of protests that are motivated by people who are long-time urban residents and are angry that their particular trade is running into low-cost competition from migrants, from the countryside.

One of the most interesting cases we saw of that about a year-and-a-half ago was a case of nationwide contagion of cabdriver strikes where cabdrivers were very angry, and, you know, stop me if this sounds like politics out at National Airport, but very angry about people who weren't officially licensed to be cabbies in the town, running their own cabs, lower prices, taking away their business.

And they started a cab strike in one city, and cab strikes spread to a large number of other Chinese cities, and that was a signal demand in a number of them. So that's one thing to add to that.

CHAIRMAN REINSCH: Okay. Let me encourage us everybody to keep the questions short and the responses short because we only have a few minutes.

I have Commissioner Mulloy, Commissioner Fiedler, Commissioner Wessel, and Commissioner D'Amato, who want to ask questions.

COMMISSIONER D'AMATO: We don't have time for all of those.

CHAIRMAN REINSCH: Well, let's see.

Commissioner Mulloy.

COMMISSIONER MULLOY: I'll be quick.

CHAIRMAN REINSCH: Okay.

COMMISSIONER MULLOY: Dr. Whyte, in your testimony, you talk about there is some magical growth target such as the widely quoted eight percent that must be maintained in order to keep China's distributive injustice "social volcano" dormant.

This Commission has been a group that has called attention to the imbalance in the economic relationship between China and the United States, that has had, in my view, a very detrimental impact on jobs and employment in our own country, and in my view, China is violating both its IMF and WTO obligations quite dramatically. Some people say, well, don't be pushing too hard because they have to maintain an eight percent growth rate or else the system will collapse.

I say that's not my problem. My problem is to look after our people and to make sure that they're following the rules. We keep a 2.5 percent average tariff on those Chinese goods coming into this country everyday, which is our WTO obligation. So I'm wondering, is it in our interest to keep this group in power in China, as we push back, and insist on a better trade balance? If I could ask Dr. Tanner and then Dr. Whyte-- DR. TANNER: Again, speaking solely for myself, I would associate myself with the general

view you voiced.

DR. WHYTE: Yes, I would also. I don't know how the Chinese get fixated on these numbers, like if the Gini coefficient goes above .4, there's going to be chaos, or there will be chaos if the growth rate goes below eight percent. I don't know where these fixations come from--lots of countries would kill for a five percent growth rate.

But I think the reality is that their leaders do become fixated on these numbers, and so it's very hard to budge them on these issues. I agree that we have no obligation to help to maintain their eight percent growth rate. We should be arguing for proper compliance with WTO and so forth. But it's going to be tough because they really feel their society might explode if they don't meet these magic target numbers. Even if it's wrong, it's a very strong conviction.

DR. ECONOMY: I think we should give as good as we get. So I don't think we need to be concerned about China maintaining eight percent growth rate.

COMMISSIONER MULLOY: Thank you all.

CHAIRMAN REINSCH: Okay. Commissioner Wessel has one brief question.

COMMISSIONER WESSEL: Thank you. Dr. Economy, environment is also your expertise, and I want to ask a question. The flip side, I think, of what Commissioner Fiedler asked--he asked about corporate activity.

Looking at environmental NGOs, entities like NRDC, for example, have visibly pulled their punches on certain issues reflecting concerns that the Chinese government might limit their ability to be effective in that country. Are they an outlier? Are you seeing environmental groups, U.S. or foreign environmental groups, pulling their punches in some ways because of concerns about being able to operate in China?

DR. ECONOMY: I'll say that I have seen it, but I wouldn't have picked NRDC. I think in the full scope of--

COMMISSIONER WESSEL: I would.

DR. ECONOMY: In the full scope of U.S. environmental NGOs, they are often quite at the forefront of doing the right thing. Some of the best work that's being done on pushing for transparency is being done out of the Beijing office of NRDC in conjunction with Ma Jun's Institute, the Institute for Public Environment.

I've often been somewhat critical of our NGOs for this, but I think that the real challenge is that they believe not only that they want to remain there and be able to do work, but also that you catch more flies with honey. So sometimes that may be saying that the Chinese government is doing—they believe that by encouraging them, you're actually going to get them to that point.

It's not a view that I subscribe to, but it's not necessarily quite as craven as what you're proposing. Although I think there are a couple that maybe are like that.

COMMISSIONER WESSEL: Thank you.

CHAIRMAN REINSCH: And the last question, likewise short, Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you, Mr. Chairman.

I just have a quick question for Dr. Economy. On Premier Wen and also your commentary in your testimony on what's going on in Shenzhen in terms of political reform and quasi-electioneering, as you describe it here, is Premier Wen sort of off on his own in terms of this campaign for political reform?

Does it reflect an increased tolerance for political reform and a desire to see how far it can be safely performed by the leadership, and in Shenzhen, was that generated internally in Shenzhen, or was there more of a plan in terms of the leadership as to see what could be done, and is it being advertised in other cities as a model or something that can be tried or is it sort of a stand-alone?

DR. ECONOMY: Premier Wen Jiabao doesn't stand entirely alone. As I suggested, there's at least one other person within the Politburo and soon to be in the Standing Committee that shares his views on the necessity to push forward with more aggressive political reform.

In terms of Shenzhen, it's too early to say whether the Shenzhen experiment itself is going to turn into something important, and then whether it's going to spread. Shenzhen was picked in part because it was part of the beginning of the economic reforms. It's a kind of match-up to say, "Okay, we did it in the economic front;" we're going to start on the political front, and probably because there was a receptive leader, but it's too early to say whether that's going to have any real legs.

COMMISSIONER D'AMATO: Yes, but Shenzhen did come from the center then rather than just simply from the ground up in Shenzhen; do you think?

DR. ECONOMY: Oh, I don't think it was a popular push. I think it's an elite move.

COMMISSIONER D'AMATO: Yes.

CHAIRMAN REINSCH: Okay.

COMMISSIONER D'AMATO: Thank you.

CHAIRMAN REINSCH: Thank you very much to our panelists. We'll look forward to seeing several of you at lunch and the roundtable.

We will now take a very brief break, and the second panel will begin at 10:45.

[Whereupon, a short break was taken.]

PANEL II: MAJOR CHALLENGES TO CHINA'S INTERNAL STABILITY

HEARING CO-CHAIR CLEVELAND: Welcome, Dr. Dunaway and Dr. Huang.

Our second panel is comprised of two experts. Dr. Yukon Huang is a Senior Associate at the Carnegie Endowment for International Peace, where his research focuses on China's economic development and its impact on Asia and the global economy.

Previously, he was the World Bank's Country Director for China from

1997 to 2004, and in Russia and the former Soviet Union Republics of Central Asia from 1992 to 1997.

Dr. Huang will be followed by Dr. Steven Dunaway, Adjunct Senior Fellow for International Economics at the Council on Foreign Relations.

Dr. Dunaway is a former Deputy Director of the Asia and Pacific Department at the IMF, where he directed the country work on China and headed the IMF's consultation missions with the Chinese government, a challenging task.

So each witness, as you know, will have seven minutes to make their oral statement, and then that will be followed by questions.

Dr. Huang, if you want to begin.

STATEMENT OF DR. YUKON HUANG, SENIOR ASSOCIATE CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE WASHINGTON, DC

DR. HUANG: Thank you, Commissioners.

I want to talk about political liberalization and economic liberalization. Obviously, given my expertise and experience, I'm going to focus on the economic aspects more than the political.

During the post-Mao period, as you know, the government has basically operated under the assumption that economic liberalization would precede political liberalization. As long as the well-being of the people was improving, they assumed that social stability would be maintained.

Despite decades of what I would call exceptional growth, the numbers of protests have increased over the years, and many observers now feel that the government has not been handling well the many emerging tensions within society.

Why have tensions increased despite the impressive performance of the economy? Let me focus on four, among many, relevant issues of which the first three are interrelated.

I would like to talk about the regional disparities and the issue of the hukou system, residency system, which I notice that you had focused on earlier. I think my views probably differ somewhat with what was said earlier.

What is unique about China's inequality? First of all, the national aggregates are not unique. Its Gini coefficient, which is a measure of its overall inequality, is between .45 and .49, which is about the same as in Malaysia and Singapore.

It's comparable to that of the United States. It's actually below that of Latin America. So China’s overall inequality is not unusual. What is unusual in China is the speed with which it deteriorated from something in the mid-20s to over 40 in just 15, 20 years. That's unparalleled globally.

The second thing that is unusual in China is that the ratio of urban to rural incomes, at 3.5, and the ratio of coastal incomes to inland of over two are among the highest in the world.

So this is unusual. It's not the overall inequality. It's the spatial

distribution. Essentially, what you have is a situation where the people in the rural and the inland areas do not have the same access to income-generating opportunities as those along the coastal areas.

Now, is this creating a problem? It is slowly over time, and it creates a sense of dissatisfaction. The hukou system essentially prevents you from gaining formal residencies typically in the urbanized areas along the coast, and the hukou prevents those migrants who live in these cities from getting social services free; therefore, they don't come with their families.

They get lower priority in jobs. They eventually become assimilated into the urban environment, but they become the disaffected and disenchanted, and they contribute to urban tensions and account for some of the disparities with the regions they had left.

Now, the government has pretty good reasons why the hukou has been left untouched over the last several decades. They're worried that mass movement into the cities will create the same slums, as you see in many other Asian countries. Those who have hukou, those who are formal residents of Guangzhou or Beijing or Shanghai, they're worried that mass movements from the interior will lower wages, reduce income opportunities, create crime, many of the same social, political issues that the U.S. is dealing with in terms of immigration. This is a source of tension.

Now, about China's urbanization rate. The population in this country is only about .46 percent urbanized. This is exceptionally low given China's geographic structure. It should actually be something in the .60s, and ultimately .70. It should be 70 percent urbanized probably ten to 25 years down the line, rather than 45 percent. And why should it?

It's because if you look at China's geographic makeup, there are very few areas where people can live comfortably. So this is going to be a heavily urbanized country.

Let me give you an example. With South Korea, during their boom years, nearly half of the population moved in over 25 years. In China, it's 15 percent. There's something wrong here.

The second point I want to mention is that China's fiscal system has not been helping. When Deng Xiaoping launched his growth strategy, he basically channeled a greater percentage of the budget to the richer coastal areas. And that's very unusual in any country that you actually put more resources in the richer areas rather than poorer areas. China has been trying to redress this. They've been trying to smooth this out and make it more of a redistribution fiscal system, but this is a slow process and there's a lot of political resistance.

Third, let me talk about property rights. Why are property rights in this issue important in terms of stability and dissatisfaction?

Well, in the urban areas, they don't have property taxes. It's very hard to value land. Cities have no easy way to get revenues so basically they sell off land, and the process is distorted. It leads to corruptive practices. It leads to disenchantment, it leads to evictions, and it leads to protests. So urban dwellers are unhappy.

In rural areas, you have a problem. If you live in rural areas, what is your main asset? It's your right to farm your farmland, but you can't sell

those rights easily. If you can't sell those rights easily, you can't move. You're locked into place. What you'd like to do, of course, is be able to sell those rights, have some money, and then move to where the jobs are. So the rural population is locked in place.

So you have this kind of dichotomy between urban-rural areas, and you have this asset and income differential, which is the highest in the world, and it leads to dissatisfaction. It may be slower creeping, but it's there, and it's a major factor.

Lastly, let me finish by talking about corruption. As in many other countries, corruption is seen as a major problem. The government has publicly expressed its concern that if not addressed, corruption could weaken the legitimacy of the Communist Party, but unlike other notable examples, protests over corruption are unlikely to bring down the political system.

The reason is fairly simple: most Chinese see corruption as a problem locally, with the local system, local officials. They see their top leadership as being reasonably clean. Thus, protests in China over corruption tend to be saying to Beijing, please help us in the local areas, we're being oppressed, rather than you must go.

And the latter, of course, is much more destabilizing. And corruption at the top is limited simply by the fact that members of the State Council, China's top leaders, they live in a fishbowl. Their every action is scrutinized. While they're in office and when they retire, they're not really allowed to seek personal wealth.

In the aftermath of the Middle East, there are concerns that destabilizing forces will spread even to China. Personally, I do not see this happening, but there are obviously a number of very complex issues for Chinese to deal with these, and if they don't deal with this, instability will increase in the future.

Thank you.

[The statement follows:]

China's Internal Dilemmas – "Testimony before the US-China Economic and Security Review Commission"

(February 25, 2011)

Yukon Huang (Carnegie Endowment and Former World Bank Director for China)

Links between political and economic liberalization

China's reform program over the past three decades has been predicated on the assumption that economic liberalization should precede political liberalization. The leadership has assumed that fulfillment of basic social and economic needs was more important than progress on other aspects of the "human rights" agenda given the consequences of decades of disappointing economic performance and the "excesses" of the Cultural Revolution. Thus, when Deng Xiaoping took over the leadership role in the late 1970s, his strategy was to open up the country to the global economy by building an industrial based, export economy that capitalized on China's comparative advantages. By concentrating resources along the coast and providing special incentives and resources, China was able to establish economies of scale in production that transformed the country into the manufacturing assembly plant for the world. This provided the basis for a regionally integrated and more specialized production sharing network among East Asian countries which has, with few exceptions, led to rapid growth and surging current account surpluses throughout the region. (See Yukon Huang, Reinterpreting China's Success through the New

Economic Geography, Carnegie Papers, November 2010)[31]

The Chinese authorities have assumed that as long as the material well-being of the public was improving, social stability would be sustained and pressures for political liberalization moderated until the day when the governance structure of the country was ready and the populace better prepared to take on such responsibilities. For much of the post-Mao reform era with double digit growth, this assumption proved to be valid, but in recent years, as noted by various observers social unrest has intensified and tensions have been exacerbated by perceptions – rightly or wrongly – that equality in access to economic opportunities is no longer the rule and that personal liberties are being infringed upon. Even with rapid growth, widening disparities are now threatening the fabric of society and aspects of the development process are leading to more conflicts on an individual as well as a group basis. The recent visit of the Prime Minister to a "petitioning" office to signal that complaints from the general public should be handled more responsively indicates that the senior leadership is concerned that these tensions if unaddressed could threaten the foundations of the political system.

To what extent is there a link between a growth strategy that has transformed China into the second largest economy and rising social tensions which could threaten internal stability? Many economists have argued that rapid economic growth would eventually create the conditions for more "democratic" institutions along with more sustainable political processes. The empirical basis for this premise, however, is not firmly grounded.

China's unbalanced growth process and implications for income disparities

The growth path that China has been following is similar in certain aspects with the approach taken by other successful East Asian countries – notably its focus on a high investment, export led approach. But the strategy is unusual in the extent that it was spatially "unbalanced" and more state driven reflecting its centrally planned origins. This strategy was remarkably successful in putting the country onto a rapid growth trajectory but it also fostered an unusually sharp increase in income disparities. (See Yukon Huang, "China's unbalanced growth has served it well" Financial Times, October 7, 2010)[32]

The link if any between growth and social stability is perhaps best exemplified by measures of income and social inequality which show that disparities have been increasing steadily. The Gini coefficient which provides an aggregate measure of inequality has risen steadily from about .30 in the early 1980s to around .48 today (with 0 being perfect equality – everyone's income is the same - and 1 perfect inequality – one person has all the income). Although, a coefficient approaching .50 is high by global standards, it is comparable to that for the United States and other successful East Asian countries such as Singapore and Malaysia and lower than for many of the more prosperous countries in Latin America.

Although the overall degree of inequality in China is not unusual, how quickly it has risen from the Mao era when incomes were among the most equal in the world (but poverty was widespread) is a concern. Increasing tensions is better illustrated by the ratio of urban to rural per capita income which is above 3 and the ratio of incomes of coastal provinces to inland provinces which is close to 2.5 - both ratios rank among the highest in the world. Since two thirds of China's population resides in interior provinces and more than half in rural areas, this regional differentiation is a major source of internal instability. The speed with which the economy has been transforming itself also means that China's institutions have not had enough time to cope with rising expectations as well as needs.

Also worth noting is the contrast with less successful developing economies, where rising inequality is usually the result of stagnating incomes. Rural incomes in China have been increasing by about 4-5 percent annually – which is unusually high by international standards – but urban incomes have been increasing twice as fast and thus regional disparities have soared over the past several decades.

Studies vary in attributing inequalities to either cross-regional differences or intra-provincial factors, but urban-rural disparities tend to be much greater in poorer provinces than in the richer coastal provinces. Thus much of the inequality in China is explained by the uneven pace of urbanization across provinces, especially in the poorer inland

[31] http://www.carnegieendowment.org/files/reinterpreting_china_success1.pdf

[32] http://www.carnegieendowment.org/publications/index.cfm?fa=view&id=41699

regions. Regional factors are also important, because of the larger urban-rural differences in the more remote interior. In these areas, harsh natural conditions militate against higher agricultural productivity and more isolated settlements raise the cost of providing social services.

The Government has launched a series of regional development programs to address these disparities – notably the "Go West" program initiated in 1999 to address the exceptionally severe ecological needs of western provinces which rank among the poorest in China; revive the northeastern provinces strategy in 2003; and the more recent "Center Rising" initiative which has focused on the more densely inhabited areas in the central parts of China.

While these efforts have led to visible improvements in the availability of social infrastructure in less advantaged areas and moderated some of the past "imbalances", they have not yet been able to reverse the trends in rising inequality. Although China's social indicators in absolute terms have continued to improve, regional disparities remain substantial. The proportion of people in rural areas, for example, with no education is three times that in urban areas. Child and maternal mortality is twice as high in rural areas as in cities. Thus some of the increase in social tensions is the result of differential access to social services.

Looking to the future – policy priorities

Recent growth patterns suggest that a process of gradual convergence is underway between the coastal provinces and the interior; GDP growth rates for the interior provinces have recently exceeded those along the coast. But the advantages of location will likely persist even if narrowed with agglomeration effects continuing to favor the larger and more globalized urban coastal areas. What then should be the course of future policies given public pressures to deal with increasing disparities and rising social tensions?

Both economic theory and experience indicate that government initiatives should not try to "balance the location of productive capacity" across regions if China wishes to maintain its rapid growth. Global experiences in many other countries in Latin America and Europe have shown that investment policies based on trying to establish new production centers in regionally isolated areas usually fail given market realities.

To evolve a socially and politically more sustainable growth process requires a strategy to "moderate differences in economic welfare" between the coastal and inner provinces and between rural and urban areas. This would involve a three-prong approach that builds upon China's past successes by: (1) strengthening the distributional aspects of the fiscal system so that regional and rural-urban differences in access to social services are reduced; (2) encouraging complementary regional development policies that recognize and build on the uniqueness of geographic and inherited differences rather than trying to work against them; and (3) eliminating jurisdictional and institutional barriers that inhibit mobility of labor while strengthening infrastructure links so that the regions and rural-urban areas are better connected.

Fiscal policies to promote more equitable outcomes

With the major tax reform of 1994, the discretion based revenue-sharing system was replaced with a more rule based fiscal assignment system allowing the central authorities to use fiscal policy more actively for redistribution. Although revenues have since grown rapidly from 10 percent of GDP in the mid-90s to nearly 25 percent today, the impact of the fiscal system in providing a more equitable access to social services is still modest - in part because of the way expenditures assignments are cascaded down to local levels without providing commensurate funding. Sub-national expenditures at over two-thirds of total spending is very high by international standards and in a country with such wide regional disparities, getting the right mix of revenue and expenditure assignments at each level of government is especially difficult. These consequences are more significant in the poorer inland provinces and partially explain why urban-rural disparities are greater there relative to the coastal areas.

Part of the problem in channeling more funds for social programs is political due to the reluctance of richer provinces to redistribute in favor of poorer regions. Redistribution within an existing pool of resources is always more contentious than providing more funding when the pie is getting larger. A rapidly growing economy will provide more funding on its own for such efforts but there are policy actions that would enlarge significantly financing to address the regional differences in social expenditures.

One of these is to oblige state corporations to pay higher dividends to the Government which could then be used

for such programs. China is unusual in that corporations have not been paying any significant share of their retained earnings to either households or to the Government. Given their surging profits in recent years, this has encouraged companies to investment more than would make sense on efficiency grounds and distorted the pattern of investment and consumption. Although there was a recent move to increase the dividend payout ratios, the amounts are still only a fraction of those in comparable countries. A major adjustment in this regard with the additional revenues channeled into social expenditures would go far to reduce differences in welfare across regions. This would help address US concerns about global trade imbalances since the shift would increase consumption, moderate growth in investment for industrial production and help offset the bias in favor of exports.

A word of caution, however, that even with increased allocations for social programs, the impact in terms of mitigating social differences and providing a greater sense of security will take time. A common assumption, for example, is that increasing social programs will encourage the population to consume more and save less as income security is enhanced. Studies have shown that while increased public support for education and health services does increase household expenditures for these services, the recent efforts to improve coverage of the pension system has actually led to increased savings since households remain unconvinced about the longer-term viability of such programs and thus have increased their savings to offset the higher contributions that they are now obliged to make.

Role for region specific programs

Like many other countries, China has relied on locality specific policies to address regional disparities in an attempt to deal with social tensions. Their effectiveness – as in other countries – depends on whether such policies are consistent with differences in regional resource endowments and comparative advantages. In China, this means recognizing that the priority for the Western Region is defined by its fragile ecological conditions and the need to strengthen its human capital base; for the Northeast, to encourage more aggressive enterprise restructuring with supportive social protection systems and tapping it natural agriculture-based advantages; and for the Central Region, to strengthen inter-modal transport links and logistics infrastructure as commercial activities shift inward to serve major population centers as growth becomes more domestically driven. Broadly China's regional programs have been respecting these differences. But there are concerns that more recent programs have led to some wasteful expenditures as part of the stimulus program for dealing with the global financial crisis.

Importance of labor mobility and the "hukou" system

Cutting across all these themes, is the role that more flexible internal labor migration policies can play. Access to housing and social services for migrant families without urban residency status remains unequal, although guidelines have become more flexible in some jurisdictions. However, for many migrants security is still linked to their "*hukou*" [33] in their home province which provides use rights to rural land and social services. In the absence of more formal land use markets, the equally contentious issue of granting residency to migrant labor in the cities is difficult to resolve. The most effective instrument to deal with rural-urban disparities would be to liberalize further the "*hukou"* system. Elements of the system have served China well in avoiding the urban slums characteristic of many other major Asian cities. Thus the issue is more about managing rather than halting the process of rural-urban migration to moderate social tensions given the pressures for a more urbanized China.

Policy-makers continue to be reluctant to liberalize the "*hukou"* system because of fears that China's cities will become even larger and potentially unmanageable. A quarter century after the reforms began, China's urbanization rate has more than doubled and is now rapidly approaching 50 percent. At the current stage of development in metropolitan areas, positive agglomeration effects dominate negative congestion effects although China's cities face major environmental challenges and urban transport systems need to be improved.

Contrary to popular perceptions, in relation to its population and land mass, China's major cities are in fact too

[33] "Hukou" – a legacy of the past centrally planned economy - is a household registration system that establishes a person's official place of residency and gives them right of access to social services and other rights including housing and land use. Changing one's official residency is tightly controlled by local authorities. Thus without a hukou, most migrant households do not have access to the education services or employment rights that are available to local residents. This makes it difficult for them to bring their families or to make permanent a work related move.

small rather than too large. Building new "secondary" towns on the edge of existing cities may be effective only if there is strong demographic, economic and environmental rationale. Fragmentation in large cities (agricultural/vacant land within the contiguously built up city) resulting from China's typical multi-ring spatial format of city development has created less densely utilized enclaves, unnecessarily increasing urban transport costs and provision of social services. More efficient urban planning which would infill "leapfrogged" areas will be an important issue as urban population growth continues to accelerate.

Finally for migrants to leave rural areas or inner provinces, they need to be able to "capitalize" the value of their land holdings and move with enough assets to bring their families and start afresh in typically more urbanized and prosperous localities. Development of secondary markets that would allow farmers for example to sell their land use rights is critical in this regard along with more developed formal markets for transferring rural property. In principle these actions are possible but practices are not uniform and markets are either distorted or tightly controlled by local authorities to the disadvantage of potential migrants. Issues relating to property transfer and confiscation for development are major sources of tension in both rural and urban areas and such incidents often trigger localized protests.

Some further thoughts – inflation and corruption

Over the past year, inflation has ratcheted upwards and drawn increasing attention from the political leadership. Many observers see the surge in prices as a potential source of internal instability if it gets out of control. Others do not see this as a longer-term issue since most of the increase is being driven by rising foods prices – due in part to weather related events. China has the resources and stockpiles to deal with the foreseeable consequences. The economic implications of inflation are more mixed than generally recognized. Price increases are helping to drive up the real value of the yuan and thus a factor in moderating China's trade surpluses. In addition, for the first time in several decades, rural household incomes increased faster than urban – thanks to the surge in agriculture prices. But with a rising urban middle class, the political implications are another matter.

More generally with a rapidly changing economic scene and a more mobile and better educated labor force with higher aspirations, social dissatisfaction increasingly emanates from the lack of credible institutions and processes for the populace to express their concerns. Venting one's frustrations in ways that are perceived to be taken seriously by the authorities are as important as actually resolving an issue.

Much of this frustration is directed at failings that emanate from corruption and inconsistent application of the rule of law. Corruption in China is a major concern and source of potential internal instability. Even the senior leadership has recognized its seriousness in noting that if unchecked it could threaten the credibility of the Party. However, its pervasiveness and corroding effects are not unusual in the Asian context.

Whether public perceptions about corruption will ever lead to the kind of agitation that has overthrown regimes elsewhere is less obvious. One distinguishing feature of corruption in China is the view that while corruption is endemic at the local level, the senior leadership is seen as reasonably "untainted". This is the result of a political system that mandates the senior leadership to live in a "fishbowl" environment and be subjected to scrutiny in exchange for assuming power. The cross-checks that come with a turnover in the top leadership every five or ten years also mean that blame becomes less personalized. Thus protesters misconceived or not, often see the central authorities as a potential savior in addressing abuses at the local level. Currently, civil unrest tends to be driven less by visions of a regime change but more by drawing attention to abuses that affect daily lives. Nevertheless, examples of dissatisfaction are becoming more widespread and there are segments of society that are thinking more seriously about social and political evolution in ways that generate pressures for more fundamental changes.

How China handles this complex set of issues will have profound implications for dealing with disparities and related tensions with consequences for internal security. These outcomes also have implications for US-China relations.

HEARING CO-CHAIR CLEVELAND: Thank you.
Dr. Dunaway.

STATEMENT OF DR. STEVEN DUNAWAY
ADJUNCT SENIOR FELLOW FOR INTERNATIONAL ECONOMICS
COUNCIL ON FOREIGN RELATIONS, WASHINGTON, DC

DR. DUNAWAY: Thank you very much, Commissioners.

I come at this from a macroeconomic point of view in addressing your question about instability. One of the keys to maintaining internal stability in China, of course, is the ability of the country to maintain very rapid economic growth.

But that's going to be increasingly difficult in coming years for China to achieve without major changes in economic policies and substantial further reforms, and the problem is, though, that it's not clear that the authorities are really up to the task of bringing about these massive changes that are needed.

China's economic model undoubtedly has been incredibly successful over the past 15 years. China has risen from being an also-ran among countries to the number two economy in the world, but time is running out on the model. And the authorities are aware of this.

Wen Jiabao himself said in March of 2007, there are structural problems in China's economy which cause "unsteady, unbalanced, uncoordinated, and unsustainable development." He essentially repeated this comment last year. So over the last four years, very little has been done to change policies in China, and it's essential for China to rebalance its economy away from very heavy dependence on investment and exports towards consumption to drive growth.

Continued heavy reliance on investment means that China is going to have to maintain a relatively substantial rate of increase in exports to be able to take up the added capacity that that investment creates, but in the current economic environment in the world economy with relatively slow world growth, it's going to be increasingly difficult for China to be able to maintain such rapid export growth.

The only way that they'll be able to do it is in terms of cutting export prices. If you cut export prices, you reduce the profitability of the Chinese exporters; in turn, you reduce rates of return on investment. That then will have a tendency to reduce investment by Chinese firms. Equally, Chinese banks seeing a decline in rates of return in the export industry, you would expect them to cut back on lending.

So China faces the prospect over the next several years of a kind of natural process that will slow growth.

Now, the authorities are aware of this, but they believe that they have ample time to bring about this transition in China's economy, but I think the reality is they have much less time to accomplish it than they believe if growth is going to be maintained without significant disruption.

As I said, the current external environment for China is considerably less favorable than it was during the 2000s. As world growth is very slow, the growth of world trade has slowed, slowed significantly. Also, in these circumstances, other countries are less likely to be lenient and give China

the kind of time that the Chinese authorities view would be optimal for making the transition.

So China is probably going to face increasing pressures externally for changes in its policies, particularly in its exchange rate policy, and is likely to face increasing trade restrictions on Chinese exports.

At the same time, within China, there is a great reluctance to speed up reform. This reluctance, in part, grows out the political process in the current jockeying for position in the new government, which comes to power. Selections for positions in the new government will be made in November of 2012. The government itself will take power in 2013.

It also reflects the likelihood that China's new leaders will be no more decisive on economic policy as the current leadership. And part of this being because the leadership in China will continue to be consensus driven, and it's very difficult to reach consensus on major changes in economic policy in China given the varied interests within the Chinese Communist Party.

In particular, it's difficult to overcome the support for the status quo policies because it's hard to argue against the current policies given how successful they've been in the past, and there's a reluctance to take the risk of making major policy changes.

And there is also the problem of how it impacts upon the Party's own position in the economy because the Communist Party maintains a very strong economic presence through the policy of commanding the heights of the Chinese economy. So certain industries are essentially closed off to both foreign and Chinese private investment and large state-owned enterprises dominate those industries.

So the need for major policy changes and reforms coupled with the strong reluctance of the authorities to initiate such policy changes at a sufficiently rapid pace suggest that China is going to face considerable instability over the next several years.

Added to that is to overcome any slowdown in growth, the Chinese will probably continue to follow relatively expansionary fiscal and monetary policies, and those expansionary policies will add to potential instability in China's economy. In particular, there is a high risk that China will run into increasing inflation problems, not unlike the situation that they faced in the early 1990s.

So I think it's ironic that by trying to cling to its position in the economy, it's going to inhibit the ability of the authorities to make necessary policy changes, and so in the end, the government, the authorities may end up sowing the seeds for growing social disharmony that they're trying so hard to prevent.

Thank you very much.

[The statement follows:]

Dr. Steven Dunaway
Adjunct Senior Fellow for International Economics
Council on Foreign Relations
Major Challenges to China's Economic Stability

Major challenges to China's economic stability center on the authorities' ability to continue to deliver rapid economic growth and development. Real GDP growth on average of 8 percent a year is viewed by the authorities as essential to broaden opportunities to participate in the formal economy, particularly for rural resident, and to generate sufficient employment for new entrants into the work force.

China has made remarkable progress especially over the past 15 years, rising to become the second largest economy in the work and the world's leading exporting nation. On the basis of these enviable achievements, China would appear to be a daunting economic colossus. However, there are substantial reasons to doubt that that China will be able to maintain rapid growth, unless the country makes major changes in its economic policies and further substantial reforms in its economy.

Why Economic Growth in China May Falter

Chinese Premier Wen Jiabao in March 2007 recognized the economic challenges that China faces and the need for policy changes and further reforms when he summed up the situation as:

> "There are structural problems in China's economy which cause unsteady, unbalanced, uncoordinated and unsustainable development."

In a more recent assessment of China's economic prospects in March 2010, Premier Wen essentially reiterated his earlier remarks when he said:

> "The biggest problem in China's economy is still imbalances in the structure -- that economic development is not stable, balanced, harmonious and sustainable."

These comments indicate the fundamental problems in China's economy, and the authorities' awareness of them. It is not encouraging though that, to judge from the Premier's comments, not much progress is being made to put China on a more sustainable long-term growth path.

There are two basic reasons to believe that China's growth could falter in the period ahead:

1. China's economic model with its heavy reliance on investment and exports to generate growth will not be able for much longer to continue to deliver rapid growth.

2. China's political system is likely to continue to create hurdles that will adversely affect the ability of the economy to grow rapidly.

The End of Investment-Driven, Export-Led Growth

Since the mid-1980s, China's economic growth has been driven by investment. Distortions in basic prices (such as low costs for capital, land, energy, other utilities, and pollution abatement); tax and other incentives; and institutional arrangements have strongly favored investment over consumption.

These policies worked fine in promoting growth until the early 1990s, when problems emerged. Investment growth began to slow as the productive capacity that new investments created exceeded domestic demand. To maintain investment and sustain rapid output growth and adequate employment growth, the government engaged in expansionary fiscal and monetary policies, which gave rise to serious inflation problems in the mid-1990s.

In 1994 and 1995, the Chinese government put in place three major reforms that modified the growth model to deal with the problem of the excess capacity generated by rapid investment:

1. One hundred percent foreign-owned firms were permitted, and these firms were provided incentives to lure investment to China and to concentrate it in the production of exports and other traded goods.
2. China's dual exchange rate system was eliminated, and the value of the new single exchange rate was set at a somewhat depreciated value.
3. Reform of the state-owned enterprises was actively pursued, relieving these firms of their social

responsibilities and cleaning up their balance sheets—launching a wave of new investment.

After the reforms, China retained its heavy reliance on investment to drive growth, but exports and the substitution of domestic production for imported goods provided the necessary outlet to ensure that the excess of productive capacity over domestic demand created by new investment was fully utilized. Hence the designation of China's development model as investment-driven, export-led growth.

But time is running out on the ability of this model to continue to produce sustained rapid growth. Ironically, this in part is because of the model's success.

Continued heavy reliance on investment to drive output growth will add to productive capacity and require continued strong export growth. However, mustering the necessary export growth will be a difficult task to achieve.

China is the world's largest exporter and to be able to maintain sufficient export growth to sustain investment, China will have to take an ever-increasing share of world trade. This will be a hard task at a time when world trade is growing significantly slower than it did in the previous two decades and when all of the world's major economies are looking to exports to provide stimulus for growth. To be able to do this, China's producers will have to significantly lower their export prices to overcome stiff competition in world markets.

Consequently, profitability of exports will decline, and as a result, Chinese firms would be expected to cut their investment as rates of return decline. Chinese banks too, if they are operating on a commercial basis, should be increasingly reluctant to finance firms' investment. Therefore on its own, growth in China's GDP would be expected to slow.

Moreover, the situation facing China could be even worse if its attempts to maintain export growth were to invite serious trade retaliation from its major trading partners, especially if China seeks to maintain a competitive advantage by limiting the appreciation of its exchange rate.

China's government of course could step in and prop up GDP growth with expansionary fiscal and monetary policy—as it has done for the past two years. While such policies may be successful for a short period of time, eventually they will create serious problems that will have to be dealt with and economic growth could slow sharply as a consequence.

This is a lesson the Chinese authorities should have learned from their efforts to hold up economic growth in the early 1990s. Nevertheless, there appears to be a substantial risk that the early 1990s experience may be repeated. Over the period 2009-10 and into 2011, rapid credit growth has been maintained to try to hold up output growth. It is beginning to be reflected in a rising inflation rate. While the authorities are aware of the risks of inflation, the decision to maintain relatively rapid credit growth in 2011 suggests that a greater priority is still being place on achieving the official target for real GDP growth of at least 8 percent.

Changing the Economic Model

China's economy needs to be rebalanced away from investment and exports toward greater dependence on consumption to generate growth. To do this will entail the implementation of some major policy changes and market-oriented economic reforms.
The Chinese authorities recognize the need for change, but they think that there is still plenty of time to act. They also appear to expect that the rest of the world will give them as much time as the Chinese feel is necessary to make this transition. However, the patience of other countries with the slow rate of change in some of China's policies—especially its exchange rate policy—is wearing thin.

The chief requirements for a rebalancing of China's economy are to remove key price distortions and make other policy changes to eliminate inefficiencies and incentives favoring investment over consumption.

Perhaps the most significant price distortion in China is the very low cost of capital. In a country that is thought of as possessing abundant cheap labor, capital is even cheaper, and because of low capital costs, along with inefficiencies in the allocation of capital through the financial system and government policies, production in China

tends to be relatively capital intensive.

The ceiling imposed on interest rates paid on savings deposits is a major factor behind the low cost of capital. This ceiling holds down bank lending rates and reduces the opportunity cost for firms to use their retained earning for investment. This ceiling needs to be lifted. At the same time, the cost of capital cannot be raised significantly without permitting more exchange rate flexibility and the country's currency needs to be allowed to appreciate more rapidly.

A higher cost of capital and a stronger currency will help curb investment in export- and import-substituting sectors. Household incomes would be boosted by a rise in bank deposit rates, significantly raising investment income, and consumption would increase. Appreciation of the exchange rate would also stem the substantial overinvestment in the export sector that is taking place, and it would stimulate consumption, as the price of imported goods would fall creating a rise in the real incomes of Chinese households.

Financial market reform is also needed to improve the intermediation of savings in China. Lifting the cap on deposit rates would not only help push up the cost of capital, it would also increase competition in the banking sector and provide incentives for banks to expand credit to new customers. Bond and equity markets must be developed to provide alternative sources of financing for firms and a much broader array of assets for households to invest in. Better access to credit would reduce the incentives of both firms and households to hold large savings. Small- and medium-sized firms have had to rely largely on retained earnings or the assets of their owners to finance investment. Consumers also have had limited access to credit. Better credit access and higher yielding assets to invest in would reduce household saving and raise household incomes over time, boosting consumption.

Moreover, the government needs to continue improving critical social services, especially education, health care, and pensions. Reducing the uncertainties surrounding the provision of these services will substantially diminish households' strong precautionary savings motive and give households the confidence to raise consumption.

Hurdles Posed by Problems in the Political System

It is not readily apparent that the authorities are up to the task of making the necessary policy changes and economic reforms needed to rebalance China's economy because of problems posed by the political system.

The near-term problem is that the current leadership is relatively weak and has an ingrained instinct toward caution. Major economic policy decisions are made by consensus among the members of the State Council (consisting of roughly fifty people, including government ministers and senior members of the Chinese Communist Party), and it has proven difficult to reach a consensus on major economic reform issues among such a large group given their varied interests. There is a strong tendency to cling to the status quo and to favor policy strategies that involve taking only small steps to change the economy. The scheduled change in leadership in March 2013 does not look like it will change this situation significantly.

The leadership change itself also poses problems for getting any significant changes in economic policies. All major positions at the central, provincial, and local government levels will change with the change in leadership. Given the considerable jockeying for position that is going on now and the uncertainties in economic prospects, no one is advocating major changes in economic policy. Decisions on positions in the new government will be made in November 2012. Moreover, it is unlikely that the new government will take major policy actions in its first year in office as the new leadership attempts to establish itself and secure its sources of power within the Chinese Communist Party. The result is a likely policy vacuum for the next three years.

But there are more a fundamental, underlying political issues that will make it difficult for China to pull off the needed rebalancing of its economy. It is not clear whether development of a more market-oriented economy is compatible with the views of the Chinese Communist Party regarding how it wishes to maintain control over the country. Other countries in East Asia controlled by single-party governments for long periods of time (including Malaysia, Korea, Singapore, and Taiwan) have successfully sustained rapid economic growth and development. But these countries have been willing and able to separate economic from political control. In China, the Party appears reluctant to relinquish economic control. Its philosophy since the onset of economic reforms in 1978 has been that the government should control "the commanding heights of the economy." Clinging to this philosophy could severely limit the development of a more market-oriented economy and undermine China's ability to maintain

rapid growth.

The reluctance to concede economic control is reflected in macroeconomic policies. There continues to be heavy reliance on direct intervention in the economy instead of relying on indirect instruments of macroeconomic control. This is particularly evident with monetary policy, where government decisions on credit policy continue to play an important role. It also is reflected in the ongoing heavy management of the exchange rate. The reluctance to concede economic control is also reflected in industrial policy. It is illustrated by the introduction of the indigenous innovation policy and by China's opaque review process for mergers and acquisitions.

The supremacy of the Chinese Communist Party is mandated, so consequently it will be difficult to more firmly establish the rule of law in China. There is talk about the need to improve the justice system, but the party is reluctant to let the courts challenge its supremacy by being the final arbiter of disputes. The rule of law is fundamental for sustaining economic growth and development. Individuals and firms need predictability in economic arrangements and assurances that contracts and property rights can and will be effectively enforced.

In the initial phases of China's development, ad hoc arrangements largely based on relationships between businesses and well connected officials tended to be adequate substitutes for the lack of a strong rule of law. Initially, high returns on investment served to offset the risks associated with the potential unpredictability of such relationship-based arrangements. But such ad hoc arrangements are not durable as an economy grows and becomes more complicated, returns on investment decline, and centers of political power and influence shift. As a consequence, increasing uncertainty in economic arrangements inevitably will lead to lower investment and slower economic growth.

Conclusions

One of the keys to maintaining China's internal stability is the ability of the country to continue the pace of its growth and development. Without sustain, rapid economic growth, China will be unable to continue to fulfill the rising expectations and aspiration of it population. It is essential for China's economy to be rebalanced away from heavy dependence on investment and exports toward greater reliance on consumption to drive growth. Although the authorities believe there is ample time to bring about this shift in the economy, the reality is that they have much less time to accomplish it than they believe if growth is to be sustained without significant disruption. The current external economic environment is considerably less favorable than China experienced before the recent economic and financial crisis, and this unfavorable environment is likely to persist for some time. In these challenging economic circumstances, other countries are less likely to be lenient and will push more vigorously for changes in China's external policies and demand a faster rate of exchange rate appreciation.

At the same time, there is great reluctance in China to speed up reform. This reluctance in part grows out of the political process and the jockeying for position in the new government to be formed in November 2012 that is going on now. It also reflects the likelihood that China's new leaders will be no more decisive on economic policy than the current leadership, and policymaking will remain consensus-driven. In such an environment, policy changes and reforms necessary to bring about economic rebalancing will be difficult to enact because of strongly held and divergent views among key interest groups within the Chinese Communist Party. In particular, it will likely be difficult to overcome relatively hard-core support for the status quo in economic policies because of the potential impact policy changes and reform could have on the party's position in the economy.

The need for major policy changes and reforms coupled with the strong reluctance of the authorities to initiate such policy changes at a sufficiently rapid pace suggest that China risks facing considerable instability over the next several years. Current relatively expansionary macroeconomic policies in the pursuit of continued economic growth could add to this instability, in particular by fanning inflationary pressures. Ironically, by trying to cling to the Chinese Communist Party's current position in the economy, the authorities could end up sowing the seeds for growing social disharmony that they are trying so hard to avoid.

PANEL II: Discussion, Questions and Answers

HEARING CO-CHAIR CLEVELAND: Thank you both. Very, very helpful

testimony.

Commissioner Wessel.

COMMISSIONER WESSEL: Thank you both for being here today and your prepared and oral testimony.

I guess I'm somewhat guided by the fact that the precursor to this Commission was the U.S. Trade Deficit Commission, which I also served on, and we had a report that said the trade deficit was unsustainable. That was in 1999.

It's still true. The fact is at what point is it unsustainable? Or are we fooling ourselves? You know, clearly from many people's perspective, the goal of instability in China is worthwhile in terms of changing its political system. We have this view, as we did with Japan and others, that everyone wants to have the U.S. model, which may not necessarily be the right approach to take.

Do they see the same threats? Do they share the same view as the two of you in terms of the sustainability? While the public wants change in certain policies, are they looking at changes at the top in other ways?

DR. HUANG: I'd like to take this occasion to respond to your first point when you mentioned the U.S. trade deficit because there's actually a very strong link with some of the issues we're talking about, that if China moves in the right direction, this will be very helpful to the U.S. interests.

If China becomes more urbanized, and 80 percent of the people lived in the cities, Chinese consumption levels would boom. Less reliance on exports would result. Greater consumption means greater import demand would help the U.S.

I think the key point for U.S. policymakers to focus on is how to make the debate with China a win-win kind of debate, that the Chinese actually see that these recommendations are in their own interests, rather than confrontational. Otherwise, they will not move very easily. So I just wanted to make this first point.

COMMISSIONER WESSEL: I appreciate that.

DR. HUANG: The second point is the Chinese do recognize these issues, but they have a much longer time horizon as to how they see this transitioning happening. They could move much more rapidly on many of these questions if they felt that the benefits would be strong enough, and they're always bothered by the fact that there is global instability, and this makes them more conservative than they need to be.

COMMISSIONER WESSEL: When you say the "the Chinese," the people or the leaders?

DR. HUANG: They're always concerned about global instability.

COMMISSIONER WESSEL: No, no. I'm sorry. But when you say the "the Chinese," you mean the people or the leaders?

DR. HUANG: I mean the leadership.

COMMISSIONER WESSEL: Okay.

DR. HUANG: The leadership sees these trends, these issues and some of the actions being discussed as desirable in the long-run for balance and good for everybody, even with lower growth. But they're very, very conservative. They're reluctant to take what I would call strong measures

when the international economy seems to be so uncertain because for them instability--and uncertainty--is a major risk.

Let me just stop there.

COMMISSIONER WESSEL: Okay. Dr. Dunaway.

DR. DUNAWAY: Well, let me add that they're also reluctant to take policy changes when they face a favorable economic environment, which was the case during the 2000s. And that reluctance stems from some of the things that I mentioned in terms of some internal disagreements within the Party in terms of the direction and the pace of reforms.

And that's the key, is all of the things that have been discussed, especially with respect to--I think the two key policy changes needed in China is, one is to raise the cost of capital by removing the cap on deposit rates, which has two immediate effects. One, over time, you would improve the allocation of capital in China, and you probably open up lending towards the medium and small-size enterprises, which is a potentially very dynamic and employment-generating part of the economy.

But the immediate effect would be a massive increase in investment income of households. Over the last 15 years, you've seen household income decline in China, and when you break it down into its components to see where it's coming from, what you find is wages and salaries have basically kept pace with the increase in GDP.

It's investment income and transfers from government that have declined the most so you could immediately put a big shot in the arm of the household sector by removing the cap on deposit rates. At the same time, you cause potential problems for the banking system because the banks in China, the big banks, they make a lot of money doing basically nothing because they have a 300 to 400-bases point spread between their deposit and their lending rates, and then they have an implicit guarantee effectively on what they lend to state-owned enterprises.

So it's good business to be a state banker in China. And so you potentially would disrupt that kind of cozy relationship, which would then have impact on certain interests within the Party that are heavily involved in the financial sector. So that's part of the internal friction, which I think is holding back reform in the country.

COMMISSIONER WESSEL: Thank you.

HEARING CO-CHAIR CLEVELAND: Mr. Shea.

COMMISSIONER SHEA: Thank you both.

I have two questions. First, both of you deal a lot with Chinese economic statistics, and I was wondering if you could comment on the quality of those statistics and any sense that the Chinese authorities might fudge them a bit in order to prevent social discontent. Keep the inflation rate lower, the official inflation rate lower, for example, than it really is.

Secondly, you said something, Dr. Huang, which struck me, that the leadership in China, political leadership, really can't pursue private wealth because they live in a fishbowl. I'm sort of paraphrasing what you said, which is a little bit different than what Dr. Economy briefly mentioned. She talked about budding resentment or potential resentment against princelings.

I just want to read a description of the Chinese political/economic system in this book called Red Capitalism. I'd like you to comment on whether you agree with it or not. It says: "what makes this structure is not a market economy and its laws of supply and demand, but a carefully balanced social mechanism built around the particular interests of the revolutionary families who constitute the political elite. China is a family-run business. When ruling groups change, there will be an inevitable change in the balance of interests, but these families have one shared interest above all others: the stability of the system. Social stability allows their pursuit of special interests. This is what is meant by calls for harmonious society."

So could you comment on that? Two questions. Dr. Huang, you want to start?

DR. HUANG: Let me take my comment about the fishbowl. Let me differentiate between the eight members of the Standing Committee or the State Council. When they assume those positions they essentially have given up their ability to operate in the economy. They can't earn income; they can't give speeches; they don't own property; they can't even travel without someone signing off on them.

When they leave and retire, you don't hear of them anymore. They can't do anything. That's what I mean by the fishbowl effect.

COMMISSIONER SHEA: Okay.

DR. HUANG: That does not apply, of course, to their families, the children and dependents. They may own companies; they may be operating in the private sector. All sorts of things can happen.

But it's also what I would say the price of, if you want to be at the very highest levels, you have to give up direct involvement in business, but that doesn't necessarily affect family members, and we know many stories about family members operating in various ways.

COMMISSIONER SHEA: Mubarak's stipend was $800 a month.

DR. HUANG: Right.

COMMISSIONER SHEA: Yes.

DR. HUANG: So there are issues. But, nevertheless, when people protest, they're not saying get rid of the State Council. They're talking about getting rid of all abusive practices at the local level.

The other comment about statistics--statistics in China are not perfect, and no country's system is perfect. I would differentiate between technical imperfections and deliberate manipulation.

COMMISSIONER SHEA: Uh-huh.

DR. HUANG: Certainly, many officials are driven by the fact that targets encourage them to make sure that the outcomes are closer to what they're supposed to achieve than the reality.

If you look at regional GDP numbers, each one is above the national average. So the government realizes there's something wrong and has to adjust it downwards.

You know that GDP numbers for any particular year may be too high or too low because the basis for collections of statistics is flawed. They tend to overstate in some years and understate in other years, but over time,

they're quite accurate. Right now, for example, the statistics significantly understate household incomes and services in China because these activities are largely private and informal.

So you get a misleading estimate of how significant consumption is. How significant is household income? How active is the service sector? All I can say is it's significantly higher than the official statistics. That's not what I would call deliberate. It's just that the technical capacity has not caught up with changes in the structure of the economy.

If you look at inflation rates in China, I'm struck by the fact that the inflation rate is practically the same in every city and every province despite the fact that relative prices and consumption baskets are different. Now that's not a misstatement. It's just they have not been able to adjust the basis for estimating consumption and inflation, which is a big headline issue, adequately to reflect differential realities.

Let me stop there.

COMMISSIONER SHEA: Thank you very much.

Dr. Dunaway.

DR. DUNAWAY: On the statistics question, I agree fully with Dr. Huang, that it's more technical problems in the system. There have in the past been a couple of situations where there was a lot of speculation that there was some manipulation. The most recent dates back to the Asian crisis in '97-'98, where there was a lot of speculation that the GDP numbers for China had been held up.

But equally, over most of the past decade or more, there's been concerns, as Dr. Huang pointed out, that there is a substantial undercount of China's GDP, in large part because of the service sector and the growing importance of the service sector.

With respect to the quote that you read, I wouldn't characterize China so much as a family-run business as more of a Party-run business because the Party does maintain a very substantial position in the economy, and I think this is a major stumbling block to China's development.

If you look at other Asian countries that developed under single party systems, Korea, Taiwan, Malaysia, Singapore, all of them seem to be able to strike a balance, where the government traded economic control for political control with the private sector, and so they were able to develop substantially faster on that basis.

Thus far, the Chinese have not been willing to withdraw from the economy, and I think that's going to be a major stumbling block going forward.

COMMISSIONER SHEA: Thank you both.

HEARING CO-CHAIR CLEVELAND: Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Madam Chairman, Chairwoman.

Dr. Yukon Huang, in your prepared testimony, let me premise this by saying last year we did a hearing looking at PNTR ten years later, the debate in Congress on whether to give China PNTR that made possible their entry into the WTO, and a lot of the argument, when you go back and look at it, was that this would help move China away from one-party authoritarian rule, Internet freedom, economic growth, et cetera.

Now, you say on page one of your testimony, quote: "Many economists have argued that rapid economic growth would eventually create the conditions for more democratic institutions along with more sustainable political processes."

And then you add, I think a very important point: "The empirical basis for this premise is not firmly grounded."

Where did this idea come from? And I mean help me understand because I think it was being used to persuade people to do something that became, I think, quite harmful to our country in the long run..

DR. HUANG: Mr. Commissioner, there have been many studies focusing on emerging market countries, developing countries, trying to look at the nature of the political system and the speed of economic development, and I would say the results are ambiguous.

You find authoritarian regimes doing really well. You find democratic regimes doing really well. But you can't actually say that one causes the other or there's a strong relationship.

If you step back a bit and look at the whole world, the general observation is that developed countries tend to be democracies, and authoritarian regimes tend to be predominantly among the poorer countries. So common sense would sort of suggest that as countries get wealthier, democracy must become much more of a driving force in societies than when they are poor.

So that's why I say causality or empirical basis is not clear. You can't argue this is proof. In China, they've certainly been taking the position that in moving low income to middle income to high income, the priority is on improving the economic well-being of the people, and they have been remarkably successful in moving about 500 million people out of absolute poverty.

But China is now at the stage of being a middle income and moving to upper-middle income where this issue of political liberalization becomes more serious. People have choices. They have aspirations.

The fact that migrant workers are no longer happy living in the coastal area, single and in dorms, and going back home or demanding higher salaries is an indication that what was good enough ten years ago is not good enough today.

So they've reached the point. Now, my personal view is this is not necessarily a bad sign. This is evidence of what I call pressure on the system. The government just last week, for example, was talking about the fact, that the system for managing social tensions and pressures must be improved.

When Wen Jiabao talks about how we (China) handle the appeals from the population about their personal grievances and that this is not being handled well this is a pressure on their system. So my personal view is this is the pressure that comes from economic liberalization that creates political liberalization, and while there may be ups and downs, ultimately the trend is in a direction where I think political liberalization will occur, and for China, the issue is how will it occur, how will they manage this process, how would they deal with it?

COMMISSIONER MULLOY: Dr. Dunaway, on your testimony, on page three, you talk about China's kind of export growth strategy, and you say this: Chinese banks, too, if they are operating on a commercial basis, should be increasingly reluctant to finance firms investing in export-led growth strategies.

Do Chinese banks operate on a commercial basis?

DR. DUNAWAY: I would say they operate probably on a quasi-commercial basis. And the reason is twofold:

One is the basic implicit guarantee that they had that if they lend to state-owned enterprises, and those enterprises, in turn, if they have difficulty in repaying, that the banks will be bailed out, like they've been bailed out twice, twice in the recent past.

The other is the problem that they face in terms of the way that China administers its monetary policy, particularly given the substantial intervention in foreign-exchange markets that China engages in.

China uses open-market operations to try to sterilize some of the intervention, but it can't rely on that to a large extent because it puts upward pressure on interest rates, and that would encourage more capital inflow.

So as a result, what they do is basically repress the financial system. Well, one of the key ways that they control liquidity in China is by what's referred to as window guidance where, in essence, the central bank is telling the banks how much to lend. So as a result, the banks are not making the kinds of commercial judgments that they should.

COMMISSIONER MULLOY: Okay. Thank you.

HEARING CO-CHAIR CLEVELAND: Mr. Fiedler.

COMMISSIONER FIEDLER: A couple of quick questions. So it's not capitalism; it's not communism; it's not socialism. I've heard "crony capitalism." We've heard testimony that it's "bureaucratic capitalism." The most common word in the phrases tending to be "capitalism," but not as if it is used in any meaningful way.

What do you guys call it?

DR. DUNAWAY: I guess to paraphrase a bit, the old movie, Chinatown, "It's just China."

[Laughter.]

DR. DUNAWAY: The Chinese call it "socialism with Chinese characteristics." I guess that's probably at the end of the day the best way to characterize it. I think it probably ends up being closer to what you might classify as more of kind of "crony capitalism" because the Party dominates substantial sectors of the economy, and a lot of the business relationships rest on associations with key people and the Party.

Rule of law is not very well ground, and there's a lot of reason to believe that it would be very difficult to establish a very strong rule of law because the Chinese Communist Party's rule is supreme. So it's difficult to see that it would set up an independent judiciary which would have the final say in matters.

So I think in early phases of development, you can probably get away with this type of relationship capitalism, but now that China has become a

much larger economy, and as changes in leadership take place, it becomes much more difficult to run the economy on that basis.

COMMISSIONER FIEDLER: What do you say, Dr. Huang?

DR. HUANG: Let me make two points. First of all, I think it's essentially ironically state-led capitalism.

COMMISSIONER FIEDLER: Right.

DR. HUANG: Let me point out something that I think is very unusual. Why is China so competitively efficient as a command economy compared to Eastern Europe because everyone is always worried about centrally planned Economies. Why is China so competitive when the other countries in Eastern Europe are not?

There is one thing that distinguishes China from all these other countries. It has built into its system extraordinary competitive pressures, which are ironic.

First of all, it exports enormous amounts so it has to meet the global market test. But even more important, the provinces are major countries within themselves, and they compete with each other. So the state could be supporting somebody or the Party could be supporting a firm, but ultimately that firm in Hunan Province or Jiangzu cannot compete with a firm in Chongqing or Beijing. It gets wiped out.

Remember, China, for example, had 29 airline companies ten years ago. Each province had an airline company. Today, it has three because the others got wiped out. So this is a state-led capitalism with what I call competitive pressures, which the world has never seen, and that's very unusual.

COMMISSIONER FIEDLER: Okay. Thank you.

I want to ask you another question.

DR. HUANG: Okay.

COMMISSIONER FIEDLER: So previous administrations, both Republican and Democrat, arguably have had a policy of favoring stability in China--U.S. administrations.

DR. HUANG: Yes.

COMMISSIONER FIEDLER: So let's, if China were to become dramatically unstable--

DR. HUANG: Right.

COMMISSIONER FIEDLER: --what would the effect on the U.S. economy be?

DR. HUANG: If China became dramatically unstable to the point where economic production and activity was severely depressed, you'd find, in fact, a major global recession. Remember, China's growth in the last year or two has accounted for almost half of world demand increase.

Suppose that disappeared. It would be very hard for the Asian economies to survive because they're strongly interlinked. Remember, half of China's exports to the United States do not represent goods produced in China; they represent goods produced all over the place but assembled in China. So the ripple effects would be enormous. Therefore, I would see, in fact, a major recessionary impact upon the United States.

COMMISSIONER FIEDLER: Do you agree?

DR. DUNAWAY: No. I think the initial impact may be significant, but there are alternative sources for virtually everything that China produces that could be brought into play very quickly.

You could look back a few years ago as there was some tightening up of restrictions on Chinese textile exports. You saw production being transferred very rapidly--

COMMISSIONER FIEDLER: To Vietnam, right.

DR. DUNAWAY: --to other countries in Asia.

COMMISSIONER FIEDLER: Thank you very much. Exactly on time.

HEARING CO-CHAIR CLEVELAND: Commissioner Brookes.

COMMISSIONER BROOKES: Thank you very much, co-chairs and thank you witnesses for being here with us today.

I guess the question I have is that you've done a great job in outlining the potential sources of instability in China. And this is directed to both of our panelists. Do we expect any significant changes under the current leadership, and then if not, any idea looking into your crystal ball what we'll see out of the next leaders of China in 2012, 2013, addressing these issues?

DR. HUANG: I do think that the new leadership will be taking more seriously this issue of disparities and the pace of urban-rural development. They have to. These pressures are enormous, and they have some fundamental decisions to make. For example, do they let the big cities get even bigger or do they go for small cities? Do they let people move at a more accelerated rate?

They have a massive unemployment problem emerging in terms of the educated people coming out of the schools whose salaries and now wages are the same as migrant workers. So there's a big social issue in terms of those tensions. So there will be changes.

Climate change, clean growth technology is a major issue that will arise and be important between the U.S. and China because China now sees green growth technologies as a driver for growth, whereas, globally, people see green growth technology as a potential repressor of growth because of its cost implications and standards. So I think that's a source of major tension and change.

China is going to be trying to move up the innovation ladder so issues of indigenous innovation, technology transfer--very sensitive issues for the United States, will become increasingly contentious in the years to come.

So I see a whole many of changes in China occurring which I think are very helpful to the U.S.-China relations. In a sense, they share common vision of what should be done, and both sides will benefit.

I also see pressure points that the new leadership will be taking which will actually exacerbate some tensions. So I think this is a process that will have to be managed very carefully.

COMMISSIONER BROOKES: And what would they be just quickly since you have kind of opened the door to that issue?

DR. HUANG: I think trade tensions will certainly continue, but I personally feel it's not a big issue. It's not a big issue because, as Martin Feldstein wrote, probably in three or four or five years, China's trade surplus will be zero, and by that time, the U.S. trade deficit will be still

significant. And then it will become a very difficult issue to talk about.

But a trade adjustment process is going on. Price inflation and other changes will also cause China's real exchange rate to appreciate. So that's going on. Technology transfer is another major concern for the United States because that's the U.S.'s advantage, and the U.S. looks at technology transfers very much through the prism of the rule of law and WTO guidelines.

I think an important point to recognize is if you look at the composition of the State Council, it's seven engineers and one economist, and under Jiang Zemin it was eight engineers and nobody else.

So what you have is a very unusual power structure. It's a technocratic authoritarian regime, dealing with the U.S. power structure, which is largely based upon social scientists and lawyers. So it's not at all unusual, in my view, that one side looks at the rule of the law as the key issue, and the other side looks at construction or production as the savior for the world.

If you think about it that way, one of the key issues for the United States is, that is facing a power structure, which is made up of engineers who see every solution as an engineering solution and a production solution. How do I make the debate or a dialogue resonate in that kind of a mind-set? And I think that for me is a tactical question.

It wasn't so important frankly 15 years ago, whereas, I think the U.S. was so powerful and its economic might so strong that one could more or less proceed on the basis of what was wanted. Today is a different world. And these things are becoming very important.

COMMISSIONER BROOKES: Dr. Dunaway, back to my original question in terms of addressing this. Also, Dr. Huang, you didn't address whether you thought the current leadership would deal with this at all or they're just going to muddle through until the next round comes in? But go ahead, please.

DR. DUNAWAY: Well, I think that sums up the situation pretty well. The current leadership will muddle through. Any significant changes in policy, I think, will come in response to external pressures. Or I think the next couple of years, there's probably less likelihood there's going to be substantial domestic pressure so it's mainly the external pressure that would drive economic policy in China.

The vacuum, as I said, in policy is because right now no one wants to stick their neck out. Everyone is jockeying for position in the new government. When the new government comes in, in 2013, at that time, too, I wouldn't expect dramatic changes in policy because the new leaders will want to establish themselves. So you're looking at maybe a three-year period with minimal policy change.

DR. HUANG: Let me just respond to your point again.

COMMISSIONER BROOKES: Yes.

DR. HUANG: Every leadership that comes into power, in China they more or less have a sense of saying we need to be practical, we need to deal with the issues which are important but doable in our time. So this leadership has more or less addressed what they want to address. As Dr.

Dunaway has indicated, you're not going to see much changes.

But the new leadership when they come in are going to say to themselves, in my ten-year horizon, there's going to be two or three major issues which I want to address, and I'm not going to tackle everything. That's one of the reasons why China is relatively successful. They're actually quite focused.

To give you an example, in Jiang Zemin's time, they more or less said my priority is reform the state enterprises to make them really competitive, but I will not tackle the financial sector. This administration, that's their obligation, and they've been addressing financial sector.

And similarly, when the new team comes into place, they will also be establishing what I call "a few selected priorities," which they will see as their obligation, and leave the next generation another set.

COMMISSIONER BROOKES: Thank you, both.

HEARING CO-CHAIR CLEVELAND: Commissioner Blumenthal.

COMMISSIONER BLUMENTHAL: Thank you both for your very interesting testimony.

I don't know what state capitalism is. I'll come back to that, but what has been described to me here definitely is a state, but it's not capitalism, as I understand it. I mean we've described lack of rule of law, the inability of Chinese savers or consumers to freely invest or even take their money out of China. Property rights aren't enforced.

The Party, as Dr. Dunaway described, is heavily involved in the commanding heights of the economy. Reading here a survey of Chinese entrepreneurs who cite 93 percent of Chinese entrepreneurs cite connections with the government to be the critical factor in their business success. So what is capitalist? I mean, you know, we puzzle about why China hasn't become democratic, because modernization theory tells us that it's supposed to be capitalist first and then democratic, but it seems like it hasn't become capitalist.

So if somebody could explain to me what state capitalism is, and what about China is capitalist?

DR. DUNAWAY: Well, I think Dr. Huang put it well when he said that I guess the capitalist part has been the ability, at least domestically, to establish a market in a lot of areas and encourage competition because otherwise you wouldn't have seen the development of the economy, you wouldn't have seen the development of the export sector.

In part, that reflects one of the major changes that was made back in 1994-95, which set the stage for the rapid growth over the last 15 years, and that's when China shifted from its previous policy and allowed 100 percent foreign-owned firms into the country and encouraged them to locate in the export sector.

So that did a lot to kick it off. One of the other reforms that they put in place in that time was cleaning up the state-owned enterprises. They cleaned up their balance sheets; they took away their social responsibilities for providing their workers with housing, health care, and medical--health care and education. And that also then freed up and encouraged a burst of what we'd refer to as capitalism.

COMMISSIONER BLUMENTHAL: Let me ask you this question. So if you're--just because time is running out, and I don't mean to be rude--if you're a Chinese business owner or a Chinese consumer or a saver, you're not protected in your property. You don't have many places to put your money, and you can't take it out.

Your contracts aren't necessarily enforced. The Party is, you have to have Party connections essentially to get into much of the economy. If they, in fact, changed in the ways that you described because the model isn't sustainable, it would be a completely different China.

So this goes to the point, I think, that Dr. Huang made, which says if we just explain to them what their interests are, which is to change in the way that Dr. Dunaway described, the Party would probably, I mean over time the Party would disappear.

So I think they probably know their interests very well, which is not to change in the way that Dr. Dunaway described. That's my comment if you want to respond to that, either one of you?

DR. DUNAWAY: I think they recognize that they need to change, and that is, as I said, by quoting the Premier. It's a realization that the current model is just not going to continue to work, and that they do need to change, and for a lot of the reasons that Dr. Huang pointed out as well, in terms of dealing with, in particular, the inequity in opportunity between the coastal and the rural areas.

So they will eventually move in that direction and in the fashion that they have in the past in terms of doing it on a trial basis in small steps. I think, unfortunately, though, the economy has reached a size and a level of complexity that it's no longer able, for them to be able to do it in small steps and to be able to continue rapid development.

Now, back to your original question, whether that's state capitalism or something else, I don't really know how to characterize it. I know how to describe it. I know how it functions and how it works, and I know the limitations and how it needs to change.

COMMISSIONER BLUMENTHAL: Why do we always feel the need to use, after the modifier, to use the word "capitalism"? I mean can we really describe it as capitalist in any way that any of us can understand and describe?

DR. HUANG: I agree with Dr. Dunaway, that we don't have an appropriate term. If you look at the structure of the Chinese economy, broken down by ownership, and you go back 20 years, and you basically see everything is state run.

When you look at it, measured by employment levels or revenues, maybe half or more of it is what I would call really private. There's no state involvement in any form. These are small enterprises and businesses.

You go to Beijing, every year, you'll see new enterprises coming up and new enterprises collapsing, just like you see in the United States, with no government involvement at all.

Then you have a very significant category, which is what I would call mixed, some kind of a partnership between local and private. I don't know how to label it, but it's got joint shareholding, mixed influences.

Then you have a portion which is purely state, the strategic industries. Now, what is very clear to me is that of the strategic industries or the totally state-owned, you will see a modest trend, not sure how rapid, of the government getting out of some of the activities. I'm not sure how they deal with this, but the role of the private is getting bigger.

The other point I would like to make in closing, this political leadership has benefited from the reforms of the previous in terms of firms becoming very efficient. The reason why China's investment rate is so extraordinarily high is because corporate profits have boomed in the last seven/eight years, and, secondly, unlike the U.S. or other economies, state enterprises don't pay dividends or any significant dividends.

So instead of the state getting 30 percent of their profits or retained earnings, they might get two or three. Therefore, they're flush with funds.

Now, what does this mean? It means there's excess investment in the state. There's excess domination of state firms in various activities, probably which they should not be involved in.

But this wasn't an issue ten years ago; they didn't make any money. Now, they do. So what is the next step of this? The next step of it is the government needs to tax this away and push it into consumption and socially desirable activities. They need to privatize some of this because the system is now generating excessive and monopoly profits in some form.

I don't know how to describe this in terms of state capitalism or not, but this is a system which is generating profits. It's becoming involved in different kinds of activities. It needs to make the state's involvement more rational.

COMMISSIONER BLUMENTHAL: Thank you for your efforts. That was an ask and tell question.

HEARING CO-CHAIR CLEVELAND: Commissioner Slane.

VICE CHAIRMAN SLANE: Again, thanks for taking time to come and give us this great testimony.

The Chinese government acknowledges that their export-driven economy is unsustainable, and that they need to switch over to a domestic consumption. Listening to both of you, it doesn't sound very encouraging. Do you see that shift occurring?

DR. DUNAWAY: Very slowly. And on a very marginal basis for the political reasons that I referred to, and particularly because of how it potentially affects the Party's position in the economy. In addition, the problem, and through my career at the IMF, particularly working in East Asia, one of the problems that we had, because China is not the first country to follow this model. You know, Japan followed it, Korea followed it, Taiwan. Southeast Asian countries all followed the same model.

And the model works very well to get started, but at some point, particularly as the economy becomes very large, and China now is the largest exporter in the world, the model breaks down.

So the chore that we had when I was at the IMF was to try to convince countries that they had reached that point where the model was not going to continue to generate the returns that it had in the past, but the problem always is a belief that the status quo will continue indefinitely.

And so that's the hardest hurdle to get over in convincing the Chinese, in particular, that they need to more rapidly move towards restructuring the economy.

DR. HUANG: As Dr. Dunaway said, China shares some of the features of an export/investment-led driven strategy of many other East Asian countries--Japans and Koreas of the world.

But those countries changed over time, and they never reached what I call the extremes that China has achieved today. Now what is exactly the one factor that is different between China and those countries, which are also very successful? And I would go back to this issue of the hukou.

If your population is stuck in the rural areas, you don't become part of the middle class. If you're not part of the middle class, you don't demand services. If you don't demand services, then only driver of growth in China is exports.

Now, if China was urbanized to the extent I would think it would be if you didn't control it, the service sector would be much larger, consumption would be much greater. China would find it could grow without having to support exports so some of these problems that you just mentioned would, in my view, naturally go away rather than having to be a center of contention.

VICE CHAIRMAN SLANE: Interesting and thank you.

CHAIRMAN REINSCH: Commissioner D'Amato.

COMMISSIONER D'AMATO: Thank you, Madam Chairman, and thank you very much for coming and for your excellent testimony.

Dr. Dunaway, in your statement, your written statement, you said the government needs to continue improving critical social services, especially education, health care and pensions, in the context of this shift in the model that we're describing.

But how likely is it that they're going to be able to afford to do these things, given their cautious nature, the slow economic recovery rate of the United States and Western European countries here in the next couple of years, and the slow shift to a new model. What are the implications, do you think, of giving short shrift to the social safety net under these circumstances?

DR. DUNAWAY: Well, over the past couple of years, they've poured more money into health care and education, in particular, but they've only kind of scratched the surface, and the reason it's so critical going forward is because a major motivation for household savings in China is to be able to provide for these basic services, and that's less efficient if individual households are saving for that function than having the government there to provide the services.

So the expectation would be that if the government could provide the services, then savings would come down, consumption would rise. But particularly in health care and education, it's kind of a long process, and thus far China doesn't really have a comprehensive plan in place because you not only need to have the funding to provide the services, but you also need some type of training programs to provide the people who are going to perform the service, and this is particularly true in health care.

On the health care side, one key question that the Chinese still have not answered is what type of health care system do they want? Whether they want a publicly-paid but privately-provided, or a publicly-provided system? And until they make that basic decision, they really can't proceed.

On pensions, it's one area where they could move much quicker. They've gotten bogged down in trying to reform the current pension system, which is a carryover from the old state enterprises, and it only covers a very small portion of the population, but they could move forward much more rapidly if they effectively put in place a new pension system.

And they could follow the model of U.S. Social Security system when it was implemented in the 1930s, where the new system would be established with a view that in 20 years time, it would begin paying out as people retired.

So the Chinese could move now to set up this new system, which would then help them to provide pension payments, particularly in the period beginning the middle of the next decade when the dependency ratio in China rises dramatically because of the one-child policy.

COMMISSIONER D'AMATO: Thank you.

Dr. Huang?

DR. HUANG: Let me just make two observations about why their budget or fiscal system has not been able to provide what I call more balanced social services, and that is China's tax structure is somewhat unusual. The bulk of revenues and expenditures are being collected at the local level and spent at the local level.

That means richer provinces have more money; they spend more money. Not as much is being collected at the central level which would allow you to redistribute, and this is a big issue.

If you look at the fiscal systems of all the East Asian developing countries, you'll see that China is actually probably next to the last in the system being able to redistribute in favor of poor areas, and this is obviously a problem.

The second issue is that the cost structure of social services differs enormously. If you live in the interior regions of the western areas of China, and you ask how much does it cost to provide health services or education services, you'll see that it costs three to four times as much per student or per person because they're isolated and there are transport difficulties.

The budgets tend to allocate the same amount per person or whatever, and when you do that, these remote areas are severely disadvantaged so there's a big problem, and they're making some progress in this area, but they also claim they don't have the revenues and resources, and that's why I go back to this dividend issue.

If you tax state corporations in China the same as the United States, you can more or less provide levels of social services in China where the quality of it is the same whether you live in Shanghai or in Chongqing. And right now it differs enormously.

COMMISSIONER D'AMATO: Thank you.

HEARING CO-CHAIR CLEVELAND: Mr. Reinsch.

CHAIRMAN REINSCH: Going back to something that Dr. Dunaway said,

and a line that I think Commissioner Blumenthal opened, it seems to me that a lot of the discussion about the economy ends up being about control, and whether or not the Party is willing to cede enough control to allow the things that you're saying need to be done to actually happen.

The previous panel made the same point with respect to some other non-economic issues, and that gets to the question that was one of the premises of the hearing to begin with, which is where are the inherent contradictions in the system, if you will, that make it impossible for them to do the things they need to do. I think Dr. Huang said and other panelists/other witnesses here over time have said that everybody knows what needs to happen in their economy. Actually doing it has turned out to be extraordinarily difficult for a lot of reasons, and both of you have outlined a number of them.

I wonder if you could comment whether one of the underlying factors here from the standpoint of the Party and the people that actually have to make these decisions, is one of control, that doing the things that have to be done in order to produce a consumption-led growth model and get away from an export-led growth model or to develop more capitalism, for lack of a better term, would necessitate the Party effectively ceding the degree of control it now has, and they're simply unwilling to do that?

DR. DUNAWAY: I guess I would look at it as not so much a question of political control but economic control, and that what's entailed in the types of policy changes and reforms that I think that China needs, is things that affect the economic interests of the Party, and so that's the big debate and the big question, is whether or not the Party is willing to give up some share of those economic interests?

As I referred to the situation in the financial sector and the banking sector, that the state-owned banks make a lot of money and that feeds into one faction, effectively feeds into one faction within the Party. Now is that faction within the Party, in the interest of improving the efficiency of the financial system, which would help to boost and maintain growth, growth in China, are they willing to give up some of their economic interests? That question, I can't answer.

Up till now there's been a lot of resistance, and I think that resistance will continue.

CHAIRMAN REINSCH: Dr. Huang.

DR. HUANG: I agree with Dr. Dunaway, that I would tend to look at this issue as economic control rather than political control. When I look at economic control, I would say there's basically control of two very valuable assets in China. One is land. You have 1.3 billion people and limited land, whether it's urban or rural. That's becoming extraordinarily valuable.

A lot of the control is who decides who gets it at what price, and all the tensions that arise from that process.

The other is what I would call the "right to operate in the system," to perform economic activities, which is very much state managed in many ways, and it leads to a lot of what I call "monopoly returns." And the government there needs to ask itself the question do I need to be involved in all these things or can I, in fact, slowly let that go to the private sector?

And I think that needs to be done in the coming years.

I think the third point to highlight in terms of political control, and probably it was a focus of previous discussions, there is the issue in China that people feel that the control in terms of security of their lives, their ability to express concern, is becoming, in the minds of many people, tighter over the last decade, and the issue in many people's minds is that with a very strong economy, China should be more self-confident; why is it that people are becoming less confident?

I think the answer is very simple. When you have a dynamic economy and all these forces are unleashed, people's expectations are getting stronger. Their ability to express is getting stronger. In that situation, the irony is that it creates its own pressures of expressions of the kind that forces the system to react.

I think the answer is they've been reacting in many ways very conservatively, and the issue for the new leadership in this particular point is how can they handle this better, and I think they understand this because they've been putting out policy messages in the press on this topic.

CHAIRMAN REINSCH: Well, I liked your earlier answer to the same question better where you said it was a manifestation of their insecurity. You don't think that's an element.

DR. HUANG: You know the thing about insecurity is it doesn't necessarily go with the weak or the strong.

[Laughter.]

CHAIRMAN REINSCH: My time is up.

[Laughter.]

CHAIRMAN REINSCH: I'll save that one for the roundtable.

HEARING CO-CHAIR CLEVELAND: We'll have a second round, but I have one question for both of you.

What would China look like if, well, first of all, why is eight percent the magic number for growth, and what would China look like if it was six percent growth, which is pretty respectable?

DR. DUNAWAY: Well, eight percent is the magic number because that's the rate of growth that's viewed as needed to generate sufficient employment to take in new entrants to the labor force plus take in some of the people from the rural areas. Now--

HEARING CO-CHAIR CLEVELAND: Can you elaborate on that because I really am interested in what's the content behind it?

DR. DUNAWAY: Well, the content behind it is you look at Chinese growth over the past 15 years, growth of real GDP has averaged better than ten percent. At the same time, employment growth, and again the numbers on employment are kind of shaky, but at least it gives you, looking at it over time it gives you some indicator, employment growth has been one to two percent.

Now, you put that in contrast to advanced countries, advanced countries over the same period grew two to three percent in GDP but managed to generate the same amount, same amount of employment growth, one to two percent.

The reason for the sharp difference and why China needs so much

growth to generate what looks like a relatively low level of employment is because production in China is extremely capital intensive, and it's capital intensive for two reasons.

We think of China as being full of cheap labor, but it turns out capital is even cheaper. And capital is cheap because of the cap on deposit interest rates, which holds interest rates down. You also have, as Dr. Huang talked about, no dividend policy and taxation of dividends. So that gives state-owned firms a large pool of funding for capital, which is the opportunity costs for which, again, given that low, low deposit rate, is very low.

At the same time, you've got the inefficiency in the banking system, which tends to funnel a lot of the savings of the Chinese population into the large state-owned enterprises, which happen to be in very capital-intensive industries.

So you get this very strange composition for growth. So, naturally, yes, you could grow, and China could easily grow at a much lower rate and generate a larger amount of employment, and that would be a perfectly acceptable situation, and that's one that they could evolve to if they put in place needed reforms in the economy, addressing, in particular, the problem with the cost of capital, which then raises the issue of the exchange rate because you can't raise interest rates without increasing the flexibility of the exchange rate.

DR. HUANG: Let me begin by asking you a trick question.

HEARING CO-CHAIR CLEVELAND: No, no, no.

[Laughter.]

DR. HUANG: If you look at the United States and China and ask which country did manufacturing employment increase last year, and the answer is U.S., not China. So actually employment in manufacturing is declining in China; it's increasing in the United States, contrary to the issue about job loss and trade.

Part of the issue in China is fictitious actually. That loss of jobs in China is not real, as basically people are leaving the formal sector and going into the informal for a variety of reasons. I think that's, to me, a very interesting trend.

But it brings me back to the question, ten years ago, you had to grow ten percent for what Dr. Dunaway said, to generate jobs because you had the legacy of all these state enterprises which were downsizing. You don't have that anymore.

So eight percent is perfectly adequate, and you're asking why not six because many other countries growing at six do really well? And I think the answer is they have not fully recognized that service sector jobs and what it associated with is really good and worthwhile. Remember, I said that these are whole groups of engineers. So manufacturing and production is their goal, not a service economy.

Now if they understood or recognized that the service sector jobs are, in fact, the future of China, there would be all kinds of changes in capital costs, and other changes including recognizing that people relocating for service-sector jobs is fine, not to just keep on producing exports along the coast, and if so then you don't have to grow at even eight percent in the

future. You could actually go to six or seven. So you're talking about a process if changing the mind-set.

HEARING CO-CHAIR CLEVELAND: Okay. Thank you.

Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Madam Chairman. I want to salute you and Bill for putting together this terrific hearing.

Dr. Huang, you talk about the priorities. You said they get very focused when a new regime comes in. They set a small number of priorities and really focus on getting them done. And I'm wondering, the new Five Year Plan, I understand is coming out in March of this year. Would that five-year plan reflect the priorities of the guys that are going to come into power next year? Where would I look for those priorities if I was looking for them? Could I look in the Five Year Plan?

DR. HUANG: The Five Year Plan is a very good summary of what I would call the overall aspirations and objectives of the country, but if you look at the 12th Five-Year Plan, which is coming out, compared with the previous, there isn't actually much difference in terms of many of these objectives.

They're actually in many ways not different from the things that you've been espousing: they talk about balanced growth; environmental sustainability; reducing inequality; giving people more opportunities; increasing the wages; providing more social services.

That's basically a statement of what they want to see themselves ten years, 15 years, 20 years; it has not changed.

There will be a few things in the plan which are a little bit different. For example, the classification of strategic, of six or seven strategic industries and technology leap. They've had technology leap in innovation in past plans also, but it's a little bit clearer and more specific now than it was before.

Likewise, the issues of inequality and some of these things we've been discussing, they're going to wrestle with this and do something else on these aspects.

You take the one-child policy, officially it's still the policy in China, and they have reviewed it, and they said they won't change it. And again the reason they won't change it it's still the last days of this. I'm very confident, frankly, that in the new regime, that will be one of the things that will go because they realize that it must go. They have a lot of problems coming if they don't change that policy.

So what I do see is broad agenda roughly the same, but there will be a few new areas where they will actually say to themselves we've got to solve this in our tenure.

COMMISSIONER MULLOY: Okay. That's very helpful.

I want to come back to Dr. Dunaway. When we last chatted, we were talking about is this banking system really a commercial one? And I think the idea is no, because they make a lot of loans that are forgiven, and they get reimbursed by the state, which I think is a subsidy to the state enterprises, and the WTO is supposed to be a free market system so we've got, in other words, we've got a problem here.

And then the point that they're not a low labor economy; they're very capital intensive. My own view is that, and I've read a book about this, they're looking at themselves in some kind of technological super-state. I mean that's where they want to head, I think. I think we'll look at that Five Year Plan with a lot of interest.

So if you wanted, if that's where your goal was, you'd continue doing what you're doing; wouldn't you?

DR. DUNAWAY: I can't disagree with that. I think part of the problem is they learned some wrong lessons out of the recent economic and financial crisis where they took away from the crisis that because they didn't have similar problems, that a very large state presence in the system was a better way to manage the economy.

Well, in the financial sector, they're basically ignoring their own history, where the banks have been bailed out consistently, and I think they run the risk that some time in the next three to five years, they're going to have to recapitalize the banks again because the rapid credit growth over the past two years, which is continuing this year.

There were already suggestions that there may be a lot of nonperforming loans being disguised by a process of evergreening them, just lending more to make sure that the loans stayed current.

So I think that the profitability and the strength of the Chinese banking system is built on this guaranteed spread between deposit and lending rates, and so the system as a whole I do not think is as strong as they would lead you to believe.

COMMISSIONER MULLOY: Thank you.

We used to operate our S&L industry that way.

DR. DUNAWAY: Exactly. Exactly, and they've, in essence, doing the same thing.

HEARING CO-CHAIR CLEVELAND: Commissioner Fiedler.

COMMISSIONER FIEDLER: So numbers are always a problem.

[Laughter.]

COMMISSIONER FIEDLER: So your manufacturing comment struck me as, well, yes, we probably had a lot of growth because we had five million jobs destroyed in the last decade so that anything on top of that would be growth.

Chinese numbers, they essentially came out of a cave. It was in my lifetime and yours that they were melting pots and pans and pretending it was manufacturing steel. So to think that when you begin economic activity, where you had nothing but subsistence activity, that a number of ten percent growth would be--as compared to what--an economy in the United States that has been in existence in a mature state for hundreds of years?

I want to enter into meaningful discussions about these things. Now, the percentage growth numbers may be important in terms of instability or in job creation, but can we please stop talking about this rapid growth which is not surprising to anybody who is still living.

And, by the way, they have a problem of maturity, just as Wal-Mart has a problem of maturity. It was a rapid growth company, and then it was everywhere, and then it's no longer a rapid growth.

So when you have the massive economic activity that they have, now you're a mature economy. It's unimportant to me that it's second, third, fourth, fifth, sixth. It is a maturing economy where expectations should be, even on their part, that percentage growth will be less.

So I keep coming back to the instability questions that this raises and the lack of political reform. I will take issue also with you characterizing stuff as an economic control. These are essentially political decisions whether or not to permit that economic activity.

It's not an economic decision; it's a political decision. Am I wrong about that?

HEARING CO-CHAIR CLEVELAND: Yes. Were you looking for an answer?

COMMISSIONER FIEDLER: Yes, I'm looking for an answer from somebody. I mean there is, it is a political process; it's not purely an economic process.

DR. HUANG: Let me make one quick observation. It's, let me just say that trying to figure out what's going on in China is very confusing, even for someone like me who lived there for eight years and who traveled throughout every single city in the country.

On one hand, you have this vision of a very centrally dominated control. You go out to the provinces, and you get a sense, they will say I don't know what's going on in Beijing, nor do I care. And my industries or activities or what's going on is going on oblivious to what the mandates are coming out of Beijing. You have that; that is also a reality in China.

In that sense, I say economic whatever opportunities or lack of is driving a lot of change in China oblivious to what's happening out of Beijing.

Then you had these kinds of, very major kinds of policies or principles, which have come out of Beijing which can influence or shape or prevent something from happening. So you have both of these factors at work at the same time.

So that's my comment about this political/economic, and those are driven, to a large extent, as you mentioned, by some political ideas or theories, which may conflict, what I call a fairly laissez-faire activity at the local levels.

I would like to just comment a little bit about maturity. A mature economy cannot grow at ten percent a year; it's just not possible. Okay. But let's go back. In terms of nominal GDP, China's GDP is one-tenth that of the United States. It's still relatively poor.

It is in a stage of growth, the so-called rapid growth, heavy industrialization stage which South Korea, Japan, other countries went through. So it is entirely conceivable that with accurate data, they could grow eight percent or nine percent for, let me say, another ten years.

I don't think technically or mathematically they could grow by ten percent beyond that. It would have to gravitate. And at some point time, a six percent or five percent, as Commissioner Cleveland indicated, would probably be the highest you could possibly do, and then eventually two or three. So I think you're absolutely correct: this is going to happen.

I think the issue for China today is, is this going to happen sooner or quicker? Should it happen sooner or quicker? And I think what we're saying

is that it actually should happen sooner because it has very good beneficial effects-- sustainability, balance, equity, viability, all sorts of things--rather than later. And I think that is a big issue for the Chinese leadership to reflect upon.

HEARING CO-CHAIR CLEVELAND: I think that was the point of my six percent question, which is, it's not just do we think it's a reasonable trend, but rather what do they think, and I think you addressed that nicely. Dr. Dunaway.

DR. DUNAWAY: I really don't have much to add. I agree with Dr. Huang because it's a natural process in terms of availability of resources, and over time those resources would be absorbed, and the rate of growth would come down.

It also could come down over time with changes in economic policy because you would shift away from this very heavy emphasis on investment. In the service sector, you don't have the same kind of capital requirement that you do in some of the heavy industry. You could generate much more employment growth generated in the service sector, so you could see slower growth because you get less investment, but much, much greater employment growth.

COMMISSIONER FIEDLER: See, the whole point of these hearings was that if they don't make the right decisions, will they create, they themselves create stability problems?

DR. DUNAWAY: And I think the answer both Dr. Huang and I have is that yes.

COMMISSIONER FIEDLER: I think so, too. Thank you.

HEARING CO-CHAIR CLEVELAND: I think that may be the answer of many of our witnesses.

Chairman.

CHAIRMAN REINSCH: Let me just have one last quick question, and then we're going to stop a few minutes early because we're hungry.

Dr. Huang, earlier, you commented on the number of engineers vis-a-vis the number of social scientists, which I think is a very interesting issue.

The research that I've seen suggests that the next tranche of leaders is going to be very different, and the engineers, if you will, are being retired out of their jobs, and that there is going to be a surplus of lawyers and social scientists coming in next. I don't want you to go on at length about the implications of that for the country, having more lawyers running it.

But given where you began by arguing that that made a big difference, when that change occurs, if it's going to occur, do you think it will make a big difference in their decision-making process and the decisions that they make?

DR. HUANG: I personally do because they will start looking at the realities of China and the world in a slightly different prism. And as you noted, I think the next changeover, we'll have more. I don't think it will be enormously more, but there will be more.

I would like to point out something that I think is quite important for U.S.-China issues: intellectual property rights. You go back 15, 20 years ago, and you see the cases about intellectual property rights violations in China,

and you will find that the majority of these cases are Western companies complaining about Chinese companies violating their property, intellectual property rights.

Today, what you find is 85 percent of the cases are against Chinese companies filed by other Chinese companies. That's a huge difference because the incentive regime ten or 15 years ago would be that's a Western company's problem; I don't get into this.

But if you have the majority of the cases are Chinese companies being affected by other Chinese companies, the ball game shifts. And this goes back to your point. It is shifting. At some point, China will have the same interests as the United States, is I got to protect IT rights, because Chinese companies have more to gain than to lose by not doing this thing.

CHAIRMAN REINSCH: That's a very old axiom that, you know, nobody cares about IP until they have some, and then all of a sudden it's the most important issue. In any event, thank you for your contributions. This has been very useful.

What we're going to do now, as I indicated in the beginning, is adjourn to go downstairs to Room 116 in the Dirksen Building for the Roundtable. We'll invite our witnesses, our other experts--I see that Jim Mann is here, and we're glad to have him join us--and the Commissioners to grab a sandwich quickly and take your place at the table.

Guests, you're welcome to come down as well. And we'll reconvene down there for the formal part of the Roundtable at 12:30, and with that the hearing portion is adjourned.

[Whereupon, at 12:12 p.m., the hearing was adjourned. The Commission reconvened, in Dirksen Room 116, at 12:25 p.m., for a roundtable discussion.]

A F T E R N O O N S E S S I O N

ROUNDTABLE: CHINA'S INTERNAL DILEMMAS AND IMPLICATIONS FOR THE UNITED STATES

CHAIRMAN REINSCH: Let's bring the conversation back. You have a microphone. Your little red light should be lit up. If it's not, punch the tab next to it so it lights up if you want to talk or just leave it on, one or the other.

Thanks, everybody for coming down. As I said in the beginning, this is kind of an experiment, and I don't know if it's going to work or not. We'll find out.

But this Roundtable is designed to create more of an interactive environment. Most of our witnesses have joined us. Elizabeth Economy had to return to New York to fulfill a family responsibility, which is always top priority.

We've also been joined, I'm happy to say, by Jim Mann, who is down

there at the far left, who is the Author-in-Residence at SAIS, former Beijing Bureau Chief for the Los Angeles Times, foreign affairs columnist, author of The China Fantasy: How Our Leaders Explain Away Chinese Repression.

Robin Cleveland and I thought that he would have a lot to contribute to this, and, Jim, I'm going to warn you, I'm going to actually give you the first track. I'll give you a minute to think, but we noticed you were there listening, at least to a good part of the last panel, so I think we'll begin just by asking you if you have any comments you want to open up with, and then I've got some themes I want to raise.

The format that we're going to follow is semi-informal. We're not giving everybody five minutes to ask questions. We'll stop you if you have five-minute questions. I've got some themes that we want to tease out based on things that came up in the hearing.

I'll begin by asking some questions, and I'm going to ask the questions primarily of our experts. What Commissioners will do, I hope, is break in if you have a question or if you have a thought or comment. We'll try to get a dialogue going between us and the experts or among the experts themselves.

We've tried to choose you on the assumption that you don't agree on everything, which I think was demonstrated today, and I can tell from side conversations that not all of us agree with all of you.

We should have a lively conversation. So just feel free to try to break in or raise your hand, or if it gets too unruly, we can do the old thing where you go like this with your placard, and I'll call on you.

What I will try to do is keep things pointed in a coherent direction so that we don't go off on tangents and get mired in details. What I'll also say to our guests in the audience is Jon Weston is in the back. He's got little cards for you, and he's going to be submitting--if you have questions that you want taken up, write them down, give them to Jon. He, in turn, is going to give them to Paul Magnusson, who is at the table, and Paul will digest them and meld them into uniform pointed questions, and if we have time at the end, we'll get to them, but no promises.

So with that, let's turn back to the topics of the day, and I think I will do what I said I just said I was going to do, which is call on Jim, if he wants to make any comments of his own about what he heard today. He's, among other things, an expert on this question that we've been wrestling with, which is whether political liberalization follows economic liberalization.

And you, I think, could tell from the previous panel that there are differing views on that subject. So maybe you'll want to start with that or start with whatever you want. We'll go from there.

MR. MANN: Thank you.

Let me just comment on the discussion I heard. The starting point, when you look at the question of political stability in China, the better part of wisdom is to realize that this is not a pro-China or anti-China division. It's true, for better or worse, that many of us think when we see American debates about China, we tend to divide things up, unfortunately, into teams, who's critical and who's sympathetic, and so on. Well, It doesn't work in this case because there are people who are deeply critical of the Chinese

government, who think that the regime is going to last, and people who think it won't, and that's true on the other side of the debate. My introduction to this was immediately after the, in the year or so after the Tiananmen crackdown, there was, of course, intense debate about what the United States should do.

There was debate over the Bush administration's efforts to maintain relations with Beijing, and whatever you thought about that argument, I would point out that as a reporter in those days, I would go to people who were critical of the Bush administration for trying to maintain relations with Beijing, and they would say why are we doing this because this regime is not going to last?

And then I would turn around, and I would go to people who supported the administration's policies, and who said, I don't see why the critics are so upset about this; we have other reasons to do this, short-term reasons, Cold War, so on, and the regime is not going to last, so why do they care? And as it turns out, both were wrong.

So you are asking the right questions. This is not a matter of pro or anti or teams. Many of the factors laid out in the second panel that I attended were valid and important.

The one thing I didn't hear, and it may have been in the first panel, is the question of the Chinese leadership, and the leadership, particularly since '89 and increasingly since '89, has always looked at how to maintain the lessons it can learn from instability in other countries, and among those lessons are of the concern about another Gorbachev and divisions in the Party.

One thing that we have seen, and increasingly so, I think it becomes increasingly clear, more so even than when I wrote that book three years ago, is that the Chinese leadership has been quite successful, strikingly successful, at preventing, at establishing political succession in ways that weren't clear before.

That is, it's managed the succession from Jiang Zemin to Hu Jintao, and it looks like it will manage the next succession without--there are factions, there are divisions and so on, but it's avoided the kind of succession crises that it, among others, had in the past.

And as they look, and then I'll stop, as they look at the events in the Middle East, they draw a lot of lessons, but they distinguish themselves by saying we don't have a Mubarak or a Gaddafi. We don't have an aging leader, and they have actually succeeded also in getting leaders to retire.

You all have noticed, asked and written about the influential role that Jiang Zemin still plays after stepping down from the party leadership, for example, still the party has managed to get people to retire as well so that, to me, is one factor not mentioned that contributes to my view that it's much more stable than most other authoritarian regimes.

And another, the lesson that Chinese leaders draw from Egypt, as they drew from South Korea a long time ago, is that these countries were militarily dependent on the United States, and that China is not, and when China is not particularly eager to have military-to-military ties with the United States, this is one of the factors it has in mind.

Let me hold up there.

CHAIRMAN REINSCH: Let's pursue the leadership issue for just a minute. Several of the panelists this morning--I think Dr. Huang was one and someone else--talked about what I would say in the last ten years seems to be a turn toward greater repression.

That may be the wrong word, but greater control, and we've had testimony in past hearings where people have talked about a fairly significant, I guess, left turn would be the correct phrase, in economic policy, as well, in the last ten years, a return to more state control, more subsidies, more state intervention in the economy, and, as was mentioned this morning, a return to more control of the population.

Number one, is that accurate? Is that an accurate assessment? Do all of you agree with that? And second, why do you think that's happening in the face of significant growth and a lot of success?

Anybody?

COMMISSIONER FIEDLER: These are our guests.

[Laughter.]

DR. HUANG: By the way, is this on the record?

CHAIRMAN REINSCH: Yes.

DR. HUANG: Okay.

CHAIRMAN REINSCH: Everything we do is on the record. It's the wonderful thing about the government.

[Laughter.]

DR. HUANG: It's interesting, if you look at Chinese political foreign policies or even domestic policies, a large number of people characterize China as becoming more assertive, more assertive because, partly because its economic strength has increased.

There are some others--and I actually fall in that camp--who actually feel that the problem is that China is not assertive. It's reactive. It's conservatively reactive. An event happens, and it then reacts. It chooses to react in a defensive conservative way.

The mistake they made was they had not established before these things arose what should they be responding and how should they deal with it? And then when it happens, they're caught off-guard.

My personal feeling is the Chinese should actually think a little bit more about all these tensions and issues and formulate a position as to what will happen or could happen, what should be China's policy, how will it affect others, et cetera, et cetera?

Now, in terms of the domestic issue that you indicated, why are there more protests? Well, it's natural to me. You have more tensions, more people moving around, all sorts of strains in the system. This country is growing incredibly rapidly, but its institutions have not kept up. So to me, it's not unnatural that more protests and tensions emerge.

So then the question I think which is more interesting is what is China doing in terms of institutional change in policy so that it becomes better prepared to deal with these in a more effective way? And my view is right now they have not evolved in that. They have not figured out a way to let these responses be dealt with in ways which I would say would be seen as

more responsive and less defensive and more constructive, and I think that is the challenge.

CHAIRMAN REINSCH: Others? Go ahead.

DR. WHYTE: I would just say on the point of whether the system has gotten more coercive and controlling people more, I think it's a complicated question. I would defer to my colleagues, and particularly to Scot, who's still here.

But my impression is there are certain indicators in that direction, mainly the greater likelihood of arrest of activists who step forward to defend the rights of poor people and protestors. So that's very worrisome, but I don't sense that in the lives of ordinary man-in-the-street types that there is some kind of re-imposition of thought control or whatever.

I think in those regards, due to increasing access to the Internet and cell phones and people moving around much more and so forth, I don't see that people are more under control or are more fearful about telling jokes about the leaders and so forth.

I think in those regards, you still have gradual pressure moving toward more and more people feeling free to say things, but prominent people who stick their necks out are more likely to get treated very harshly now, I think, than they were ten years ago.

MR. MANN: I guess I disagree with that.

DR. WHYTE: Okay.

MR. MANN: I think that what you need to look at is organized opposition, and I think that they've tightened up on control of any kind of organized opposition. So you can say what you want as a joke about a leader, but you can't form an organization outside of Party control. And that's less true. There is less tolerance I think of civil society than there was a few years ago.

DR. TANNER: I'm not quite sure I'd characterize it the same way. First of all, a lot of the sorts of things we're describing now have a much longer lineage than we're talking about now. I recall thinking, 13, 14 years ago, that there was a fairly clear two-sided strategy that they were moving toward in terms of social control.

And the reason I choose the word 13, 14 years ago is because it became increasingly apparent when they revised their criminal and criminal procedure codes in the late 1990s, '96, '97, that what they were trying to offer the vast majority of Chinese people, apolitical Chinese people, was a deal whereby if you continue to stay out of politics, they were going to try and offer a system that was relatively clean, had a fair amount of oversight, was legally predictable, and relatively clear.

If you chose to be either in an officially suspect religious group or politically active and dissident, then they were very deliberately making the state and its coercive system as opaque and unpredictable and potentially repressive and high-risk as they possibly could.

And the place where you could see this most clearly back then was the invention of this category of law for crimes against national security.

If you've ever, and I really don't recommend this for a pastime, but if you've ever sat down and read through any of those crimes of state security,

my God in heaven, they are the vaguest things.

COMMISSIONER FIEDLER: Yes, we had a hearing on it.

DR. TANNER: Yes, yes, yes. And it's, in other words, you've committed a crime when they decide you've committed a crime. And that's not an accident. They had plenty of good smart lawyers looking that over who could have made that a lot clearer and who have tried to battle to clarify things since then.

We had another whack at the state secrets law just recently; right. Well, I think we saw that as the strategy for a decade, but what motivated my pessimism this morning questioning whether they really are committed to political and institutional reform anymore, is the fact that I'm not even sure that apolitical people who try to make any use of this legal and institutional system can count on not having the system come back on them anymore, and I think you particularly see this in things such as the just unpardonable way that they have treated parents trying to get to the bottom of what happened in the earthquake or the milk, the poison milk incidents.

You know, throw a man in jail for trying to find out why his kid got poison milk, for God sake. And those aren't professional dissidents; right. So at that point, you have to ask yourself are they still going forward with the portion of the strategy that creates greater predictability for average apolitical citizens, and then I have serious questions whether they are.

CHAIRMAN REINSCH: Dan.

COMMISSIONER BLUMENTHAL: Yes, I want to put down a proposition and let everyone react to it, which is essentially this: let's say we're all wrong about stability in China because we've been wrong so many times, wrong about the Soviets, wrong about--

CHAIRMAN REINSCH: Speak for yourself.

COMMISSIONER BLUMENTHAL: Except for Bill, I guess, was, predicted the collapse of the Soviet Union, which I didn't know till now.

[Laughter.]

COMMISSIONER BLUMENTHAL: Suharto--I was just rereading some of the East Asia stuff in the '90s, in '98, people were writing about how stable he was. He was gone a year later.

So let's say we're all wrong. So all the indicators you look for in a successful transition to democracy, civil society, rule of law, social trust don't seem to be there in China.

So let's say we're all wrong, and I know nobody likes to--I'm in the policy analytic business too, and nobody likes to predict, but at some level of probability, what do we see coming next? And would we in the United States even know who to talk to?

Our policy of engagement right now seems to me to be so narrowly based on the existing Party and government leaders, would we even have a clue who to talk to if we're wrong, and the Party won't last even the next succession, let's say?

CHAIRMAN REINSCH: Go ahead.

HEARING CO-CHAIR CLEVELAND: When you ask who, do we know who to talk to, who should we talk to now?

COMMISSIONER BLUMENTHAL: Yes. That's part of the premise of my question, which is, you know, it seems to me that we ought to build some hedges into this policy that assumes linear course of the next 25 years.

So my questions really are what if we're all wrong and somebody--and they can't last and somebody comes next? Who are those people? Second, do we know who those people are? Third, are we talking to them? And fourth, how can we be talking to them now?

CHAIRMAN REINSCH: Okay. Who wants to handle that?

HEARING CO-CHAIR CLEVELAND: And part, having just come down the hall from the foreign operations where the majority staffer was lamenting the fact that up until a matter of weeks ago, we were still letting AID decide who in Egypt would get U.S. democracy grants? We were letting the Egyptian government make that decision for us. So in an effort to avoid that or repeat that mistake.

COMMISSIONER SHEA: May I add another concept into the question? The whole conversation so far has been about essentially the coastal regions of China. The majority of the land mass of the geography of China is inhabited by ethnic minorities or significant portion.

So what about Tibet, Xinjiang? Where would that play in?

CHAIRMAN REINSCH: Let's not load too much onto the truck. Who wants to take a crack at it? Anybody?

COMMISSIONER BLUMENTHAL: Yes, so--

CHAIRMAN REINSCH: Don't load anymore.

COMMISSIONER BLUMENTHAL: No. What if we're wrong, and they don't last, who comes next? And, again, put your cards on the table. Is it something much worse or is it a democratic transition?

The other one is would we have a clue who to talk to in the case of a crisis like this? Can we get a clue right now and actually start to reach out to some of those people?

COMMISSIONER D'AMATO: I have a subset to that.

CHAIRMAN REINSCH: Well, let them talk for a few minutes first. Scot, you want to go?

DR. TANNER: My pessimistic gut reaction to that is that they have done such an extraordinarily effective job of rooting out any sort of potential leadership in society that, first of all, I don't think this government is going away any time soon.

But assuming I'm wrong, I fear it's going to have to be somebody who is already a member of the Party who becomes changed in the course of a crisis.

CHAIRMAN REINSCH: Okay. Jim, you were going to say?

MR. MANN: Well, it's hard to separate that from what would cause this, but I would say, first, I agree with Scot that it's not going to be, I just don't think it's going to be a democratic transition. I think if something happened really quickly, it would be a military leader.

If it was against the entire Party, and, again, I don't think that's going to happen, but if you had a populist uprising against the Party, then it would be someone from within the military. I don't think it would be a democratic transition.

CHAIRMAN REINSCH: Yes.

DR. DUNAWAY: Just two points. One is the ambiguity about what will come next, the Party uses quite effectively to preserve its position. So that's part of why it's difficult, even among the Chinese.

The other is that one possibility is the dissolution of China, which is a major concern, that China could easily break up into essentially economic zones with splits between the north and the south and the west, and I would think that that would be kind of a more likely scenario in the event that Party legitimacy was totally negated.

CHAIRMAN REINSCH: Who else buys that? There is historical precedent, but the stuff I've been reading, lately at least, says that's not likely--I'm just not close enough to it--says that that's unlikely to happen.

COMMISSIONER MULLOY: Who said that?

CHAIRMAN REINSCH: Lots of people. I mean I think--

DR. DUNAWAY: You ask any Chinese, and they'll tell you that.

CHAIRMAN REINSCH: Really?

DR. DUNAWAY: Yes.

CHAIRMAN REINSCH: Okay.

DR. DUNAWAY: In particular, if you talk to young educated Chinese, and you raise the question of the Party slipping from power, and the first thing they'll tell you that, no, that would create instability and could potentially lead to the dissolution of China and that couldn't be tolerated.

MR. MANN: I think that's the Party's success in getting people to believe that.

DR. TANNER: Yes, I think there's a difference between the Party's ability to create a nightmare in the back of people's minds and what is a likely scenario, and I mean this all has a familiar ring about it. We debated this whole question of a multi-regional division of China for about four or five years after Tiananmen.

I for one never became persuaded that there were organized forces in place to bring together coherent separate parts of China.

VICE CHAIRMAN SLANE: But isn't that part of the Taiwan issue? If they let Taiwan go, then the whole thing may unravel?

DR. DUNAWAY: Well, that's an argument that they put forward a lot. Why I would suggest that there would be this possibility of breaking up along regional lines goes back to a point that Dr. Huang made during the testimony, is we have a tendency to think of China as a monolith with the government in Beijing and the leaders in Beijing, you know, putting down the dictates that everybody follows.

But as the old Chinese saying is, "the emperor is in Beijing, and Beijing is far away." So local officials do carry a lot of influence in their local regions. So you could see, and again, at the end of the day, it's going to be factions of the Communist Party that would break apart.

COMMISSIONER BLUMENTHAL: Obviously, this is one of the hardest things in human activity to predict, but we have to, it seems to me, be prepared for something that is going to happen. And I wonder, last part of my set of questions was what should we be doing now to hedge against this authoritarian resilience and that this continues forever?

DR. TANNER: I'm sorry. I didn't quite follow your question.

COMMISSIONER BLUMENTHAL: So right now the policy is basically based on--

DR. TANNER: The hedge against authoritarian resilience?

COMMISSIONER BLUMENTHAL: Well, so we're not caught completely by surprise if something--

COMMISSIONER FIEDLER: You mean if authoritarianism continues unabated?

COMMISSIONER BLUMENTHAL: No.

HEARING CO-CHAIR CLEVELAND: No.

MR. MANN: Or to prepare in the event that it doesn't continue?

HEARING CO-CHAIR CLEVELAND: Right.

COMMISSIONER BLUMENTHAL: Yes.

DR. TANNER: Oh, okay.

COMMISSIONER BLUMENTHAL: But the scenario everyone says is impossible, which is that they don't last as long as we think that they will, or in the current configuration that they're in, you know, what should we be putting into our policy that prepares for that?

CHAIRMAN REINSCH: Jeff?

COMMISSIONER FIEDLER: Let me ask just a quick question. We all say that nobody believes in Communism. They sort of don't believe in the Party in the same way that they did before although it delivers to them privileges. Therefore, isn't there a large number of people who play along with the Party for privilege, who are not necessarily strong believers in it, so that there is this whole sort of amorphous group of elites, if you will? I actually say the middle class doesn't believe in it at all and is afraid of the Party. I think he was talking about who would occupy leadership positions in a new government?

So, I believe, much to my chagrin, that that will be elites again. It will come from the group that already exists in power but is hedging right now, not to be too rapid in the change that they want to see.

COMMISSIONER BLUMENTHAL: Yes, I guess my question was, is there a way for the U.S. to prepare for a massive discontinuity in China today? Can we begin to do things to prepare for that?

MR. MANN: What's going on in the Middle East begs that question. This is the reason that we've been caught so flat-footed in the Middle East because we've not thought about--

DR. TANNER: Dan, if I can say something that's apt to be unpopular in this room? That strikes me as very strong persuasive reason to try to have at least a reasonably solid mil-mil relationship with the Chinese military.

COMMISSIONER FIEDLER: By the way, all of us want, actually, we don't disagree about strong mil-to-mil relationships.

DR. TANNER: The only thing worse than the Chinese Communist Party comes apart at the seams is the Chinese Communist Party comes apart at the seams and none of our general officers is on decent terms with any of theirs.

COMMISSIONER BLUMENTHAL: Anyone else want to--

CHAIRMAN REINSCH: Anybody else want to comment?

MR. MANN: Well, There are a range of other things we could do. What Robin Cleveland mentioned before on aid in Egypt, I don't know where things stand on this in China now, but when I was there, in theory we had a Fulbright Program to admit Chinese to the Fulbright Program in the United States. In theory, we picked, and in practice we gave the decision to the Chinese government, and that happens over and over again, and we shouldn't be doing that.

We need to find ways to break loose from the reliance on students and children in the United States, and we need to find ways to form relationships with people outside the elites. We need to find a forum, ways to do that.

COMMISSIONER BROOKES: We have ties with the elite, and we talk about mil-to-mil situations, and we've seen this in the past, and I'm a supporter of IMET and having channels to the military, but ultimately these individuals often do what's in their national interest. It may give you access, but it doesn't mean they're going to do your bidding.

So you have to remember that, and some people put this, this hope, that because general knows so-and-so and general so-and-so knows general so-and-so, that that's going to mean there's a big difference, but we have found out, going all the way back to Indonesia and other places, even on those relationships we find, ultimately, that they will do what's in their national interest or in their interest even though you may have a channel to them.

So you can't bet on that. It's about the best you have, but you can't bet on that, that they're going to do--

COMMISSIONER D'AMATO: Like Hainan Island is--try to get a-hold of--

COMMISSIONER BROOKES: We've seen this time and time again. I'm a supporter of IMET and other things, but the fact of the matter is that you can't count on that because they're going to, once again, decide what's in their interest.

CHAIRMAN REINSCH: Go ahead.

MR. MANN: I wish I had a list of--

CHAIRMAN REINSCH: Broadening the scope of--

HEARING CO-CHAIR CLEVELAND: Who would, in terms of groups that are sort of logical--I'm sure if Elizabeth was still here, she'd talk about environmental groups. She'd probably talk about building partnerships between U.S. and Chinese environmental NGOs. What are the organizations, and, particularly, Dr. Huang, in the context of the rural-urban, coastal-interior cleavages, what are the organizations that we should be looking to, not necessarily to accelerate or hasten the day when there is regime change, but who may be active at the local level, who are viable potential partners, political or economic partners?

DR. HUANG: I don't have a good answer to this question. Let me just change the issue. If someone were to ask me in the United States, who would you reach out for if it was to collapse, my answer would be you can't reach out to any specific group. This country is too diversified with too many interests and too many groups and everything else, and they're all pretty sophisticated.

So it's not going to be that simple. Now you're talking about a country with 1.3 billion with all sorts of diversified issues. Chinese are not the same as the people in Guangdong Province. People from Hunan can't even understand the people in Beijing, et cetera, et cetera.

You got all sorts of issues here. So I actually don't see it as necessarily--I mean it's one option, but I don't see it as particularly productive to find a group in a country of this size and diversity.

Now I'll add one more thing. Who do the Chinese look at in terms of evolution? And the closest they've come to is Singapore. Okay. Now what do they say to themselves? Here's a domination of one party, captures 95 percent of the seats, and still feels insecure--okay--and it's not like a Communist regime.

It's basically promising people prosperity, good life, et cetera, et cetera. I deliver, you vote me back into power, and they give support to those who vote, and change, if it occurs, occurs within the party. If they find an opposition leader they think is bright or whatever, they conscript him; they buy him into the system.

COMMISSIONER BLUMENTHAL: I don't think the Chinese look to Singapore. I think certain authoritarians within China look--

DR. HUANG: Me too. But my point, China is not--actually--I don't think--

MR. MANN: I think that's actually very well put.

COMMISSIONER BLUMENTHAL: And I also don't think that that helps in terms of our discussion here because who's the Lee Kuan Yew in this scenario?

DR. HUANG: No, no. No. My point is actually the following. The most likely scenario, of course, is that change in China will occur from within the Party. Okay. If you speak to the vast numbers of the people in places of position, at least half of them you would find to be, they don't fit the stereotype of a Communist leader. They are educated in the States; their children go to the States. They have all sorts of connections and move all around there.

They are there because you can't get to the vice minister level, whatever, unless you're a member of the Party. You can't be head of the Central Bank unless you're a member of the Party. Zhou Xiaochuan is a Party member. Is he really a Communist in the same incarnation? Not the same as someone else.

So I think what you have to basically do is that there is this level of people throughout the system who are basically saying this system is going to change. It will change because I'm thinking differently. It will change because my kids are thinking differently.

And the Party is forced to think differently. If you go out and lecture at the Communist Party School, I'm shocked by how much they want to listen to all sorts of things you wouldn't think a Communist system would want to think about because they also recognize they can't continue in the same way.

What we cannot predict is how they incorporate those ideas into the system, and who it actually affects, but the fact of the matter is they realize

that something is going to happen and a lot of their people are hearing the same things we're talking about, and it challenge is what do I do with this? What do I do with this?

COMMISSIONER FIEDLER: Can I make a comment?

DR. WHYTE: I'm a little puzzled by part of this discussion--the suggestion that we're only dealing with the status quo leaders at the top and their children coming to our colleges--I mean one of the things that's developed over the last 30 years is an extraordinary network of contacts between Americans and Chinese at all levels in all kinds of--

COMMISSIONER BLUMENTHAL: Yes, no, I--

DR. WHYTE: --and, for example the Kennedy School at Harvard has regular groups of mayors and governors and ministerial types and--

COMMISSIONER BROOKES: Military officers.

DR. WHYTE: --military types as well coming. Obviously American companies are also dealing all the time with not only officials but also with local firms all over China. There are also all kinds of educational exchanges. There's just a huge network of contacts that have been built up between Chinese and Americans.

Now this doesn't give us one person that we can look to--oh, let's hope he'll come out on top--but nonetheless I think we have a lot of contacts with influential Chinese of many types. We can't count on them to do our bidding or something like that, but I think there are a lot of people in the Chinese system at all levels who want to change things and who look to the time they've spent in America, and to people that they've dealt with in other countries to help them in this effort. , I think this context gives much more positive possibilities for the future, at least, than this idea that there's going to be this unknown vacuum.

CHAIRMAN REINSCH: Okay. Jeff. Then Robin.

COMMISSIONER FIEDLER: It's a little too much of a top down discussion.

CHAIRMAN REINSCH: Thank you.

COMMISSIONER FIEDLER: In the sense of, yes, I understand the policy need for like who's going to be the government and who are we going to deal with and therefore should we cultivate them, but this notion, and Dr. Huang, you said in answer to a question that Wen Jiabao had been talking about petitioning, this, that, and the other thing, and that was like beginning of liberalization.

But if I wanted to talk about that as a Chinese citizen in Beijing and wanted to talk about it with three or four other people, I'd be in jail for ten years. So liberalization is not quite--

So this notion that change will only be delivered from the top has been contradicted by what is happening in North Africa, and if you stop and look, change from the top is called a coup d'état, generally speaking, and elsewhere, whether it be the Philippines in the Aquino thing, whether it be in Indonesia, change came from the bottom, from ordinary people who we don't know, and change within China will come from ordinary people we don't know pushing it.

The question becomes will the elites who have governmental

experience seize on to that and occupy new positions of power? And in the end, I actually don't think that we need to know who they are, and it's dangerous to cultivate them because it puts a target on their chest and a number of other things.

I think there is plenty of people there who can handle this. Now, I don't know if you agree or disagree with that notion.

CHAIRMAN REINSCH: Robin? No.

COMMISSIONER MULLOY: I have a comment if I could?

CHAIRMAN REINSCH: Well, wait. Does anybody want to react to what Jeff has said first before we turn to Pat? I want to come back to this.

MR. MANN: Well, I generally agree with that. I mean I think we can't pick leaders. In fact, I think we should be, I mean to the extent that we focus on individuals at all, we should be focusing on anti-reformers, too.

I had a unique experience in China in the '80s where the dissidents that I was speaking to, some of the dissidents I was speaking to, were the old guard, and those were the meetings you were told don't bring your translator. That was a different time.

But we should be talking a lot to the people who don't want things to change either because it's--yes.

CHAIRMAN REINSCH: Pat.

COMMISSIONER MULLOY: Jim, I read your book some years ago, but I think you talked about the Communist Party and said it's a ruling party now, and that people will hook into it because it provides avenues to be in the elite and to be running things, and that the concentration of wealth is going to be managed by these guys?

So I keep wondering why do we think that China is going to move toward a democracy or something? I don't see it in their history, at least. I'm not a great China scholar, but I don't see a lot of democracy in their history. What, why do we think there's going to be some big revolution in China?

CHAIRMAN REINSCH: I don't think anybody is saying that.

COMMISSIONER MULLOY: Okay. Well, I thought we were talking about some big change coming. I just don't see it.

CHAIRMAN REINSCH: Well, I think they were talking about a change away from the Party, but we didn't really address the question of toward what kind of system. But, Dick, you want to--

COMMISSIONER D'AMATO: Yes. On that point, you had mentioned earlier you thought that the civil society was shrinking; but it was an interesting part to Elizabeth Economy's testimony this morning about what's going on in Shenzhen, where there is some real political reform going on, some electioneering, private money coming from overseas, a number of other political reforms that have sort of been sponsored by the mayor of that town along with the Premier, which is a contradictory kind of trend.

I wondered if you knew anything about that and what that was all about? That says that the leadership may be interested in experimenting with political reform at some levels and see how it plays out. Is that true?

HEARING CO-CHAIR CLEVELAND: Allowing it.

COMMISSIONER D'AMATO: Or allowing it. I don't know if you're

familiar with that Shenzhen experiment.

MR. MANN: I'm not very familiar with it. But I would, she also mentioned, I think, that Shenzhen is a place for experimentation.

COMMISSIONER D'AMATO: Yes.

MR. MANN: It was originally, and sometimes, sometimes they allow an experiment rather than a policy. It's a way of delaying. And people in China tend to think of Shenzhen as not, not all, not necessarily a--

CHAIRMAN REINSCH: Okay. I want to return, but, Robin, one more thing--

HEARING CO-CHAIR CLEVELAND: Well, I wanted to shift the topic back to economics.

CHAIRMAN REINSCH: Okay.

HEARING CO-CHAIR CLEVELAND: Go ahead.

CHAIRMAN REINSCH: Let's just spend one more minute, if we can. Thanks to Blumenthal, we kind of skipped to the end, which was, all right, what happens if there's a crisis, and a regime change, if you will, how do we prepare for that, what do we do about it, which is, I think a good line of inquiry.

Can we spend a couple more minutes on whether or not that is actually likely to happen and how we might get there? It seems to me, going back to what Dr. Huang and several others of you said, that the dilemma, and this is--I apologize for chronically bringing this up--but it seems to me the dilemma they face is that the only way to address the problems that you've identified is to undermine the Party's leadership or control of the government.

And that that's kind of a Catch-22 for them. They can't solve the problems that we've been talking about without damaging the system that they've created and, therefore, the people in it.

Now, in a way, that could lead you to Dan's hypothesis, if they take those steps, because they feel they have to deal with economic problems, they have to deal with urban-rural problems, they have to deal at some level with inequality problems, they have to deal with--what was the--not distributive justice--the other--

DR. WHYTE: Procedural.

CHAIRMAN REINSCH: --procedural justice. Thank you. They have to deal with those issues. As they deal with them, if they deal with them successfully, they end up making the Party less significant, and they end up, de facto, creating other centers of power, or is that wrong?

DR. TANNER: No, I think that largely is their dilemma, that they have now been trying for 15, 20 years, to try to create a more cleanly governed, efficient, somewhat accessible, and transparent system, and one of the points I was trying to make this morning is that, you know, through all of this period of time, the abuses in the system that were causing unrest ten, 12 years ago are still the same ones. They haven't had much luck with that.

And you're right, that most of the models, most of the next models that are available for dealing, for trying to give people a better voice in government, to mobilize people, to attack these abuses, are fairly liberal ones. More independence of courts, more, returning to encouraging village

elections that are relatively competitive, that sort of thing, and I think that's where they have in the last decade come up to the edge, looked over, looked down and said, you know, I don't think that's the direction we want to go. But that is the next collection of models for them if they want to go ahead with this.

CHAIRMAN REINSCH: Others? It seems to me that what that suggests is that their dilemma is if they go forward along that line, they undermine their control. If they don't do anything, they simply encourage more protests, and we end up potentially with the kind of scenario we're seeing.

DR. TANNER: Though I should add that there is, that doesn't mean that's the only thing that anybody is going to put forward. Marty, tell me if you agree with this. I mean there's always a market in China for somebody to come forward and say what we need to do is centralize power and take it away from these local clowns.

Now, I don't think that's going to be any more successful the next time around than it's been in any other time in the past. But there may be some, there may be some effort to try and put that forward.

DR. WHYTE: Well, yes, I don't want to respond specifically to that point because I don't have any special insights. I think power is already pretty centralized, but I guess I'm, as I already indicated this morning, a little more of the view that China's leaders are not simply dug in and not unwilling to change.

They're, in fact, making some dramatic domestic policy changes. I don't really understand it. I mean I don't personally have a high regard for Hu Jintao and the other top leaders, but on the other hand, there are an extraordinary number of very well-educated and very bright people, in the Party and state bureaucracy, and somebody is making some very good decisions on some fronts and making real progress.

For example, I talked earlier about the rebuilding of a health insurance safety net extending welfare back-up payments to the countryside, and other recent reforms. Now, this doesn't seem to me the sign of immobilized leadership—one that feels that we've got to the end of the line, and whatever we do further is going to undermine the system.

I think the leadership still feels that they don't have to significantly democratize or decentralize, and that by continuing their strong state-led, not only economic development, but also social policies, that they can keep control and even perhaps reverse the rising tide of protests.

I mean when you think about it, the rising tide of protests so far, they're kind of like mosquitoes compared to this great, leviathan of a political system. You know, 1989 came very close to destabilizing things, but since then--

COMMISSIONER FIEDLER: You take out the leadership of small protests early, you don't have large protests.

DR. WHYTE: Okay. But anyway, I see them as at least trying to make a number of policy reforms to improve the lives of the people and deal with some, at least of the sources of popular grievances. I don't study legal reforms--but it's not inconceivable to me that the leaders could decide--well, clearly, we've got to give people a way to initiate lawsuits safely

against local officials who are abusing them, and that would make people less angry while it would also keep our local officials under more control. So let's take that on.

I don't know if it's going to really happen. They've talked a lot about it, but as we heard this morning, it's not that much of a reality yet. People are still taking a big chance if they try to mount a lawsuit against the abuses of power of local officials, but it's not inconceivable to me that China's leaders could say that at the bottom of the system, we've got to make changes to relieve pressures and give people more ways to vent their discontent without destabilizing the system, and if we do that, we're going to be able to keep "riding the tiger," as Gordon White's book said years ago.

HEARING CO-CHAIR CLEVELAND: Dr. Huang, you said in your testimony, you pointed out three things that they could do to reform the hukou system, and I will not do it justice if I try to repeat it, but that seems to get at your point, Dr. Whyte, that there are more than marginal policy changes that they could, that the Party could put in place that would continue to buy the goodwill of the citizens, most of the citizens.

What you didn't say in those sort of three things that would reform the hukou system and address a number of these grievances is whether or not you thought that they would do what you thought was necessary? You laid out the path and left open the question of the likelihood.

DR. HUANG: On the hukou system, think about it. It's the same tensions and debate you have in the United States about immigration, which is stuck.

MR. MANN: Not really.

DR. WHYTE: But these are Chinese citizens.

DR. HUANG: Right. No, the difference is these are Chinese citizens, but these Chinese citizens don't have the right to live in Beijing or Shanghai. They don't have the right to go to the local schools. They're not given the same treatment in getting a job. They don't move their families there. Okay. To me, it's almost similar to an illegal immigrant or somebody. They can't get a Social Security number. They can't go to the local schools. They can't boom-boom-boom. They don't have the rights, boom-boom-boom. They have to take substandard jobs. They could be deported, and they are. During the Spring Festival or Olympics, they were all gathered up and they're sent back to their home provinces. It's the same as how we treat illegal workers, and that's a contentious issue.

So that's why I'm saying it may be a fairly obvious change. Even if you did proceed with this, it's not, you know, it's fraught with political tensions for the government because that means the natives in Beijing and Shanghai will start blaming the government for allowing these people to come in there, and maybe wages are going to be lower; there's more crime. They're going to say, government, you have destabilized my city.

Okay. But here's the big issue here. Urban wages are increasing at nine to ten percent a year. That's a record globally. Rural wages are actually increasing by four to five percent a year, which is also a record globally.

So the great irony is both rural and urban people in China, their

incomes are increasing historically and globally at the highest rates we've ever seen. Yet, ten percent compared to five percent leads to huge inequality.

So the real issue, as a person, even though you're getting richer and better, do you feel worse off if your neighbors or somebody else is growing at ten, four and five, and I've come to the conclusion that as an economist I used to say you shouldn't be bothered, you're getting a lot better. I've come to the conclusion that human beings are really envious of those whose chances are much worse.

CHAIRMAN REINSCH: But according to Dr. Whyte, that's wrong.

DR. HUANG: No, I understand that.

HEARING CO-CHAIR CLEVELAND: I liked your--I can't remember if it was in your--

DR. HUANG: But our surveys in the World Bank, we used to get 95 percent ratings for various things we're doing. Now, they're down to 85 percent or 80. Now, 80 percent approval rating in the U.S. would be fantastic, but not so fantastic when it was 95 percent.

And that's the question for me because if you actually told me are they going to be rioting or doing anything else, I'd say no. Are they reasonably happy? Yes. Whatever. But is the pressure or sense of disenchantment worse today than it was ten years ago when I was starting off? Definitely so.

If I look at my staff in the Beijing office, who are paid fantastic salaries compared to what they were earning before, five times what I was paying five years ago, they're unhappier now than they used to be.

COMMISSIONER FIEDLER: Money is like gas in a vacuum.

DR. HUANG: Yes. Because there's all sorts of things going on in the economy where they say I'm being excluded from; I could be doing better, boom-boom-boom. But they're better off, but nevertheless the satisfaction is lower. They're actually expressing their views publicly or in different ways that they never would have done ten years ago.

And they challenge more than we've ever had, and I say it's fine; it's good. But that's what I'm saying, to me, is even this success generates a breed of pressure, and that's to me actually good. That's the only way something will change.

DR. WHYTE: Just a couple of footnotes. One is--

CHAIRMAN REINSCH: Dr. Whyte, rebuttal.

DR. WHYTE: --according to our most recent data, the Hirschman tunnel effect is still working for people in the Chinese countryside.

CHAIRMAN REINSCH: You better explain that for us.

DR. WHYTE: The tunnel effect is if you're stuck in Somner Tunnel in Boston, the old-style tunnel, and the lane next to you starts moving, do you get angry because they're moving or do you say, hey, pretty soon I'm going to be moving?

HEARING CO-CHAIR CLEVELAND: Or do you change lanes?

DR. WHYTE: Well, assuming you can't change lanes, Albert Hirschman argues that at least for a considerable period of time, you're going to be optimistic. You're not going to be envious, and that still seems to be —the

cases in our most recent survey. The fact is many rural people do feel that they're moving ahead, and so they're not really comparing themselves with urban people so far as we can tell.

But back on the hukou system, very broadly, I think policymakers, ordinary citizens realize that it has to be changed, dismantled. So I think that is an area that they're trying to address. In fact, some of the things they claim they've addressed, but they're not being enforced.

So it's supposed to be possible for migrant kids to go to urban public schools now, but they're not letting them in, or they're still charging them, huge fees and so forth.

So I think there's a recognition that they've got to take this on, and that it harms China's economic development. The hukou system creates, social tensions and so forth. So I think that is an area where , I tend to be somewhat optimistic that changes will eventually come.

But they've been announcing since the late '90s, here's the fundamental hukou reform, this is going to get rid of these bad features. Each time they announce it, and then a few years later, the local officials have watered it down. But I would note that urban citizens in our surveys are as much or more strongly critical of the discrimination built into the hukou system as villagers and migrants.

If you ask anybody in any society, “is it fair that somebody just because they're born in a rural area, if they move into the city and they're working in the city, they can't send their kids to the local public school?”, Large majorities of citizens in any society are going to say, no, that's obviously unfair.

So there's very little support in principle from urban people for hukou system and its discrimination, but when you get to the reality of what's happening to my wages, what's happening to the cleanliness of my neighborhood and so forth, that's a different story.

DR. DUNAWAY: I wanted to make the point that there have been supposedly several reforms of the system and supposedly the large elements of it have by now supposed to have disappeared.

I think one of the big factors on why it persists is something very common here in the U.S., in terms of unfunded mandates. Because the provision of health care, education, that's the responsibility of the local governments, and the local governments, in turn, aren't getting the resources from the central government to be able to fulfill those obligations.

And on their own, they don't necessarily have the taxing authority to be able to raise substantial resources. So I think that's a big hindrance.

HEARING CO-CHAIR CLEVELAND: Speaking of unfunded mandates, that's actually where I wanted to go.

CHAIRMAN REINSCH: Well, now is your chance.

HEARING CO-CHAIR CLEVELAND: Good segue. Is stimulus policy in China? I mean is what they did with the 700--what was it, Nargiza--$752 billion package--are we going to see more of that in terms of an approach to buy goodwill, and then what are the implications in terms of local governments having to ante up to match whatever the demands are from

Beijing or the offer is from Beijing?

DR. DUNAWAY: Yes, I think you're going to see continuing stimulus, and the key reason being is I think is that in the absence of that stimulus, growth will fall short of the target because, as I explained, the key thing that keeps China growing is how well it can maintain investment in export growth, and I don't think it's going to be able to do that going forward. So that you'll see the government step in.

Now, in terms of unfunded mandate in terms of what they did with the stimulus package during the economic and financial crisis where they passed it off to--a substantial portion of it off to the local governments, well, in turn, the local governments essentially passed it on to the banking system. And so you'll see more of that continuing.

So, yes, the ones left holding the bag at the end of the day is going to be the banks, and then it's going to end up in the government budget eventually or hidden somewhere in the government if the government has to step in and restructure the banks again.

COMMISSIONER SHEA: Didn't they do something like that around 2000 where they recapitalized the four state banks and put the nonperforming loans in something called asset management companies, and then the stimulus package, part of that was $1.4 trillion directing the state banks to loan funds, with the expectation in many cases that those loans will not be paid back.

So when you talk about hiding it or hiding it inside the system, it seems to me that this is, hiding these loans, these nonperforming loans, in the system and refinancing them and just putting them off to another day, how long can that be sustained?

DR. DUNAWAY: Well, it can be sustained for quite awhile. In terms of--

COMMISSIONER SHEA: Foreign exchange.

DR. DUNAWAY: In terms of recapitalization--well, it doesn't matter about foreign exchange. As long as they have the ability to print money, they can take care of it.

The original '98 recapitalization of the banks, and then the subsequent recapitalization again, and commercialization of the banks in 2003, all of the financing for that has been kept off the government's budget.

In '98, in the '98 restructuring, the AMCs stepped in, took all of the bad loans off the books at face value and issued to the banks bonds. Now, the AMCs managed to collect about 20 percent of the face value of the loans, which was barely enough to do the servicing on the bonds, and the bonds had a ten-year maturity.

Okay, in 2008, they supposedly matured, and the AMCs were supposed to go out of business. Well, they didn't. They extended them. They extended the payment of the bonds, and they made some quasi-public guarantee about the repayments of the principal.

On the restructuring of the banks in 2004, a lot of that was done with central bank money, where the central bank just basically gave big loans to the banks, and in some cases loans to the AMCs to buy nonperforming loans off the books of the banks.

And, again, all that debt is sitting out there, and the AMCs don't have the money to pay it back. So at some point someone is going to have to recognize the debt, and the proper thing to do would be to take the debt onto the books of the central government.

COMMISSIONER SHEA: Write it off.

DR. DUNAWAY: Well, not write it off. They're just going to have to pay it off. And that payoff in large part would probably come from, in essence, from printing money.

CHAIRMAN REINSCH: Okay. Dr. Huang.

DR. HUANG: Yes. I wanted to step back a bit and summarize my own feelings about some of these policies. By many standards, I personally feel that China's economic policy has been extraordinary, extraordinarily successful.

And the aspect of why I think it's successful is that they've been able to adjust it to fit changed circumstances. Now, that doesn't mean I don't see vulnerabilities. We've talked a lot about the vulnerabilities that are shaping up, and I personally am saying to myself they now need to do the next step of adjustment, and if they don't, they're going to have some problems.

That's why I personally think issues like hukou, one-child policy, mobility, tax reform, these are going to be things that you'll see in the next administration, and that's why I'm a little less critical of what's happened in the past because I say to myself take the stimulus program. This is a country whose revenue to GDP ratio is around 24 percent.

Yet, you had this extraordinarily powerful, socialized state-led economy where the revenue to GDP ratio is extraordinarily low. Most economies of this form would have a revenue-GDP ratio of 45, 40 percent, not 24. So what do you do?

You push out the money to the banks, and you know it's not going to be paid back because it's really a budgetary expenditure, not a banking expenditure. And then you recapitalize, and then you say, well, that's not bad. I say it's bad eventually but not necessarily right now.

It's an extraordinary way of getting the economy to fund your expenditures now when you have a very weak tax system. It's a terrible way of approaching it if you had a sound fiscal system, which they don't have, so they've got to strengthen the fiscal system, and if you ask me, I know they're going to do this, and then they won't have to do this.

So the critical question in China is will they do the things that they need for the next ten years? What I was saying earlier, there's two or three major things that this leadership needs to deal with that this current leadership didn't deal with and said specifically I would not, and I think this is something we have to bear in mind.

DR. DUNAWAY: Let me add one thing. If you look at it in terms of, the total stock of debt in China, if you would take onto the books of the government all of this previous restructuring, and even allowing for further restructuring of the banks, compared to the potential assets of the government, it's very small.

Because the government owns--what--60 to 70 percent of the major

corporations, and so the market value of those firms is quite high, and would be more than enough to offset it. So it's not a question of creating a big fiscal problem in China right now or over the medium term.

MR. MANN: Well, to tie it into stability again, the question was asked this morning, what happens if the growth rate goes down below eight percent. So--

HEARING CO-CHAIR CLEVELAND: I said if it--

MR. MANN: What's magic about the eight percent? So suppose it does go down to three or four percent? The economic tensions that exist now, I mean we see on currency, the economic tensions between the export sector and other sectors that get played out on currency policy, well, those tensions become a lot more acute.

What happens to rural-urban? Right now the divisions look not that great and extremely manageable. If the growth rate goes down by quite a bit, that's going to affect urban residents' attitudes towards hukou, towards people from the rural areas in the schools. So that is a source of tension.

Then on the other side of the equation, I think they're doing what they need to maintain general stability, and so Bill's point is right, the dilemmas undermine their control, in a general sense, but in the specific sense of the Party and underlying belief system, I think there are a lot more people in Chinese cities now who agree with the idea--it's a minority overall--but agree with the idea of a one-Party state than the overall ideology of the Party. And in that sense, they're maintaining, they are succeeding in maintaining control.

CHAIRMAN REINSCH: Well, let me ask you to pursue the last piece of that for just a minute. We were talking earlier about the Party, and I think, actually I think Fiedler made the point that--or maybe it was you--I can't remember--made the point that basically all these people joined the Party, not because they believe in the Party or its doctrine, but it's because they perceive it as the only way to get ahead.

HEARING CO-CHAIR CLEVELAND: It was Fiedler.

CHAIRMAN REINSCH: Jeff. Remember him?

HEARING CO-CHAIR CLEVELAND: I said Fiedler.

CHAIRMAN REINSCH: That was Fiedler. Okay. They see it--

DR. WHYTE: I wouldn't disagree that much.

CHAIRMAN REINSCH: Okay. Well, that suggests maybe the question is how many of those people are there? I mean it kind of implies a Party that is hollow at the core. I mean all these people belong to it because they have to, not because they believe anything.

That's not to me a prescription for an institution that's going to survive a long time. Are there lots of people in the Communist Party that actually buy into the theory of it?

HEARING CO-CHAIR CLEVELAND: Well, what is the theory?

MR. MANN: Well, if the theory is viewed as one-Party control, Leninism, or a general one-Party control, then I would say "yes." If it's beyond that, I'm not so sure.

DR. TANNER: No, I think they buy into, I agree, as does Marty, that a certain amount of the motivation for this, for Party membership, is a way to

get ahead, but you now have a lot of other ways to get ahead in China that you didn't have 30 years ago. And I also think that these folks are in on a strongly governed, hopefully, relatively efficient, and militarily strong and internationally respected China. We shouldn't understate the appeal in China of a party that can offer that.

DR. WHYTE: Let me also mention that it's always struck me the most educated Chinese wear their country on their sleeve. They worry about China all the time. So you don't just join the Party because you want to get ahead personally and have a better life, but also out of national loyalty and patriotism. If the feeling is that the Party is where it's at, and if you want to contribute to the development of the country, you better get on board--that's a very strong motivation for joining. This sort of commitment to China's growing strength and stature in the world helps sustain the Party's standing.

Now it's certainly true that whenever they mention socialism, Marxism, and so forth, most Chinese people go ooh, ooh, ooh, what is that? And, you know, there is obvious hypocrisy of claiming China is pursuing socialism with Chinese characteristics. I mean older Chinese had to study what socialism really consists of, and they certainly know today's China is very different. So I'm not convinced that a strong sense of patriotism and the idea that I can advance my own interests while also helping to build my country are not a strong enough reason.

Now, I'm not sure how many Party members will defend the Party till their last drop of blood, as Muammar Gaddafi said, but I think the Party rests on more than just personal opportunism.

DR. TANNER: And I think another aspect of what makes that appealing is one thing they've been very successful in doing for the last 20 years is defining the Party in terms of an implied enemy, and one of those enemies--in terms of an implied enemy. And that's us.

I'm continually amazed at how many of my Chinese colleagues really do seem to believe that we have these extraordinary elaborate strategies for surrounding and engulfing and undermining and dividing their country, when I come home and I read the paper, and we barely seem to be able to get anything done at home, let alone--but that does--that idea does sell.

HEARING CO-CHAIR CLEVELAND: Have the rules for joining the Party changed? Is that what you're saying? How you go about it? And what the--

DR. WHYTE: In all periods, the rules--I mean the whole nature of a Leninist party is the Party is not shaped by the social backgrounds of its members. The Party determines what kind of people they want in, and then they change. Party recruitment and composition to suit current policy goals. And so in the beginning of the reform period, they made huge changes. Those who joined during the Cultural Revolution, if they were a political activist loyal to Mao, helicopter cadres and so forth, most of them got demoted, or expelled, or at least many of them did.

And then all of a sudden, college degrees, jeez, you know. So trying to get college educated people to join became the order of the day. In the Cultural Revolution, if you were well-educated, that was a mark against you in terms of getting into the Party, but after 1978 the reverse was true.

HEARING CO-CHAIR CLEVELAND: So what's the template now?

DR. WHYTE: It's still very much--

MR. MANN: Businessmen.

DR. DUNAWAY: They were hoping several years ago to bring more business people into the Party. There was a major push.

DR. WHYTE: Right. Leading people in all spheres of society, well-educated people, the meritocracy, technocracy, whatever, but including knocking down all kinds of barriers, including particularly the ones that had barred private entrepreneurs from joining. You know, millionaires now can be Party members.

HEARING CO-CHAIR CLEVELAND: I should know this, but how do you join? Do you sign up? Somebody sponsors you?

[Laughter.]

COMMISSIONER SHEA: Two letters of recommendation.

[Laughter.]

HEARING CO-CHAIR CLEVELAND: What's the actual--

DR. TANNER: Oh, God, if Mike Oksenberg knew I can't remember this.

[Laughter.]

DR. WHYTE: I assume it's changed, but it used to be you actually were--

DR. TANNER: Sponsorship by multiple members.

DR. WHYTE: There used to be Party courses. You had to study for months. You had to have a mentor, a Party member who individually mentored you, had regular heart-to-heart talks with you, and then there had be a vote in your Party branch that was approved at the next higher level of the Party, and that only got you to be a probationary Party member, and then six months or a year later, if you had behaved all right, you would be admitted to full Party membership.

HEARING CO-CHAIR CLEVELAND: But I doubt that's happening now, which may speak to I think Bill's initial question, which is what's the ideology holding it? I can't believe businessmen are going through that kind of six-months of--

DR. WHYTE: Probably not.

HEARING CO-CHAIR CLEVELAND: --mentorship, and probationary period. So does that suggest that the process for becoming a Party member has changed so fundamentally that what we keep talking about in terms of this, this organization that is maintaining stability, there is no there there anymore in terms of the definition of--

DR. WHYTE: Well, there's a difference between a Party member and a Party cadre. Now, the Party cadre is a full-time Party official, and for those people there are Party schools, Party academies, training courses, and so forth, and then you're sent on various assignments and regularly evaluated.

You have to prove yourself. So, Party cadres are the people that really matter, so the fact that a millionaire is a Party member is more symbolic in some sense, and he may get invited to meetings and so forth, but he's not a full-time Party official.

Okay. And the full-time Party officials, there is more--they haven't invited me to join the Party so I can't really tell you from the inside, but

there's more in the way of --

MR. MANN: Structure.

DR. WHYTE: Yes, it's more like joining the U.S. military or something like that, in which there is a regular set of training and promotion routines and so forth, and common activities that are designed specifically to meld people together.

CHAIRMAN REINSCH: It just seems to me that--I'm going to get to Dennis in a second--it just seems to me that an organization whose--perhaps not overtly--but whose real goal is its own self-preservation is not a recipe for long-term success.

Dennis.

COMMISSIONER SHEA: Yes, just following the same vein about Party membership, I was wondering if our guests could talk about the princelings in China? The princelings as a source of social resentment, tension? Anybody want to talk about that?

MR. MANN: Well, it's been a source of tension and growing since the '80s, when, for the first time, Chinese kids could, first, two things happened. One, people could go out to the United States. That created a situation where Chinese leaders sent their kids to the United States, and more importantly, as China started to open up the economy, leaders' kids would go on to develop their own economic interests.

It is a source of huge resentment at two levels. At the central level, which never gets, which is untouchable in the press, there's the relatives or the kids of senior leaders going into business. That's one corruption issue.

At the local level, corruption does get covered, and actually it's a source of instability and, you know, you get the son--there was an incident last year. The son of a local--

COMMISSIONER SHEA: "My father is Li Gang."

MR. MANN: Yes, exactly.

COMMISSIONER SHEA: All right.

MR. MANN: And that does get covered, and, in fact, the local press has occasionally, over the last thirty years been encouraged to cover local corruption.

But at the national level, it's not. And changing that is at the heart of questions of political reform.

DR. WHYTE: And I believe it's the case that if he becomes the new Party head, Xi Jinping, will be the first true princeling--

MR. MANN: Yes.

DR. WHYTE: --to rise to the top. I mean, Li Peng was sort of an adopted son.

MR. MANN: Adopted by Zhou Enlai, yes.

DR. WHYTE: But Xi is an actual princeling, —but people don't seem to think that that is barring him from succeeding Hu Jintao.

DR. TANNER: Well, let me ask a quick challenge about how serious that is? In 1989, in the run-up to the protests, yes, this was an issue. I vividly remember one of the most popular wall posters at Beijing University was an enormous nepotism chart that somebody put up listing all of the top leaders here, and right over next to them was his brother-in-law holds this

position, and all this sort of thing, and people gathered around that all day and, indeed, it was a living document.

People would get out pins and say, no, wait, you forgot. His sister-in-law is the Party Secretary of such and such. That angered people because in 1989, the opportunities for getting ahead in the system and for getting into business and stuff like that were, I think, relatively limited, but the opportunities to get ahead in Chinese society right now are, I would argue, far greater than then, and I really wonder if this issue has quite the purchase in angering people that it had in the past.

I'm not saying it doesn't anger people, but should we not exaggerate its influence?

MR. MANN: I would, just to answer that, one, it's not whether I think it is. I've just been through those certain cables that no one is supposed to read, and the U.S. Embassy in Beijing seemed to think--

[Laughter.]

MR. MANN: --and the Embassy in Beijing seems to report from time to time that nepotism and corruption are a serious issue.

COMMISSIONER MULLOY: That the princelings is a serious issue?

MR. MANN: Yes.

CHAIRMAN REINSCH: Pat, you were going to raise something?

COMMISSIONER MULLOY: Yes. I want to come back to this issue of the Party. When I studied Marxism and Leninism, I think the Party was the vanguard of the proletariat.

HEARING CO-CHAIR CLEVELAND: Long time ago.

COMMISSIONER MULLOY: Yes.

[Laughter.]

COMMISSIONER MULLOY: And then Jiang Zemin, I thought what he did was he brought the three represents meaning he brought all these other folks in.

MR. MANN: Right.

COMMISSIONER MULLOY: So it ceased to be a Communist Party; it became a ruling party. That's what I saw going on.

I guess I should ask this question. Does anybody think anything in China's history is going to drive them toward a democracy or a functioning democracy or are they going to have something else, which I think, my impression--that's what I think? But I want to get the view of the experts here.

COMMISSIONER D'AMATO: Well, Taiwan.

MR. MANN: I was going to say, you know, that most of history would argue in your favor, but there are, there are examples, including Taiwan.

COMMISSIONER MULLOY: Where would you put your money though? I mean if, just on your judgment, where is this headed?

MR. MANN: None of my money is going into China one way or another. It keeps me honest.

[Laughter.]

DR. TANNER: No, I think that the pressure for that is going to be there.

COMMISSIONER MULLOY: The pressure for?

DR. TANNER: The pressure for a more democratic system is going to be there. The Party has, at least on the question of the rhetoric of democracy, has thrown in the towel. When it speaks about itself and justifies itself, it increasingly uses the language, the names of institutions and things of democratic systems.

I think that idea is very persuasive. Now, am I sitting here, yes, am I sitting here and predicting that China is going to go democratic in my lifetime, which I hope has quite a few more years yet--

COMMISSIONER MULLOY: We do too.

DR. TANNER: Thank you--no, because the institutional changes that would be involved in carrying that off in a country of that big size, that population, and that many administrative levels, are just mind-boggling, but, yes, I think the pressure is always going to be on them to at least be able to claim that they are moving in that direction.

DR. HUANG: If I could offer also some personal thoughts here. First of all, Taiwan to me is very unusual situation. I'm not quite sure whether it would have become a democracy if it didn't have this kind of 20 percent mainland/80 percent Taiwanese mix, and how you evolve into something which is acceptable to everyone?

That's quite different. It's a very unique situation. So I just want to flag that's not the case in China.

Princelings can be both positive and negative. There's a lot of respect for people who are princelings if they basically show that they're interested in the good of the people, doing political things. It gives them a lot of respect and admiration. If you're out there apparently just making money and doing various money things, it's a very negative thing. So I think it can be interpreted either way.

The third point I would make is I think there is also--this is purely personal observation--I think the concept of conflict of interest among family members is less of an issue in Asia frankly than the United States. You look at Singapore, for example, how can you have your wife being essentially secretary/treasurer, and you have a brother or father who is guarding the federal reserve system or something like that, or another person who owns, runs the franchise, and seems perfectly fine? No conflict of interest here, the fact that my wife is secretary/treasurer.

Okay.

HEARING CO-CHAIR CLEVELAND: I think there's some perception in Singapore that it's clean. I mean you've got to draw the difference between conflict of interest where there are ethical or--

DR. HUANG: It's clean. But I don't think in America, no matter whether it's clean or not, you could possibly appoint your relative to be secretary/treasurer for the president. It just wouldn't happen.

DR. WHYTE: Jack Kennedy had Bobby Kennedy as the--

DR. HUANG: No, today--

DR. WHYTE: But it did elicit a certain amount of controversy when he appointed Bobby as his attorney general.

DR. HUANG: No, I think it did. But think about, today, I don't think it actually would happen. I think people would basically say, well, maybe it's

possible, but why do I want to do that?

There is also a big difference in Singapore because it is legal, but this family's income if you total it is beyond recognition. It's legal but beyond recognition in terms of the total amount because you have multiple salaries from multiple sources, and they're all legal.

And if you have a prime minister's salary who is a 1.5 million, and you're in the cabinet, you get a million dollars salary, and the other one is a couple million dollars, pretty soon the family is breaking $20 million. It's all legal. But you would never do this in the States because the States would see this as conflict of interest.

HEARING CO-CHAIR CLEVELAND: They pay the cabinet member a million dollars?

DR. HUANG: Excuse me? I don't know. You all have greater control over this, but I don't think it would ever happen in the States. You'd never pay your--you wouldn't pay your president a million dollars. You won't pay a cabinet minister a million dollars.

I think the other point I would make is there is, I think, frankly, a streak in Asian society of respect for authoritarianism.

COMMISSIONER MULLOY: Yes. That's what I think.

DR. HUANG: I've been in the States here probably longer than most of you. I've been in Washington since 1949. Okay. I've never served on a jury of a criminal case although I get called to a panel, and the reason I know is the defense lawyer says I will never take a Chinese on the defense on this panel, on this case.

COMMISSIONER MULLOY: Because they'll convict.

DR. HUANG: Yes. No, because the Chinese are too, believe too much in the rule of authority. Okay. Now, I'm always selected for cases which have some kind of financial thing or dollar amount; they want me as an economist. But if it's a criminal case, Asians are excluded because Asians respect authoritarian regimes or authority much more than Westerners.

And I've been here for 65 years. They feel like that way. My mother has lived here since 1944 when the Falun Gong was demonstrating whatever. I asked her what's going on because for me it looked like it was overdone, and she would say to me this is not good. It destabilizes the country. They should put them down.

There's a large streak of that in China who basically feel that we've got all these tensions, we've got all these things, we need a fairly strong government. As long as my life is improving and I can feel I'm getting better, I'll live with this. I don't think that would be the case in many other countries.

MR. MANN: What happened to the South Koreans?

DR. HUANG: I don't want to get into generalizing--

[Laughter.]

CHAIRMAN REINSCH: This is a good segue to one more topic I want to cover, but do you want to comment on authoritarianism?

DR. WHYTE: I think there is both a long historical pattern in China of as Dick Solomon wrote--fear of luan, fear of chaos. I think then the Party leadership plays up that fear very big, and it also, by nipping off potential

up and coming leaders outside the Party , they try to make it seem--we're the only game in town, we're the only ones protecting you from chaos.

Now, it didn't work very well for Mubarak. You know, he said the radical Muslims are going to take over, and now he's gone—. So I think there is something to this theme of fear of chaos and desire for order, but I don't think it prevents some kind of eventual democratization. Democracies can be very strong, you know, with rule of law, orderly societies and so forth. So there's a difference between chaos and being more democratic.

HEARING CO-CHAIR CLEVELAND: I draw a distinction here. I think most Asian cultures, there's a respect for consensus and authority, hierarchy and authority, which I distinguish, I think is very distinct from authoritarianism. And so, but you both kept using, mixing those words. Which?

DR. HUANG: I would agree with you on that.

DR. WHYTE: Yes, yes.

HEARING CO-CHAIR CLEVELAND: And the question is when does authority move to authoritarianism, that then people lose, I mean it's no longer accountable and lose respect--

DR. WHYTE: I mean China also has a long tradition of respect for authority but also of willingness of people to risk their lives to challenge corrupt authority figures.

HEARING CO-CHAIR CLEVELAND: That's where you get to the--yes.

DR. WHYTE: So both things exist. Right. It doesn't mean Chinese feel they have to accept everything their leader does, right or wrong.

CHAIRMAN REINSCH: That's a good transition to a topic that I wanted to raise. It surprisingly hasn't come up very much all day although it's been implicit in a lot of comments, and that's the question of corruption, which we've looked into before, but our panelists haven't really gone into it in any detail, and I think for me it's an important question because it illustrates some of the dilemmas that the government has.

I'm not sure they can deal with the problem without undermining themselves. It goes back to the same thesis I've mounted before, but rather than ask you to comment on that, let me just--can somebody put the corruption issue into perspective, if you will, or scale for us?

Is this a mosquito on the hippopotamus or is this a, you know, a fundamental endemic problem that ultimately could destroy them or is it somewhere in between?

DR. TANNER: I have always felt that this is potentially--this is one of, if not potentially, the most serious threat that they face. They've been, the Chinese government has been relatively successful I would say in the last half-a-dozen or so years in getting the corruption issue out of the headlines as much.

And, by the way, just in an aside, we were talking about things that the United States can do in it relationship. I do think we're perfectly justified in spotlighting that problem, particularly, vis-a-vis our businesses over there.

I think that this is one of the things that could really be an issue that could be the banner that brings together a large number of people to form a

large protest.

What we have right now, as a couple people pointed out, is a lot of small-scale protests. In 1989, there were a couple of slogans that brought together all these people of different backgrounds, students, middle class folks, and whether the worry of inflation was the biggest one or corruption was the biggest one, I can't say, but the two of them were tremendously powerful.

And then you ask folks who were screaming for democracy, "Minzhu zheige cer dui ni shi shenmo yise," what does this mean--what does this word mean to you, "democracy," the answers that came back were frequently "do something about corruption," not multi-party elections or anything that, you know, I taught a generation of students to define as democracy.

It was getting rid of corruption. So I think, I personally think that that's potentially the most serious one.

DR. HUANG: May I interject here? I think corruption, when we do these surveys and indicators, I don't think, it would be hard to differentiate whether corruption is worse or better in China, India, Indonesia, Malaysia, Bangladesh. Some are democratic; some are not. Whatever.

They're actually all grouped very closely together. So I think in all those countries corruption is actually a big concern and really bothersome. So that's the case.

Now, in China if--and people are really--and a lot of the people on a daily basis are affected in ways which I think causes some very bad feelings and stresses. Is it likely to trigger them to talk about democracy or some of these democratic--my personal view is not necessarily. It generates a sense of there's something unfair. This is no longer a just society and people are not doing things which are right.

It doesn't necessarily go to the next step, I think democracy or vote or whatever it is. That's not, they don't see that as the necessary solution. Okay. So I don't know where that goes.

I mean in other societies, and I've seen this in some of our other studies, corruption gets to a certain point where people think that it is corrupting the top. They're getting the largest share, and they get 60 percent, and the next level get 30, 40, 20, down the level. And they basically say to solve this problem, I have to keep rid of the top.

And I was trying to say in this morning's testimony, you have this unique situation in China. You may have princelings and those operating, but the person at the top doesn't get 60 percent. He almost gets nothing. Okay. So regime change can't be the end of a corruption concern.

There may be all sorts of things you have to do, and you have to fight the local systems, the polices, the petty, petty Party officials locally, and then you have to focus on how come they have so much control over resources? I mean there was this highly publicized case of a truck driver who was sentenced to jail for--I don't know--20, 30 years for not paying his tolls.

Remember this case? Not paying his tolls, and they sentenced him to ten or 20 years for not paying the tolls on a toll road. Somehow he got

around it, and it came up--I don't know exactly the number. He was accused of not paying something like $150,000 worth of tolls, but this guy only made $10,000 a year. Okay. So what it exposed was a very corrupt local transport toll system, which was ripping off people because how do you expect people making $10,000 a year driving trucks of freight to pay $150,000 in tolls? And the answer, of course, you can't.

So when that became publicized, unjust, unfair, he was released from jail, and I think that's very good, but that kind of corruption, this kind of ridiculous abuse of what I would call the rights of people at local levels does get people extremely angry.

But it doesn't necessarily mean that you throw away the top leadership. That's something different.

DR. WHYTE: I also know that this is an area that the Party keeps trying to get on top of and get credit for, and so you do have these high profile arrests of officials, who are thrown in jail and so forth, and for certain kinds of corruption, of course, people are executed in China, which I don't think we're doing in our society these days.

So they can play very tough, but the problem is, of course, that this is where you run up against the issue of --are we going to change our system politically? Corruption is still managed by the Party. There is not an independent Hong Kong style anti-corruption commission or something that was brought into being outside the Party to clear up things.

So there's inevitable suspicion that the top Party officials are making decisions to scapegoat this guy and let this other guy slide and so forth. So there is still--think the population has a considerably jaundiced view about whether the Party's anti-corruption measures are really being fairly and vigorously pursued.

MR. MANN: Well, just a couple points on that. First, this is something where American businesses could help, I'm actually pessimistic on that. It's hard enough to get American businesses to bring a WTO complaint.

I have not yet seen a Foreign Corrupt Practices Act case involving China. You know, when people are extorted they tend to, if they're going to say no, they tend to just pull out.

But corruption, again, on the local versus national level, if you get a case of car accident from a kid of a leader or police brutality, people take to the streets, but for people to protest on corruption at a national level, it requires, again, an organization. You have to plan a protest about high level corruption.

And the remedy for corruption at the national level, again, is press coverage or an independent press, but that's where the, that's again where the leadership digs in and says no. They tend to, the language used is that the Party wants to make itself more accountable, and it means, we'd like to be among other things, that we would like to be accountable on corruption. But then they can't quite see their way to do it.

The cutting-edge issue would be if there was a consumer issue, like milk again, that was of nationwide import and was vastly worse even than that milk scandal. Yes, I guess that could bring people out, but overall I'm pessimistic.

DR. TANNER: Jim, since you've addressed something I brought up, I want to clarify something. I think a Foreign Corrupt Practices case is an interesting way of going about it, but what I was thinking of specifically was this: I can't remember the last time I heard a high-ranking U.S. government official talk about doing something about corruption problems that U.S. business faces in China.

The other thing, the other place where it's disappeared, and you talked about an independent press, I can't remember the last time I saw a major international news media report on China focused on the problem of corruption, and I'm not just talking about Chinese government controlled press sources. I'm talking about all the international ones I see in my hotel room when I'm over in Beijing.

COMMISSIONER MULLOY: Do you think that--

DR. TANNER: It's an issue that people who survey corruption say is there, that the Chinese people seem to believe is there, that we are somehow not spot--I judge that we are not spotlighting nearly enough either in our official communication or in our press coverage.

COMMISSIONER MULLOY: I'm not judging our--but do you think the companies have to accommodate themselves to that, that the companies have to accommodate themselves to that reality over there?

CHAIRMAN REINSCH: Well, under U.S. law, they can't.

DR. DUNAWAY: But, look, a week ago, you had the Minister for Transportation--for train dismissed, the big story across the international press. So the stories are still there.

COMMISSIONER SHEA: It was unclear why he was dismissed. I mean--

DR. DUNAWAY: Well, but there was no hesitation on the part of the newspapers to indicate the reasons why he was dismissed.

DR. HUANG: High speed.

DR. DUNAWAY: High-speed rail.

MR. MANN: American companies at the level of we'd like a trip to the United States for myself and 12 of my best friends, sure, it hapens all the time. I don't know about all the time, but at the level of 100 million, yes, a million dollars under the table, I don't think we're going to, it's going to be hard to find out.

CHAIRMAN REINSCH: Well, it may be hard to find out. I mean those would be violations of U.S. law.

DR. WHYTE: Yes.

CHAIRMAN REINSCH: And for the last ten years, there's been a fairly significant uptick in prosecution of the statute by the last administration and this one. I don't remember offhand if there's been more China cases. I'm inclined to think not.

There are, I guess the politest way to put it is there are more target-rich environments to look for if you're a prosecutor, particularly when you think about access of information and discovery and your ability to get somebody to talk.

China is a much more difficult place to develop the information you need to prosecute an American because, you know, with all these cases, unless it's something that happened here inside our borders, you know, you

have to build a case under U.S. law, and you have to prosecute under U.S. law, which is not the easiest thing to do.

My sense, though, about what's going on in China is the approach is incredibly superficial, you know, and it follows what you, exactly what Dr. Whyte described. You know, there is a big campaign. They arrest a few people. They shoot a few people. And then it all goes away. In two or three years, it all comes back and they do it again.

They don't fundamentally change anything because I think they can't change anything because if you want to root it out, if you will, you need to have a governance system that works differently.

HEARING CO-CHAIR CLEVELAND: I think we're to some extent confusing terms, and I guess I'd be interested in what we define as corruption, and having had a miserable experience at the Bank trying to do this, I mean there's a big difference between the fees and bribes and the problems at local levels, which I think most people have trouble with, deal with, whether it's the local tax office and/or fees they pay under the table to get their kids into school. That issue is separate.

And you both just mentioned that corruption as the issue of the milk scandal. That was more about demands for specific levels of production, cutting corners. It wasn't what we just talked about or I guess you just mentioned, a million dollars under the table being paid in a bribe.

So I guess my question is what do we, when we're talking about corruption, what do we mean by that because I think it does have the potential to put pressure on the regime if indeed high level officials were found to be accepting gratuities for services performed or engaged in?

That's one order of issues. I think that has the potential to rally all kinds of people against the government versus what people endure on a daily basis, which I don't see as a catalyzing--

CHAIRMAN REINSCH: Well, I don't want to put words in Jim's mouth, but I think the examples he cited and my response was really focused on the bribery issue.

HEARING CO-CHAIR CLEVELAND: But when we talk about corruption as a potential pressure point or a factor that would influence either a policy change by the government or neglect by the government, what are we talking about as the basket of issues?

DR. DUNAWAY: The kind of day-to-day corruption you were talking about, I see that as having potential economic costs. There used to be this discussion in Southeast Asia, particularly, and with reference to Indonesia versus the Philippines, that you had, you had clean corruption in Indonesia, that somebody came, told you what the bribe was, and you knew that no one else would come. Okay. So you could predict your costs and you could predict when your shipment would clear Customs so you could operate efficiently.

In contrast, the Philippines was, it was a case where it was unclean corruption where one guy would come in and ask for a bribe, and the next thing you know five other guys can come in on top of it.

So there is that element. But the problem is that even the clean corruption over time becomes the unclean, and so then you end up with this

economic problem because you fall into a situation where it becomes increasingly difficult for you as a businessman to predict what your costs are.

CHAIRMAN REINSCH: That's a fascinating new term, you know, "clean corruption." I've never heard it.

DR. DUNAWAY: No, it's an old term.

HEARING CO-CHAIR CLEVELAND: Are you talking about as a businessman, it makes it challenging to operate, are you talking about, the local factory in Chongqing that's got a revenue-base or revenue stream of a million bucks, or are you talking about international? I mean at what, I guess what I'm asking is at what level does it become really relevant to a political community as well as the national economy?

DR. DUNAWAY: It's going to hit at all those levels in different forms. You know if you're a large foreign direct investor, and you come in, okay, you know a lot of it is going to hinge in terms of what kind of land situation you get, you know, in terms of utilities and what you may have to pay, and also in terms of taxing, it can have an impact on you.

MR. MANN: I would throw out the idea that domestic corruption is politically a more explosive issue than foreign companies. And we've been through this with other countries, but privatization, the questions of who ends up with what shares; and how those are always potentially explosive issues? DR. WHYTE: But I would say that it's very hard to draw a boundary around what people consider as corruption because--

HEARING CO-CHAIR CLEVELAND: That's what I'm trying to get--

DR. WHYTE: It's shades. If we're talking about two of the incidents that have given rise to the greatest anger, the milk scandal and the school children killed in the earthquake, neither of those so far as I know involved direct paying of bribes, but both of them involved people who were supposed to be doing things to protect people who were cozying up with authorities to allow them to cut corners, and the result is that many people were harmed.

Well, is that corruption? I think lots of Chinese would say that's official corruption, but it didn't involve--I'm going to bribe you so I can build this school with shoddy materials.

DR. TANNER: I think in the research I've done, one of the most common and annoying scenarios for people concerns the taking over of the, the illegal confiscation of land or the destruction of houses, moving people off the land. The stereotypical scenario is people have their houses, people have their apartments, people have their land taken away by local authorities who are working in collusion with a developer.

HEARING CO-CHAIR CLEVELAND: Right. Actually, the Bank has a very good study on this right now, and they talk about the land is expropriated. A value is paid for it that's substantially less than what it's worth.

DR. TANNER: That's right.

HEARING CO-CHAIR CLEVELAND: And then it's turned around to a local developer who sells it or develops it, and each step of the way the little guy is sort of left out of the equation. So that will be sort of a framework for corruption. But how would you translate that to a national kind of

definition, separate from the land expropriation?

DR. TANNER: I'm not following what you mean by translate it to a national definition?

COMMISSIONER SHEA: Are you saying, Robin, say combining a milk scandal with a high level--with a member of the Standing Committee, the Politburo, with money being exchanged? If that type of situation was exposed, would that trigger a political event? Is that what you're saying?

HEARING CO-CHAIR CLEVELAND: Yes, I'm trying to--I'm sort of trying to get at, first of all, what the threshold definition is of corruption? And I think, Marty, you sort of said it doesn't tend to be about money. So is there a common--

DR. TANNER: Well, I'm not sure in the case that I just described, I'm not sure that it isn't about money. Certainly, people who protest and get angry about these things appear to suspect that large amounts of money changed hands with the local official. In fact, you'd probably have a hard time persuading them that it didn't.

HEARING CO-CHAIR CLEVELAND: But does that have the potential to turn into a national I shouldn't say political event, but does that have the potential to trigger nationwide protests? It doesn't sound like it. It sounds like a local--

DR. TANNER: I think possibly regionally because one of the other complaints, one of the other complaints that you read is they've coined a new term, "mass incidents with no direct interest." And this is, again, if you think it's bad in English, you ought to read it--

DR. WHYTE: I believe Yu Jianrong coined that phrase

DR. TANNER: Yes.

HEARING CO-CHAIR CLEVELAND: Mass incidents with no direct interest.

DR. TANNER: Yes, and it's a case where somebody has been wronged, as if having their land taken away, and they start a protest, and everybody else either has had the same thing happen to them, knows somebody who's had something them, thinks they know somebody.

And these things get a size and a seriousness that goes way beyond the direct interest, personal interest that was involved. You know, again, you don't want to necessarily confuse police claims with reality, but they claim that this is something that they're increasingly seeing.

HEARING CO-CHAIR CLEVELAND: Dr. Huang was going to--

CHAIRMAN REINSCH: Oh, I'm sorry. Dr. Huang.

DR. HUANG: I would say my definition here is very broad. My definition would be very broad that corruption is where you have some private interest gaining at the expense of public interest, and because I see the milk scandal or the school earthquake damage ultimately reflects the fact that somebody pocketed something which allowed someone to sell something or build something at higher value than it was cost him.

The standards of the school's construction were below what was specified. Some contractor pocketed money. That's to me bribery in the end. The milk scandal means that you didn't regulate well enough because people were using cheap adulterated powder and getting, selling it for

something which should have been pure and therefore he saved costs and he's made money at the public expense.

And then you have what I call the very clear case of bribing you to get a contract. In each case, the public is getting something that's costing the public more than it should because somebody is paying a bribe; someone is pocketing it.

I don't think in China actually that they would actually sit there and try to differentiate these incidents. What they basically see is somebody taking advantage of the system to make money for themselves somehow, and it's all relatively--

HEARING CO-CHAIR CLEVELAND: As distinct from taking advantage of a system to make money for themselves to get ahead, and that's okay because--

DR. HUANG: No, I think they're all bad. I think they're all bad, but I would say they would complain about--they've accepted the fact that all the food is adulterated; all the cooking was adulterated. Somebody is pocketing the money and may not be really careful. I think it's--I mean what I see bad is when that pervades the feelings of the people, eventually get the sense of someone saying there's something wrong with our system or whatever, you know.

I think the milk scandal really shook up everybody because they said how could everybody behave like this? Our kids are at risk and people didn't seem to care, you know.

HEARING CO-CHAIR CLEVELAND: Isn't that just like the--

MR. MANN: I'm sorry.

DR. HUANG: No, go ahead.

MR. MANN: No, I agree on the milk scandal or the buildings in the earthquake. Large-scale financial scandal becomes part of the background to political issues whether--and this is not just China. With Mubarak, I couldn't have told you beforehand how many businessmen were profiting which members of the family in what way, and this is true, it's part of the context whether it's Chiang Kai-shek or Batista or Marcos or anyone, and if things build up to a certain level, then you get a loss of confidence in the regime, and then it's a security issue of--

HEARING CO-CHAIR CLEVELAND: Back to your initial testimony. Is it a loss of confidence in the regime or is it a loss of confidence in your "happiness" factor, your opportunity to get ahead? How do those two connect in terms of--

DR. WHYTE: Well, again, we didn't ask questions directly about how people feel about Hu Jintao or something like that, but my sense is that from other people's surveys, that you're not at anywhere near that state regarding China. In other words, the people do not look upon Hu Jintao as Ferdinand Marcos or Mubarak or who ever.

They certainly may recognize a certain amount of cronyism or children in business and other kinds of things, but I think they also feel that this is a strong and relatively effective government that is still moving China ahead in positive ways.

I would say you're not at anything like the level of disenchantment

with a top leadership or at the system as a whole or anything like that.

MR. MANN: No, I agree. But that is a danger.

DR. WHYTE: That's the danger, yes.

MR. MANN: Yes.

DR. WHYTE: Yes, and the worry is could this change overnight? And if certain information is revealed that the Chinese people don't know about, but becomes widely circulated say, rumors of much more blatant, high-level corruption that could be much more threatening.

CHAIRMAN REINSCH: We're getting to the end of our time.

COMMISSIONER MULLOY: This has been very helpful. I just want to build on something that Dr. Whyte just said, the idea that-- here's what I think. I have a sense that the Chinese sense that they were the great civilization and superior kind of to other people and other civilizations, and they fell apart.

DR. WHYTE: With some reason.

COMMISSIONER MULLOY: And a couple of hundred years, and they mainly fell apart because the Westerners came in there and beat them up and all that. And they're on the road back to being numero uno again. Is that kind of what people sense, and that's--

HEARING CO-CHAIR CLEVELAND: That's a different debate.

COMMISSIONER MULLOY: Well, I think, no, I think it's because I think if you've got a regime that's moving you back toward being numero uno, you're going to be pretty happy with those guys. If that's a burning thing that's in them--I think it is--they'll put up with a lot if they're moving in that direction; won't they? DR. HUANG: There is some truth in that. They take a lot of pride in some of these things that have been happening.

COMMISSIONER MULLOY: Yes.

DR. HUANG: And therefore maybe the tolerance for other things is increased in the process.

COMMISSIONER MULLOY: Jim, do you have any--

MR. MANN: Well, the whole question is the last words you said, "If they're moving in that direction." What happens if there's a downturn?

DR. WHYTE: You have to remember what the Soviet Union once was--they sent up the first earth satellite, the first person in space, they seemed to be catching up, but where is the Soviet Union today? So--

HEARING CO-CHAIR CLEVELAND: So your concluding comment is that China has not reached its Sputnik moment?

[Laughter.]

DR. WHYTE: Well, the Chinese have sent people up into space, however, so--

MR. MANN: We have.

CHAIRMAN REINSCH: Well, on that note, let me thank everyone. Let me thank particularly our guests and our panelists both for their work this morning and for sticking with us this afternoon. I for one thing it's been enlightening and very, very helpful to us.

It will be reflected, I think, in the annual report that we do, which we'll be sure to get to all of you. So thank you very much, all of you, and thank you also to the people in the audience who stuck with us but didn't

have any questions. So I don't have any of those to ask, and with that, we're adjourned.

[Whereupon, at 2:23 p.m., the roundtable was adjourned.]