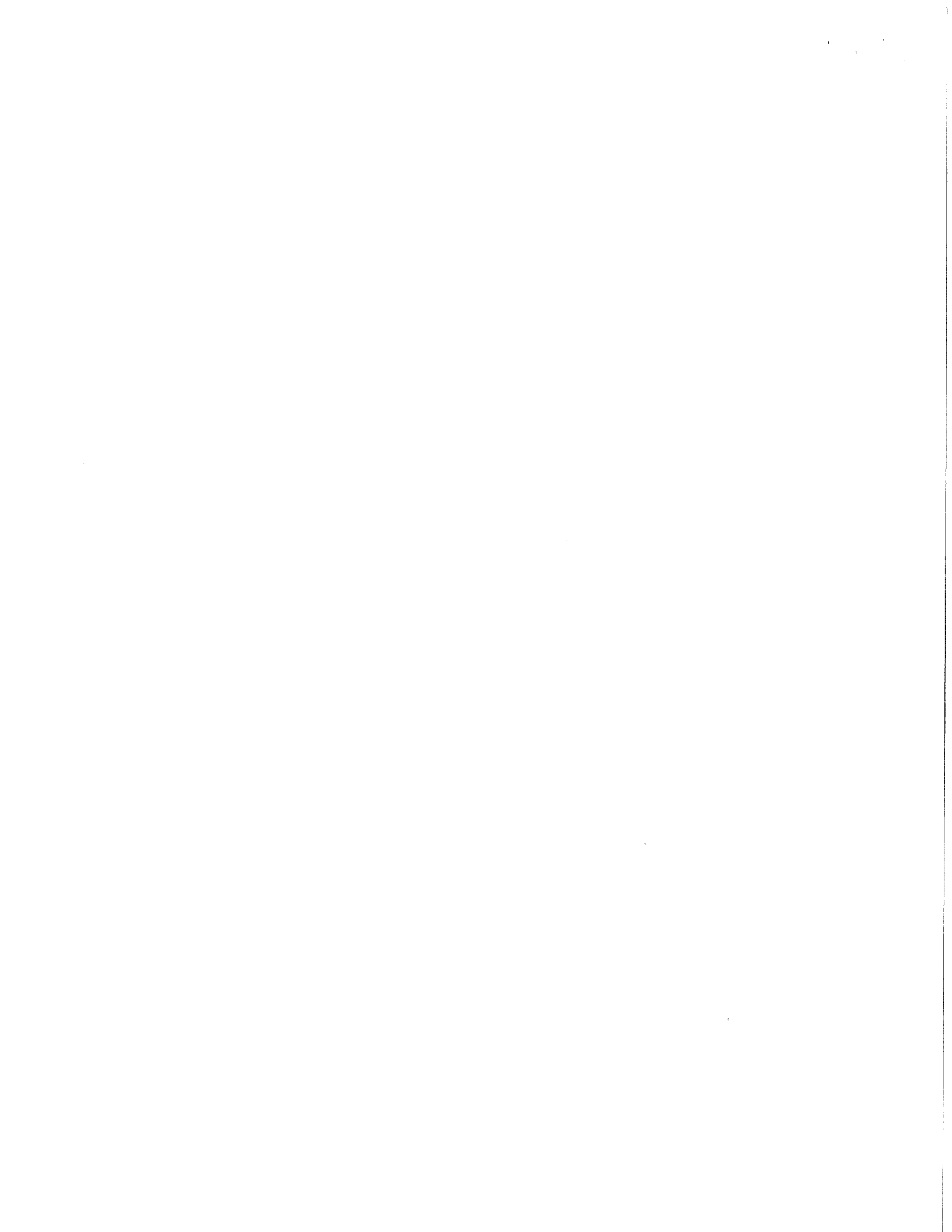


CHINA AND MFN

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CHINA AND MFN

Mr. Chairman, and Members of the Committee, thank you for inviting me to testify. The views presented here are my own, not necessarily my employer's. While I am here under the auspices of the American Chamber of Commerce in Hong Kong, I do not speak primarily as a businessman. My first book was about Asian nuclear proliferation, a subject of concern here today. I spent the 1970s at Hudson Institute primarily as a consultant to the Department of Defense and other U.S. government organizations on issues of diplomacy and security in Asia. I have risked my career and life in support of human rights, the subject of greatest concern here today. So I intend to speak about American interests, not just American business interests.

Since June 1989, the U.S. has accumulated a broad range of grievances against China: 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. Chinese actions inflame American human rights sensitivities; worsen the U.S. trade deficit at a time when concern about that serious problem is heightened by recession; and endanger U.S. arms control efforts just when America has engaged in a war which it hoped would reduce Middle East tension and proliferation of dangerous weapons.

The timing of China's actions has exacerbated Washington's antagonism, and the range of China's actions has created against itself a broad and improbable Washington coalition of those concerned about human rights, arms control, and fair trade. The range of those antagonized by China's actions includes 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. They demand an effective response. Nothing said in this paper is intended to minimize the grievances or to deny the need for effective American responses. At issue is not the need for a response but rather which tools will achieve the most effective response.

Frustration with China's failure to respond adequately and promptly to American concerns has led a broad Congressional coalition to seek a single powerful weapon to express the depth of American frustration, and depriving China of Most Favored Nation trading status has appeared to be the only weapon of appropriate magnitude. While it may be of appropriate magnitude, it is aimed in the wrong direction.

Depriving China of Most Favored Nation status will have the following consequences. On

the positive side, it will allow us to express our frustrations with China in a very dramatic manner. On the negative side: It 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, recently our strongest wartime ally, 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

Depriving China of MFN status will primarily damage America's friends. It will devastate Hong Kong at a moment when that territory is particularly vulnerable. It will set back Taiwan's economic adjustment program. And it will seriously damage those in China who are most friendly to American policies.

Hong Kong is the last stable outpost of thoroughgoing Western liberalism in developing Asia. (Singapore's severe restrictions on the press and the Philippines' instability eliminate them as competitors. In fact, Singaporean political leader Lee Kwan Yew taunts Hong Kong as the last outpost of Western systems in Asia.) Hong Kong's living standards and standards of freedom are the highest in Asia outside Japan. But Hong Kong is territorially and economically part of China, and the MFN weapon is directed primarily at Hong Kong.

Hong Kong's manufacturing is done primarily in China. Hong Kong firms employ only 800,000 workers in Hong Kong as compared with at least two million inside China proper. (Some estimates run as high as four million.) Likewise, Hong Kong is the international financial capital of China. Bank of China employs more people in Hong Kong than in China proper and the rest of the world combined. One dollar out of every six of Hong Kong's currency circulates in China's Guangdong Province rather than in Hong Kong itself. Because Hong Kong is China's primary trade, foreign exchange, and technology window, the burden of U.S. denial of MFN status to China falls disproportionately on Hong Kong.

The easiest way to visualize the impact of MFN withdrawal on Hong Kong is to realize that it imposes 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.¹ 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.

It is a great irony that some draft anti-MFN bills require China to honor its commitments to Hong Kong (so far it has honored them impeccably), but creates a U.S. threat to Hong Kong far greater than anything which has been feared from Beijing.

U.S. Interests in Hong Kong. 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)² 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. 900 U.S. businesses located in Hong Kong have invested US\$7.1 billion there, equivalent to 31 percent of all foreign investment in Hong Kong, and U.S. financial institutions have US\$37.7 billion of assets there. 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. It is also an affront to a major ally, Britain; both last year and this, Britain's Prime Minister has written to President Bush to express Britain's concern that the U.S. would consider a policy which would have such a devastating effect on Britain's efforts to ensure the continued stability and prosperity of its territory.

Taiwan will not be as badly hurt as Hong Kong, but will be injured significantly. Taiwan has been undergoing a major adjustment. Higher wage costs stimulated by democratization

¹ The second order consequences are estimated in Miron Mushkat, "Is She Out of Favor? The Question of China's Most Favored Nation Status," Baring Securities, Hong Kong, May, 1991, p. 10. All other figures come from official Hong Kong government publications. It is not generally realized that these widely quoted government estimates do not include second and third order effects and therefore could drastically underestimate the consequences.

² Hong Kong Trade Department, "The United States and Hong Kong," (draft), p. 2

and higher exchange rates pressed by the U.S. have made much of Taiwan's low tech industry uncompetitive. (In U.S. dollar terms, wages rose 90 percent in two years.) The primary means of adjustment for low tech industry has been a move to the coast of China. 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 loss of MFN. The textile, furniture, assembly, and electronic assembly industries will also be damaged. Senior Taiwan officials have expressed their concern about the negative consequences of China's loss of MFN status.

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 China is not homogeneous, and 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. MFN deprivation by itself will do grievous damage to progress in improving human dignity in China.

The core of China's export economy is several coastal provinces, most notably Guangdong Province adjacent to Hong Kong, Fukien opposite Taiwan, and the Shanghai area. Guangdong has the population of France. Its people speak mainly Cantonese, whereas Beijing's language is Mandarin. (When they can get away with it, local Guangdong officials often pretend to visitors from Beijing that they cannot speak Mandarin.) Workers in Guangdong earn 60 percent more than China's average -- a difference that makes them inhabitants of a different world from the people of the interior.³ In Guangdong, as in the other high-growth coastal provinces, there is far greater freedom of speech and movement; people watch Hong Kong television and listen to Hong Kong radio. Large numbers of people move to and from Hong Kong, and communicate to their province-mates the reality of life outside China. As in the other 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.

So great are the differences between conservative Beijing and the relatively liberal coastal areas that papers sponsored by the Joint Economic Committee of the U.S. Congress have spoken of "Two Chinas." So intense is the competition between the exponents of the two approaches that testimony to the same committee has warned of the danger of "structural

³ Workers' 1988 annual per capita income in Guangdong was 1600 yuan compared with 1024 for China's overall average. Source: State Statistical Bureau, "China's Social Statistics--1990."

immobilization."⁴

Beijing is fearful of the coastal provinces' increasing autonomy and determined to get them back under firmer control through political and 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. After the Cultural Revolution and the Tiananmen Square repression, ideological appeals no longer mobilize much support. They must therefore fall back on pocketbook issues. But, with a worsening drain from state enterprise deficits, the only way they can put more money in people's pockets is through liberal reforms. As Premier Li Peng's last major review of the economy made clear, the conservatives have no theory of economic victory. Piecemeal and rapid, but inadequate, acceptance by the conservatives of liberal reforms in the last six months underlines the conservatives' plight.

Conversely, the reformists' appeal is broad and getting broader. They are delivering higher living standards, they have delivered some of the highest rates of growth in world history, and they have spread the benefits around so as to create a broad base of support for further reform. The recent elevations of Shanghai Mayor Zhu 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; subsequently 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. While the leading conservatives have acquiesced in much of this approach, these measures will ultimately destroy the tight economic, social and political control which is the essence of the conservatives' political program.

⁴ Joint Economic Committee, Congress of the United States, "China's Economic Dilemmas in the 1990s: The Problems of Reforms, Modernization, and Interdependence," Volume I, pp. 13, 16. I do not mean to suggest that all of China's reformers are on the coast or that all important officials in Beijing are conservative. But a reformist society has been created along the coast with two characteristics: Structural changes caused by economic development make life freer and better than in the interior regardless of official policy. And reformist success has reached a critical mass that would require massive force to reverse.

In the struggle between the old-line conservatives of Beijing on one hand and the youth and coastal reformists on the other, depriving China of MFN status would cripple the liberals. It would devastate the economies of the reformist coastal provinces, weakening their political base and exposing them to the accusation that their policies make China vulnerable to foreign manipulation.

Some supporters of MFN deprivation believe that these 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 provide the only available opportunity to argue that the liberals' case is even weaker than their own. More important, it would deliver to the ultra-conservatives 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.

There is ample precedent in China for well-meaning liberals to entrench the conservatives in power. Former Communist Party Secretary General Hu Yaobang fell when liberal political movements prematurely challenged the right of the establishment to rule. The current repressive conservatism in Beijing achieved power only because the gathering of a million dissident students in Tiananmen Square gave conservatives an argument that the stability of China was endangered. Liberal General Secretary Zhao Ziyang cried openly when the students refused to disperse, because he understood what the consequences would be. Deprivation of MFN would hand the conservatives an equally potent argument that further liberalization will put Chinese sovereignty at risk.

Advocates of MFN deprivation may feel like the strongest opponents of China's repressive conservatives. But the anti-MFN bills give China's ultra-conservatives the only issue that could sustain them in power and offers the return to isolation that some of them seek but cannot advocate openly.

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 in that it suggests some special favor. On the contrary, 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 over 160 countries and territories).⁵ 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.

Hong Kong firms with production in China are among the world's greatest exporters of toys and apparel. Without MFN status, the tariffs on the most important categories of toys would rise from 6.8 percent to 70 percent. The tariffs on most categories of apparel rise to 90 percent. These numbers constitute expulsion from the system.

Similarly, 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. This thrust arises from the breadth of demands made as well as from specific points made in the bills. Most notably, one anti-MFN bill refers in four different paragraphs to Tibet as if it were a separate political entity from China. But even without the references to Tibet, the thrust of the sweeping demands is a general condemnation of China and expulsion of it from the international system.

Does the U.S. Congress really want to dismember China? 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.

⁵ Countries now denied MFN status are Afghanistan, Albania, Cambodia, Cuba, Laos, Mongolia, Romania, the USSR, and Vietnam. Source: U.S. Consulate in Hong Kong, citing an official document dated May 15, 1991.

China As A Member of the International System

There is a widespread image that, after June 4, 1989, China reverted completely to the bad old days when it was a rogue international actor, an autarky, and a totalitarian polity. While China's violations of trade rules, human rights standards, and U.S. arms control standards are important, and in the case of Tiananmen Square detestable, they do not constitute the kind of reversion that this image implies.

China and the International Political Order. Prior to 1972, China believed that international disorder served its interests; was actively subverting the governments of many countries in Southeast Asia and elsewhere; had such a hostile relationship with the Soviet Union that military clashes had occurred and the Soviet Union had been tempted into preemptive nuclear strikes; maintained a hostile relationship with Japan; sided automatically with an aggressive North Korea; was aggressively hostile toward Taiwan; and automatically voted against the United States on any United Nations resolution pitting the U.S. against a radical third world country.

Suppose that in February, 1972, either Richard Nixon or Henry Kissinger had predicted that by 1991 Chinese foreign policy would have the following central thrusts. It would be at peace with all its neighbors. It would have succeeded in rapprochement with the Soviet Union and developed a highly cooperative relationship with Japan. It would be a primary force for peace between North and South Korea, would be looking to South Korea's economic policies as a mentor for China, and would be rapidly expanding trade with South Korea. It would be welcoming visits by senior officials from Taiwan, as well as hundreds of thousands of tourist visits from that territory, would give preferential treatment to land ownership by Taiwanese, would accept a Taiwanese foundation as the legal interlocutor on trade, and would be attracting Taiwanese investments at a rate in the neighborhood of US\$100 million per month. And it would accede, in the face of its most dearly held anti-imperialist principles, to U.N. Security Council authorization of a U.S.-led war on Iraq. Had Kissinger or Nixon made such a prediction, it would have been dismissed as self-serving utopian nonsense.

Today that "utopia" is reality. Since we welcomed it into the system, China has become a predominantly cooperative force, a supporter of stability in world politics. While Chinese nuclear reactor and arms sales are serious issues, they represent a qualification to the underlying foundation of Chinese cooperation. American interests require us to act against Chinese proliferation of nuclear and missile technologies--just as we did when France and West Germany far more seriously violated our non-proliferation policies. But far more important American interests require that we act with targeted sanctions and incentives that do not jeopardize China's role as a basically cooperative and constructive participant in international society.

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

after 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.N. 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 percent, the U.S. 16.4 percent, Japan 27 percent, and China 26.1 percent. In 1990, China's trade rose to 32.4 percent of GNP.⁶ While there

⁶ The 1989 data for China, Brazil, the U.S. and Japan are from IMF, *International Financial Statistics* (1990 Yearbook). Data for Soviet trade are from IMF, *Direction of Trade Statistics* (1990 Yearbook) and for Soviet GNP a CIA study which gives Soviet GNP as \$2.5 trillion. 1990 China figures are from the U.S. Consulate in Hong Kong (exports \$61 billion; imports \$59 billion; GNP 1772 billion yuan, which at an exchange rate of 4.7832 equals \$370.46 billion). The latter exchange rate is the average 1990 exchange rate as specified in *International Financial Statistics* (March 1991).

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.⁷

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.⁸

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. 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-

⁷ I am indebted to Prof. Nicholas Lardy for this observation. See his "Redefining U.S.-China Economic Relations," National Bureau of Asian and Soviet Research (June 1991)

⁸ China's 1990 tax revenue was 54 billion dollars out of a GNP of 334 billion dollars. U.S. government revenue was \$1094.9 out of GNP of \$5,463.3 billion. This is based on U.S. Consulate in Hong Kong calculations derived from China's State Statistical Bureau Annual Report and from the 1990 report of the Minister of Finance. The Consulate uses a foreign exchange rate of 5.209 renmenbi per dollar.

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.⁹

The story of China's continuing economic reforms is virtually unreported in the U.S. It is startling to return to this country and 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 economic 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, that has 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 political system--notwithstanding that serious problems, including its trade deficit with us, remain.

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.

⁹ For further details of China's financial reforms, see William H. Overholt, "The Emergence of Chinese Financial Markets," *Asian Survey* (May 1991).

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. 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;¹⁰ (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. Unlike the areas of strategic behavior and economic reform, one cannot argue that Beijing's recent policies have been predominantly in the right direction. Abuses have become both deeper and more extensive.

¹⁰ As this is being written, a spate of articles has appeared based on Washington criticism of China for trying to expand its exports by devaluing its currency. While it is true that China has devalued its currency several times, the currency is still overvalued and therefore on balance a deterrent to exports. It would be complete hypocrisy to criticize China for moving closer to market-level exchange rates. The real issue is whether China will, as promised, eliminate its export subsidies and refrain from using exchange controls for protectionist purposes.

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 and 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 that their official Chinese government hosts begin 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. Ordinary Beijing citizens quickly pour out their bitterness about Tiananmen Square and tell the visitor juicy anecdotes. The **Asian Wall Street Journal** (probably the most anti-Chinese of the world's major newspapers) and CNN are available in the major hotels, and any Chinese who has Foreign Exchange Certificates (which includes almost any of the millions who have learned enough English to make use of English media) can get access; both the **Journal** and CNN, incidentally, are banned in Singapore. This is not to say that China has become a bastion of freedom of speech; it is to say that there has been remarkable improvement in a bad situation.

Part of the reason for this change is the relative benevolence of some Chinese leaders before Tiananmen Square. But the primary reason is structural; this is why greater freedom has persisted even under a leadership hostile to human liberties. 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. Along the coast, tens of millions of Chinese have access to foreign broadcasts, and, unlike before, they have radios; they have the money to afford radios, and China's more dynamic economy now produces plenty of radios. In Guangdong, people have televisions which receive Hong Kong television and they see Western images including videos of Tiananmen Square.

The Communist Party no longer monopolizes control 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 now 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.

The dynamics of the relationship between economic opening and social liberalization are powerful beyond what Americans could ever have imagined in 1972, when we began to encourage the 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 the 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, 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.

This progress is inexorable. It has changed China from a totalitarian society where the state controls virtually all thought and action into an authoritarian society where, despite chilling human rights abuses, most people have substantial space, legal or illegal, in which to form relationships, receive information, form and express opinions, and make a wide range of personal choices. So long as the economic progress continues, Beijing's leaders cannot reverse or halt this change. Even while government policy has regressed, the enhancement of freedom caused by changes in social structure has moved forward.

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. These can be stopped only when national trauma has left the population in thrall to a totalitarian ideology -- a situation China's population has experienced and put behind it. These forces will lead any nation down the slippery slope of liberalization--not quickly but inexorably over several generations.

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. While Americans rightly reject the narrow Marxist equation of human rights with having a job, and job security, at the price of political repression, it is equally narrow-minded to focus exclusively on political rights when families live on the edge of subsistence.

In the mid-1980s, a World Bank study showed that over 100 million Chinese had incomes of less than US\$30 per year.¹¹ In other words, a person had to live for a year for about the amount many people in this hearing will spend on a restaurant dinner tonight. 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. Measures to deal with the regressions are urgent necessities, but expulsion of China from the international economic and political system would thoughtlessly jeopardize past gains.

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 available. 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

¹¹ Unskilled workers in foreign firms, a relatively privileged class, start as low as RMB 100 (US\$20.90) per month. See "PRC Labor in Brief," *Business China* (April 15, 1991), p. 52

subject to IAEA inspection.¹² Prison labor exports appear to reflect local entrepreneurship rather than national policy, although there has been national level connivance, and officials promise that the infractions will be corrected. 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. Travel and emigration from China are much more extensive than from the Soviet Union. Of course, it will take careful verification of real progress to determine whether such preliminary indications are valid. And even if these indications are valid, they show only that progress is possible if the U.S. takes firm measures.

Our military has recently demonstrated the enormous benefits of smart bombs, which reliably hit the precise target at which they are aimed and minimize damage to civilians and the general environment. 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.

¹² Although IAEA inspection is an important first step that should rule out weapons production, very serious concern remains as the reactor does not seem configured properly for either power or research, creating suspicion as to its intended use.