

# Broken China

by William H. Overholt

*A Hong Kong Insider Offers  
the Pros and Cons of America  
Ending Most Favored  
Nation Status*

SINCE JUNE 1989, the U.S. has accumulated a broad range of grievances against China. These include persistent outrage over events at Tiananmen Square, exacerbated by recent arrests and sentences; revelations that China is exporting the products of prison labor; a huge trade surplus; unfair Chinese trade practices such as pirating of intellectual property; sales of a nuclear reactor to Algeria and of missiles to Syria and Pakistan; and refusal to support GATT membership for Taiwan.

The range of China's actions has created a broad and improbable Washington coalition of those concerned about human rights, arms control and fair trade: both liberals and conservatives, leading Republicans as well as Democrats, and important parts of the Executive branch in addition to the vast majority of the Congress.

American grievances are substantial and legitimate. At issue is not the need for a response, but rather which tools will achieve the most effective response. Depriving China of Most Favored Nation trading status has appeared to be the only weapon of appropriate magnitude. It is aimed in the wrong direction.

Depriving China of Most Favored Nation status will devastate China's liberal reformists by depriving them of their economic base. It will strengthen China's repressive conservatives by providing them with a national security justification for their policies. It will enhance Chinese military spending, the political role of the Chinese military, and Sino-Soviet military cooperation. It will worsen the livelihoods of millions of impoverished people. It will devastate Hong Kong, the principal outpost of Western liberty and free trade in Asia, and will do significant damage to Taiwan. By damaging Hong Kong, it will constitute a major affront to Britain and will put us at odds with the policy of virtually every one of our allies. It will endanger Chinese-American cooperation over Korea, Taiwan, Southeast Asia, United Nations votes on Iraq, and a vast array of the most vital international issues. It will damage American competitiveness in the world's most dynamic markets.

#### DAMAGE TO FRIENDLY TERRITORIES

The easiest way to visualize the impact of MFN withdrawal on Hong Kong is to realize that it imposes

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sanctions on the output of 71 percent (2 million out of 2.8 million) of the workers employed by Hong Kong firms. The Hong Kong Government estimates that Hong Kong would lose US\$8.8 to 11.7 billion dollars of trade; that is up to US\$2,000 for every person living in Hong Kong. This trade loss alone would cost economic growth of 1.3 to 1.8 percent of GNP annually; independent analysts estimate the second order effects (e.g., lost investment, lost orders from Chinese consumers) to raise this cost as high as 2.7 percent of GNP. These huge losses would come at a particularly delicate moment, when Hong Kong is just beginning to recover from the political and economic shocks of June 1989. The combined effect of lost trade, lost investment, and lost confidence would be devastating.

Hong Kong is also the headquarters of American business in Asia. Although Hong Kong is a British colony, there are far more Americans (20,900) than British (17,650) in Hong Kong. Of the 581 multinational corporations with regional headquarters in Hong Kong during 1990, 252 are American, followed by Britain with 77. Hong

Kong's per capita consumption of U.S. goods is higher than that of any other foreign territory outside the Americas; \$1179 per person in 1990 compared with \$292 for the EC. It imported \$6.6 billion of American goods in 1990.

Some 70 percent of American businesses in Hong Kong would be adversely affected by China's loss of MFN status, with many losses amounting to tens of millions of dollars and some in excess of \$100 million. Extensive layoffs would occur not just in Hong Kong but also across the United States.

MFN, which in its consequences is primarily an attack on Hong Kong, is therefore an attack on the primary U.S. business headquarters in Asia, on Asia's freest political entity, and on the world's preeminent example of free trade.

Taiwan would not be as badly hurt as Hong Kong, but would be injured significantly. Taiwan has been undergoing a major adjustment. Higher wage costs stimulated by democratization and higher exchange rates pressed by the U.S. have made much of Taiwan's low-tech industry uncompetitive. At least 80 percent of Taiwan's shoe industry (one

of the world's largest shoe industries), and likely well over 90 percent, has shifted to the mainland and would be devastated by the loss of MFN. The textile, furniture, assembly and electronic assembly industries would also be damaged.

#### MFN AND THE POLITICS OF REFORM IN CHINA

Depriving China of MFN is intended primarily to promote human rights in China by punishing the Chinese government. But MFN deprivation will grievously damage those parts of China that have done the most for their people while helping those who oppose further economic and political liberalization. The leaders of China's

export economy are several coastal provinces, most notably Guangdong Province adjacent to Hong Kong, Fukien opposite Taiwan, and the Shanghai area. Guangdong has the population of France. In the fast-growing coastal provinces, there was no loss of life at the time of Tiananmen Square. The coastal provinces introduce innovations such as stock markets long before Beijing

has approved them. The leaders of these provinces have been relatively moderate in dealing with dissent, relatively relaxed in dealing with rapid social change, and encouraging of further economic liberalization.

Beijing is fearful of the coastal provinces' increasing autonomy and determined to get them back under firmer control through political, tax and regulatory measures. In response, the coastal provinces have mobilized local political support, rebuffed Beijing's efforts to impose far higher taxes, and insisted that their path is the only path to save China's future. The result has been a broad division between coastal liberals, with broad sympathy from the younger population and other reformist groups of the interior, and the old-line conservatives of Beijing.

The old-line conservatives are in trouble. As Premier Li Peng's last major review of the economy made clear, the conservatives have no theory of economic victory.

Conversely, the reformists' appeal is broad and getting broader. The recent elevations of Shanghai Mayor Zhu

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Rongji and State Council Commission Chairman Zou Jiahua, along with many lesser appointments, indicate that the reformers are making political inroads. They have credible solutions to the major problems of liberalizing a socialist economy: use bond markets to control money supply and thereby contain the inflationary impact of price liberalization; use stock markets to raise money and privatize loss-making state enterprises; liberalize the economy gradually to avoid the hideous social disruptions of the precipitous Polish strategy.

Some supporters of MFN deprivation believe that sanctions would bring Beijing's conservatives to their knees. If so, temporary damage to the reformists would be justified. But Beijing is insulated by some of the world's largest foreign exchange reserves (\$30 billion of foreign exchange and gold) and one of the third world's lowest debt service ratios. For all its problems, China's economy is more financially and economically resilient than most Third World economies.

Moreover, deprivation of MFN will fail to bring Beijing to its knees because it will have almost no support from America's allies and friends. Japan, Europe, and Southeast Asia have all greatly improved political and especially economic ties with China in the past year, and those trends will continue.

For China's ultra-conservatives, deprivation of MFN status would deliver the only persuasive argument against further liberalization, namely that further opening of China's economy and polity will make China once again vulnerable to the foreign intervention that humiliated China repeatedly during two centuries prior to 1949. There is no more powerful or persuasive argument in Chinese politics; it is the central reason why the communists came to power in China in the first place.

#### THE SPECIAL CHARACTER OF MFN DEPRIVATION

Depriving a nation of MFN status is no ordinary sanction. Most sanctions take for granted that a country is a member of the world economic and political system and, in that context, send a message that we believe the country is not obeying all the rules of that system and will face

specific penalties until it complies. Controls on military sales, controls on high-technology sales, Section 301 penalties, Special 301 penalties, bans on high-level contact, Voice of America broadcasts, and such acts as President Bush's meeting with the Dalai Lama, all are targeted sanctions intended to induce action on specific points of grievance without challenging the country's membership in the global system.

In contrast, depriving a nation of MFN status expels it from the system. "Most Favored Nation" is a misnomer that suggests some special favor. It merely signifies non-discriminatory treatment and is a status held by almost every significant country. Denial of this status is confined

to only nine of the worst enemies of the United States (out of more than 160 countries and territories). We do not expel Japan from the system even for very large trade deficits and very serious trade barriers. We do not eject Thailand, Malaysia, and Indonesia for much more extensive violations of intellectual property rights than China's. We have not even denied Iraq or Burma Most Favored

Nation status despite human rights abuses that make Tiananmen Square look tame.

The political force of depriving China of MFN status is not to create incentives for specific objectives but rather an attempt to impose a general humiliation, to attack Chinese sovereignty, and to expel China from our community of nations.

Does the U.S. Congress really want to return to the days when China was an outlaw nation whose foreign policy was based on the assumption that we, and the international system we lead, constituted a dire threat to China's security? Such an assumption made opposition to us, and disruption of the international system, a central objective of Chinese foreign policy. It would presumably do so again.

#### CHINA AND THE INTERNATIONAL POLITICAL ORDER

China's adherence to a basically cooperative international policy derives from its economic interests. The entire restructuring of China's international relationships after

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1978 reflects a decision to emulate China's Asian neighbors in, first, giving economic development priority over international political and military struggles, and second, pursuing economic development through international cooperation. This decision has been an extraordinary success for China for a U.S. policy that facilitated China's integration into cooperative economic and political relationships even when much of China's policy was still antagonistic to a broad range of U.S. interests.

Take just one recent example: China abstained on the crucial U.S. Security Council vote that authorized the war against Saddam Hussein. This was the crucial vote behind President Bush's successful engagement of the United Nations in support of his policy, because, as a result of a century and a half of humiliation by Western powers, it has for two generations been a central principle of Chinese foreign policy never to support Western intervention against a third world country.

When I inquired about this from a top advisor to China's leaders, he replied that China's economic development policy requires, first, that China remain at peace with all its neighbors and, second, that it maintain access to international capital markets. He said that the vote on Iraq was necessary to maintain access to international capital markets.

Because the whole structure of China's cooperative international political relationships derives from its successful strategy of economic opening, a successful effort by opponents of MFN to expel China from the economic system would inexorably destroy the basis of China's integration into a cooperative global political order. We need Chinese support for U.N. votes to extricate our troops from Kurdish Iraq, for peace and non-proliferation in Korea, for reconciliation with Taiwan, for stability in Southeast Asia, for a Cambodian solution, for the Mongolian food aid program, and for a range of equally important issues. Currently we are getting that support, and we should not jeopardize it unnecessarily.

#### CHINA AND THE GLOBAL ECONOMIC ORDER

Economically, China has joined the world system to a

greater degree than any other communist or formerly communist country. To judge a country's participation in the international trade system, we can measure its trade as a share of GNP. For 1989, economically China's worst year of recent times, the Soviet Union's trade was 5.4 percent of GNP, Brazil's 16.0 percent, the U.S. 16.4 percent, Japan 27.0 percent, and China 26.1 percent. In 1990, China's trade rose to 32.4 percent of GNP. While there are serious statistical problems in comparing developing and developed nations with this measure, no statistical adjustments can belie the fact that China has emerged from autarky to become a full participant in international trade. It has not reverted to pre-1989 practices and indeed has made great advances since 1989.

To measure the extent to which a country is still a predominantly socialist country, we can measure its government enterprise sector as a share of GNP. In China, this share is about one-third, virtually identical to that of France or Italy.

Another measure is the share of GNP that the government extracts in taxes. By 1990, China's tax share had declined from the extremely high

levels typical of a communist economy to only 16.2 percent, substantially below America's 20 percent.

China's economic reform program remains in place. There has been no abandonment of the internationalization of the economy, the move to family-based and market-driven agriculture, the move toward finances based on loans rather than grants, the spread of Western-style financial markets, the extensive role of private firms, or the enthusiastic welcome of foreign investment.

Indeed, reforms are actually making rapid progress. Since Tiananmen Square, China has greatly liberalized its approach to foreign investment, encouraging wholly owned foreign ventures. Western investors are far more welcome in China than in the Philippines.

Tax reforms also benefit foreign investors. Foreign banks are being allowed to operate in major cities. Many key commodity prices have been reformed. A new Singapore-sized investment zone is being opened outside Shanghai. Likewise, the current leadership has embarked on a sweeping financial revolution.

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A national bond market has expanded rapidly and offers the best hope in the world of reforming socialist countries for containing inflation while liberalizing prices. Since last December, China has opened two official stock markets and numerous unofficial ones; in five years or so, these are intended to become a major instrument for raising investment funds, increasing competition, and reforming China's inefficient state enterprise sector. With the help of the Chicago Board of Trade, it has initiated futures markets, which are now active in seven provinces. It has moved to a near-market official foreign exchange rate, with over one-third of foreign exchange transactions occurring in free markets. Helped by this reform, China's authorities have announced an intention to eliminate export subsidies.

The story of China's continuing economic reforms is virtually unreported in the U.S. It is startling to find that East European economic reforms are widely lauded whereas Chinese reforms are dismissed as failures. The Soviet reform is already in a state of collapse. In Eastern Europe, all economies have contracted since 1988 while China's has steadily expanded since 1978.

Putting East Germany aside, the most auspicious East European economy, Poland, is likely, on fairly optimistic political and economic assumptions and with billions of dollars of Western subsidies, to break even with 1988 only in 1995. After that many years, China's economy had already grown by over 70 percent with no subsidies. China's gradual approach is much less disruptive of social order. China's devotion to an Asian mode of development, focused on institution-building, with many success stories, appears superior to East European patterns that seem vulnerable to Latin American-style political disruptions. And China's economic success continues; this year's growth is expected to be 7 percent, twice what the U.S. would consider a boom year.

#### CHINESE ECONOMIC SUCCESS IS IMPORTANT FOR SEVERAL REASONS:

First, China has joined the global economic system — our system — faster and more successfully than anyone would have imagined possible. As a major beneficiary

of that system, China is now a cooperative and constructive force in the world economy as well as the political system.

Second, China provides the only success story so far for reform of a communist economic system, and it will likely become an important model as some of the East European experiments get into trouble. We have a vital interest in having at least one example of successful reform of a communist system, in order to maintain the hopes of reformers in countries like the Soviet Union, where Gorbachev has hopelessly botched the reform. Without an example of success, reformers in other formerly communist systems may lose credibility, and hard-line socialists may return on the argument that reform is hopeless.

Third, the widespread distribution of economic benefits from China's economic reform has created exceedingly broad social support for further reforms, has associated the relatively liberal political sectors with economic competence and has created an extensive elite with direct, positive and successful experience at dealing with markets. Beneath

the conservative surface of Beijing's politics, this creates a momentum for further economic reform and eventual revival of the political reformers — so long as the process is allowed to continue.

Fourth, China's success at growing rapidly and at spreading the benefits of growth widely have immensely improved the dignity of life for a large fraction of the world's population.

Fifth, economic success has irreversibly changed Chinese society in ways that improve human rights even in the face of a repressive leadership.

These developments, vital both to China's future and to U.S. interests, would be sacrificed by expelling China from the economic system. Not only would the multiplier effects of foreign contacts be lost as a result of the sanctions, but also China's conservatives would likely take this as an opportunity to impose vast additional restrictions of their own.

To say this is not to argue that the U.S. should tolerate a huge deficit caused in part by unfair Chinese practices.

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But other levers can be applied to the trade deficit without expelling China from the system. Moreover, much of the trade deficit could turn out to be an artifact of: (1) inevitable difficulties in adjusting a managed economy to the requirements of international trade, even though there have been some relatively heroic measures such as the rapid adjustment of exchange rates to eliminate export subsidies; (2) the temporary necessity — last year — for an austere anti-inflation program; (3) prudent measures to raise reserves in the face of a Western financial boycott; and (4) the export into China of much Hong Kong and Taiwan low-end manufacturing, which in effect transfers the trade surpluses of those countries to China while leaving much of the profit in Taiwan and Hong Kong.

The correct policy for the U.S. is to act directly against unfair Chinese trade practices such as piracy of intellectual property and unreasonable barriers against imports.

#### CHINA AND HUMAN RIGHTS

Tiananmen Square and Tibet rightly have provoked outrage and rightly demand a world response. Abuses have become both deeper and more extensive. But here too it is important to discuss American policy in the broadest context and to ensure that our policies are likely to achieve their objectives.

When Deng Xiaoping became China's leader in 1978, China was a totalitarian system. The entire population's access to information was tightly controlled. Movement of people was totally controlled. Political controls on thought, speech and action were omnipresent and universally effective. The Communist Party dominated social life and controlled all of China's business enterprises. Foreigners were a rare curiosity, and few Chinese were allowed abroad. Even China's intellectuals were terrified to criticize the political leadership.

Today the situation is quite different. It is more common than not for Americans visiting China to find their official Chinese government hosts criticizing the political leaders within minutes of their first contact. Intellectuals and officials vigorously and openly

debate the merits of a wide range of economic and political options.

Hundreds of thousands of foreigners visit China, and hundreds of thousands of Chinese travel abroad. Throughout China one encounters some of the hundreds of thousands of Taiwanese visitors to China, who tell about the better life in Taiwan and often do not hesitate to harangue local people about the deficiencies of communist management. While there are still restrictions on freedom of movement, students and businessmen travel all over China, and millions of workers migrate, legally or more often illegally, to better lives in the coastal provinces. Workers from Sichuan in

the interior work in coastal processing plants and, once a year, travel back to Sichuan with tales of a different kind of life.

The Communist Party no longer monopolizes the flow of information, the range of opinions, the details of business decisions, or access to jobs. It can strongly influence them, but not monopolize control of them. After all, many workplaces are wholly foreign-owned.

Many more people have the right to choose their jobs or to change jobs. All these result from the opening of China's economy and the willingness of the rest of the world, most notably the United States, to encourage that opening.

A professor manages to send his son to graduate study in New York. The son gets a summer job at the university, earning ten dollars an hour or eighty dollars a day—daily earnings substantially higher than the father's monthly pay. The father is shocked and tells his colleagues, who study how this could happen. Soon the whole university knows the story, and some of the analysis that goes with it. Shortly the story spreads throughout the city. From that moment, the university and city are changed.

All this goes on even while the country experiences a Tiananmen Square and even while thousands of political offenders are imprisoned. The number of political prisoners declines a few hundred or a few thousand under a liberal and rises under a conservative,

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but meanwhile the freedom of speech and thought of several hundred million people is being expanded by the dynamic of economic progress, contacts with the outside world, expanding communications, and enough money to enjoy a radio and a bit of travel. Moreover, the experience of Taiwan and South Korea shows that the national forces of communications, rising incomes, education, mobility, and social complexity lead inevitably to broader freedom and to movements for democratization.

The problem with MFN deprivation as a human rights policy is that it halts or reverses such forces. Other measures — welcoming dissident students, acclaiming the Dalai Lama, beaming Western views into China, spreading the story of Tiananmen Square, confronting Chinese leaders in international fora — all promote official human rights without hindering the social changes that create permanent unofficial human rights progress. To say this is not to say that one should accept a Tiananmen Square incident in order to facilitate economic growth. It is not to ignore political prisoners. The point is to use levers that promote progress rather than hinder it.

There is another problem with MFN deprivation as an instrument of human rights policy, namely the direct impact of economic deprivation on millions of people. In the mid-1980s, a World Bank study showed that over 100 million Chinese had incomes of less than US\$30 per year. One aspect of this was the widespread incidence throughout China of the one-pants family—the family which was so poor that it could afford only one pair of pants. Typically, the husband would wear the pants to work during the day, and the wife would remain in bed. Then the wife would get to wear the pants while the husband stayed in bed.

A major consequence of the Chinese economic takeoff has been the elimination of one-pants families from large regions of China. This is an enormous improvement in human dignity that human rights advocates need to respect. Conversely, a measure which would slow or

reverse this progress cannot rank as a satisfying way to promote human rights. While it is obviously not the intention of those who would remove MFN to subject millions of Chinese women to the unnecessary indignity of the one-pants family, they must accept responsibility for consequences as well as intentions.

#### OVERVIEW

The successful efforts by Presidents Nixon, Ford, Carter, Reagan, and Bush to draw China into the system have brought enormous benefits for international order, for U.S. foreign policy, for the welfare and dignity of Chinese people, and for the global economy. These

benefits largely remain in place despite the regressions that have antagonized Washington since June 1989.

The pressure to deprive China of MFN status has arisen from the frustrations of dealing with simultaneous grievances against China on a broad range of human rights, trade, and national security issues and from a feeling that no other measures are avail-

able. But, in fact, powerful measures are available but may need time and vigorous application in order to achieve results. There is even some evidence that important results can be achieved without much delay.

China has provided assurances that the nuclear reactor for Algeria will be subject to IAEA inspection. Beijing has announced a policy of eliminating export subsidies. Much of the trade deficit may prove to be an artifact of the Chinese business cycle, and much of the rest may be negotiable with the help of appropriate sanctions. China is sending a series of buying missions to this country, senior Chinese officials have said they expect to buy more from the U.S., and there are preliminary signs that the trade deficit is declining.

Our diplomacy with China possesses numerous powerful smart bombs — from Special 301 sanctions to public acclaim for the Dalai Lama — which are aimed directly at the target. But MFN deprivation is the ultimate dumb bomb. It will miss its intended target but damage friendly forces. ♦

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