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Cures that Kill

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A Crisis of Faith

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Beyond Bush

Chas Freeman • Zha Xiaogang • Niu Jitao



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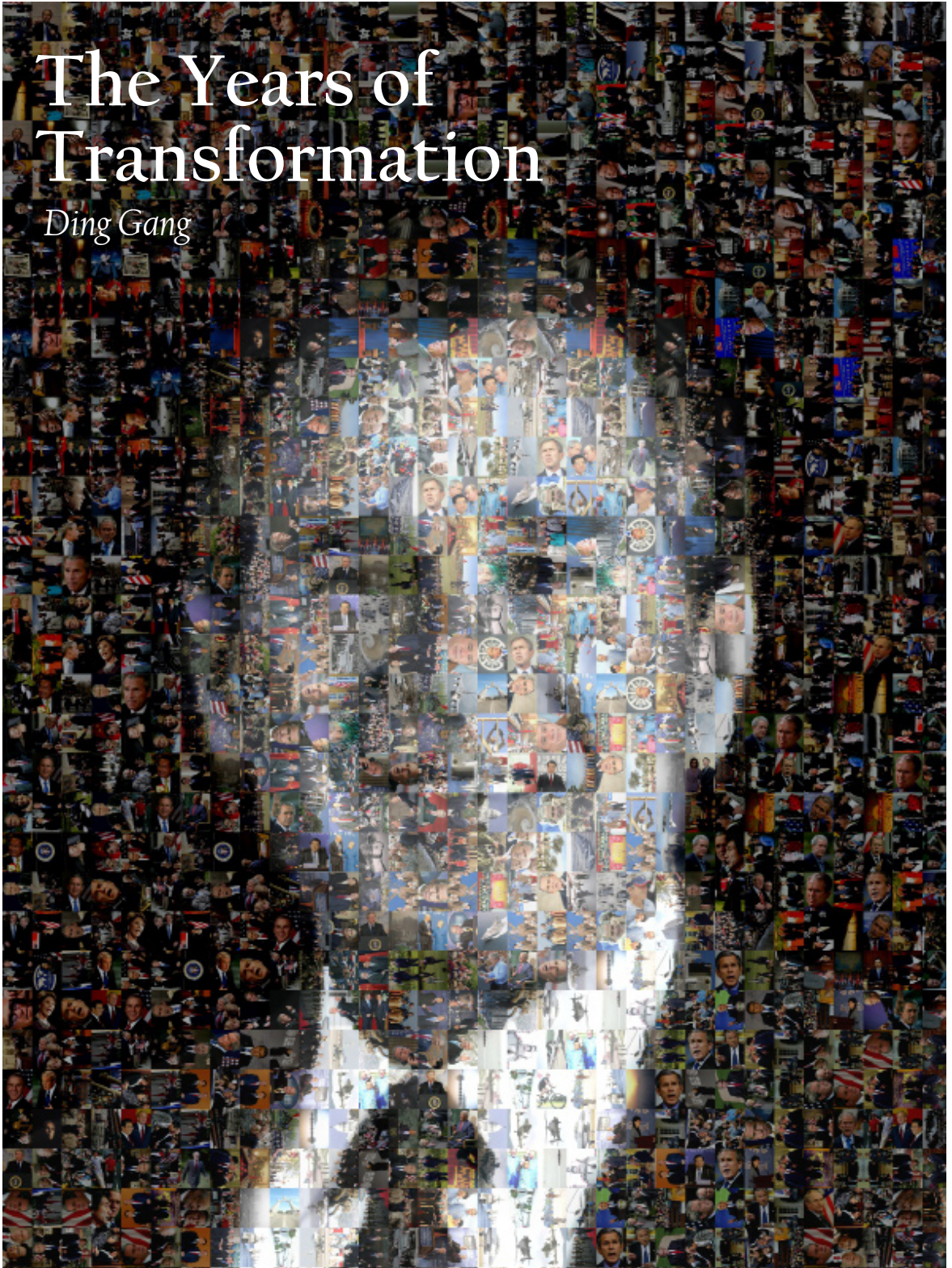
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The Years of Transformation

Ding Gang



While most of the world is celebrating the end of the Bush presidency, and looking forward to an Obama-led America, China feels some uncertainty. Simply put, things weren't that bad for China with Bush at the helm. Under Bush, the United States awoke to the realization that China must be engaged with cooperation, not competition. When American constituents and other foreign governments sought to reprimand and isolate China, the White House tempered its criticisms and, instead, actively engaged Beijing in many areas, such as the Six Party Talks with North Korea.

When assessing Chinese-American relations during the eight-year tenure of President George W. Bush, 2002 is the key to understanding the dramatic shift that occurred in US-China relations.

The outlook wasn't so rosy in the beginning. Shortly after coming to office, Bush declared that he would "do whatever it took to help Taiwan defend herself" – strong words that suggested the abandonment of the United States' strategic ambiguity on the Taiwan issue. Worse, the incendiary comments came on the heels of a collision between a US EP-3 spy plane and a Chinese fighter jet. The back-to-back incidents caused a diplomatic fallout as relations soured: Military contacts were discontinued, harsh words were exchanged, and a combative relationship looked to be on the horizon. Of course, September 11th changed all that.

The September 11th terrorist attacks spurred the most significant readjustment in American global strategy since the end of the Cold War. Anti-terrorism took priority over all other national threats. This shift in global strategy brought with it change to Chinese-American relations. As Washington sought Chinese cooperation in the war on ter-

ror, the United States began to realize that China was not its enemy, at least for the foreseeable future.

Since then, the two countries have experienced an unprecedented level of stability in their relationship, a condition that persists today. 2002 came to be known as the best year for Chinese-American relations since 1972 and an equally significant turning point.

Of course, this sea change in America's strategic outlook is only one side of the story. It takes two to tango and China changed as well, partly out of coincidence and partly due to conscious effort. It was during this period that China's economy shrugged off the effects of the Asian Financial Crisis and reentered a fast track of development. In 2002, China's GDP exceeded RMB10 trillion for the first time, registering a year-on-year growth rate of 8%. As China's economy grew, so did its clout around the world. While 9/11 certainly proved instrumental in pushing the United States and China together, it can be argued that it was just a matter of time before the Bush Administration adjusted its China policies - in fact, it had little choice as China's rapid development all but guaranteed its emergence as a global power.

In 2002, the two countries had three high-level meetings: President Bush's visit to China and visits to the United States by President Jiang Zemin and Vice President Hu Jintao. These high-level visits may not have achieved any earth-shaking results, but they symbolized the emerging partnership between the two countries. Most importantly, they will have inestimable far-reaching significance for the development of Chinese-American relations in the years to come.

The shift was also felt in the US Congress, especially on the critical issue of Taiwan. In 2002, the number of congress-

sional visits to Taiwan decreased to 9, compared to 25 for the Chinese mainland. This showed that not only had the Bush administration's policy changed, but the US Congress had also tilted its focus toward Beijing.

Of course, that year was not all positive, as the US Department of Defense submitted to Congress its annual report on China's military power, which stressed a number of worrisome aspects of the Chinese military and their growing ability to achieve cross-strait unification by armed force. Moreover, the critical US-China Security Review Commission of Congress issued its first annual report that year, warning that China's rapid economic and strategic developments posed a threat. It argued for a tough stance toward China to ensure its compliance with trade laws and to prevent the spread of weapons of mass destruction. To China, it was nothing short of a re-emergence of the "China Threat Theory."

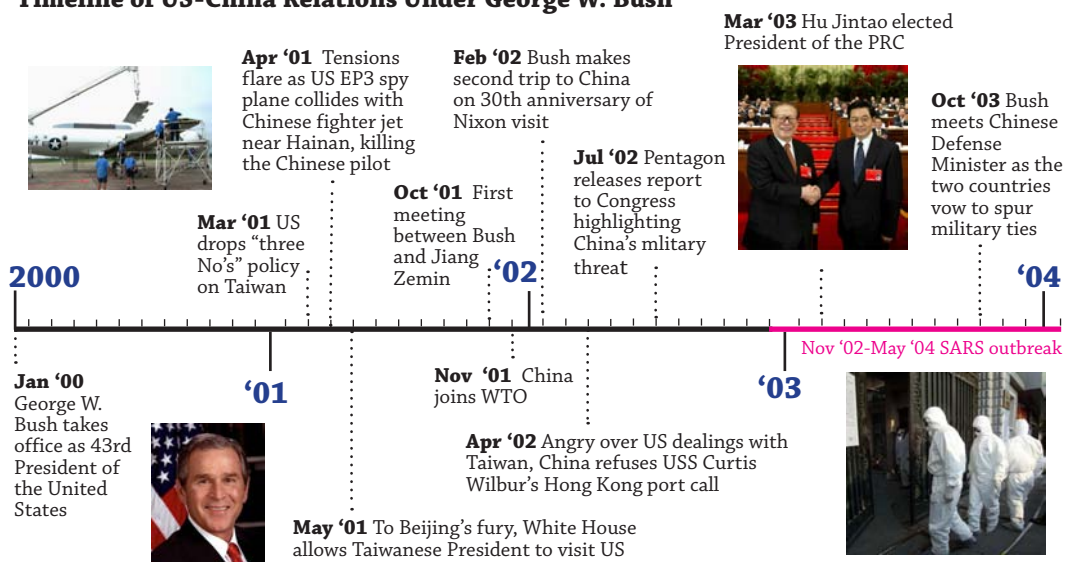
Fortunately, these incidents didn't have a significant, destabilizing impact on cross-Pacific relations, thanks to the US-China partnership, newly forged

by the Bush Administration. It was this fundamental change in the American approach to China in combination with China's correct understanding of this transformation that led to continued development and even further expansion of Chinese-American relations in the subsequent years. It was also thanks to this change in vision that the Bush administration and the United States earned the favor of the Chinese government and people.

Looking back at US-China relations during the Bush era, many people may have concerns over whether the stability enjoyed since 2002 can be sustained. There is certainly cause for concern. For instance, the United States is likely to enter a recession following the current financial crisis, which could spawn isolationism and protectionism, straining the relationship.

There is also uncertainty over how a new president, Barack Obama, will take over the mantle of Bush's positive approach toward China. Will his mantra of "change" mean another significant read-

Timeline of US-China Relations Under George W. Bush



justment in bilateral relations? These are relative unknowns, and while there will certainly be some refashioning, as there always is with a new administration, I don't believe any major shift will occur. The primary reason is that 2002 was more than a good year for the bilateral relations. Rather, it was a historical turning point that recast many of the basic principles of the relationship, reinforcing the mutual need both countries have for each other. Those transformations are largely irreversible. For instance, dialogue between the two nations now spans many levels from economics and trade to nonproliferation and military issues. The question of whom to talk to in the event of a crisis - from a financial meltdown to an EP-3 like incident - is no longer an issue.

Underlying these shifts is the change in how each perceives the other and the shortened distance in respect and understanding at a cultural and even human level. An internet search on US-China relations produces the following three top results: "Yao Ming," the basketball star, "High-level mutual visits," and

"China's economy." The last two reveal the intensive diplomatic and economic interaction that characterizes the relationship today. More significantly, the larger-than-life popularity of Yao Ming as sports hero and cultural icon shows that China's soft power is expanding, bringing with it greater mutual respect.

As Winston Lord, former US ambassador to China, once said to me in early 2002, "The Chinese-American relationship is a very complicated one. We should not be too optimistic when it is plain sailing, and neither should we be too pessimistic when it encounters a problem." Viewed cynically, these words could mean improving the relation will be very difficult, but on the flipside, it means neither side can bear a breakdown. In the years since 2002, the latter view has grown increasingly prominent as the United States and China work together to find solutions to global problems, from the financial crisis to climate change. The cooperative mechanisms that have been built up since 2002 should make the road a little easier. ☺

Ding Gang is Senior Adviser to the Global Times.



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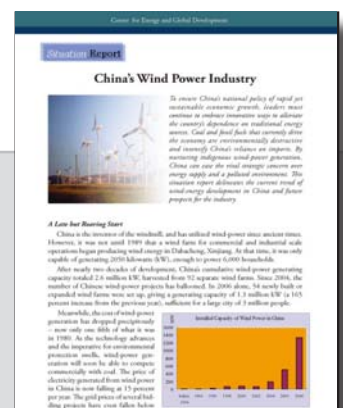
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Looking Beyond Bush

Three experts look at what is next in military, economic and environmental relations between the United States and China

Military Relations

Chas Freeman

The military relationship is the least developed and most troubled aspect of US-China relations. The fact that the two militaries have not normalized their relations or developed any depth of mutual understanding and confidence is worrisome. Each now is predisposed to believe the worst of the other's intentions and to mirror every aggressive move made by the other. Under this veil of suspicion, it would be all too easy for the US and China to stumble into military disaster in Korea, should various contingencies break out; in the Taiwan

Strait; or, as the EP3 incident illustrated at the outset of the George W. Bush presidency, elsewhere along China's borders. Despite efforts during both the Clinton and Bush administrations to increase military exchanges, mil-to-mil relations have not come close to their pre-1989 levels. The overall relationship between the two militaries remains tinged with hostility born of mutual ignorance. Institutional linkages are nearly non-existent and exchanges tend to be more ceremonial and touristic than substantive. Relations between the US Pacific

Command (PACOM) and the PLA are rudimentary, while other US regional command structures that currently or potentially rub up against the PLA have no relationship whatsoever with China's military leaders. It is not clear how they would handle an incident outside the PACOM area of responsibility, say in Central Asia or Russia. In early 2007, the two sides showed the inadequacy of



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their dialog about matters in space when China shot down a satellite in low earth orbit. Given the power of the two countries and their increasing interaction along China's borders, in its near seas, and above its atmosphere, both Washington and Beijing have a vital interest in rectifying the situation.

In a small step towards better communication, a crisis hotline between the two countries was opened earlier this year during Defense Secretary Robert Gates's visit to Beijing. But such communication cannot be effective if those communicating with each other do not know each other and do not trust that their counterparts are professionally competent, honorable and trustworthy. The presence of military officers from Taiwan at US military academies and staff colleges precludes attendance by officers from the PLA. This leaves few opportunities for the military leaders of the future on both sides to get to know each other. The absence of exercises on subjects of common concern, like terrorism, piracy, humanitarian relief or peacekeeping operations means that the two militaries do not have a chance to familiarize each other with their respective doctrines and operational practices. It is too early to say what the Obama administration's approach toward China or

the PLA will be, but the president-elect does seem to favor dialog with nations with which the United States has real or imagined differences on national security issues. The populist wing of the Republican Party, ascendant for the past eight years was, by contrast, deeply suspicious of China and reluctant to engage the PLA. President-elect Obama does not know China first hand and does not have much of a record on China issues. Given the many very serious problems the current administration is bequeathing to him, and the generally satisfactory nature of US-China ties relative to relations with others, he is not likely to see the US-China relationship as requiring major attention, barring crisis. To protect himself in contingencies, however, President Obama would be wise to develop a positive agenda for specific programs of US-China cooperation in the military sphere. Since 1993, when the United States and China reestablished military dialog after a four year break following China's suppression of the student uprising in Tiananmen, there has been an obvious agenda for such cooperation. It includes exchanges at all levels, visits by ships and aircraft, and training and exercises in search and rescue, disaster relief, peacekeeping and anti-piracy operations. The implementation of this

agenda has been interrupted by serious incidents between the two countries (like the EP-3 incident off Hainan Island and the bombing of the Chinese embassy in Belgrade) as well as by differences over the Taiwan issue. The Obama administration should make a serious effort to advance the agenda and insulate it from the vagaries of politics.

The PLA's modernization over the past decade has been impressive. This is the fruit of a notably single-minded focus on Taiwan contingencies. The PLA's capabilities are now clearly sufficient to deter Taiwan from provocative movement in the direction of independence. Chinese army building has also played a role in compelling Taipei to move toward the accommodation of Chinese across the Strait. However, in many respects, China remains poorly prepared to defend its territory as a whole. The Chinese army is mostly unmechanized, and it has little ability to move troops to China's borders with the speed that would be required to deal with a major incident. PLA training budgets for high tech weaponry have increased but remain inadequate. The Chinese military's educational level has improved but remains relatively low. The PLA leadership is acutely aware of the many challenges it faces in achieving modernization for defense. If misunderstandings are to be avoided, it will be important for the Obama administration to initiate a dialog with the PLA about its modernization priorities, as its Taiwan-related build-up shifts into lower gear. If the two sides of the Strait can incrementally reduce tensions and build cooperation, it will be difficult to imagine anything that might cause a military clash between the United States and China. Korean, South Asian, and Central Asian contingencies are not difficult to deconflict with improved communication. In some cases, the United States and China share interests in these regions and

might be able to cooperate. But I do not see the basis for anything but limited Sino-American military cooperation, and only in a small set of limited circumstances, for short periods of time. The United States and China are not and will not become allies, but we can cooperate to mutual advantage when this serves our mutual interests. Opening the way to such entente and engagement in support of common objectives is a worthy and achievable objective for a less ideological and more realistic US leadership.

Chas Freeman is a former US Ambassador to Saudi Arabia and Assistant Secretary of Defense for International Security Affairs. He is currently the co-chair of the US China Policy Foundation.

China's Economic Wishlist

Zha Xiaogang

While the United States has suffered the most severe financial turbulence since World War II, China has protected American financial stability by continuously purchasing its treasury bonds. China bought treasury bonds worth US\$ 43.6 billion in September, nearly double the amount it purchased the month before. While it is true that China did this partly for its own benefit, it is undeniable that America is in great need of such help at this difficult moment and Americans should not be quick to forget that China lent Uncle Sam a hand.

When President Obama takes power, China has a wishlist of specific "changes" it would like to see.

First, China wants to see the United States substantially loosen restrictions on technology transfer. Currently, high technologies occupy a very small percentage of the trade between the two countries. With the sharp sword of export control hanging over this sector, many enterprises do not even bother

going to the Department of Commerce to apply for a transfer license, knowing that their request has no chance of approval. This policy not only harms China but also impedes the economic restructuring of the United States. If the new administration continues the old policy of constraining technology transfer, it will eliminate its own companies' chances of getting a slice of the pie in China's new economic stimulus package.

The second item high on China's wish list is for the United States to uphold a disciplined financial and monetary policy. Washington should no longer expect China to stand at the receiving end, buying treasury bonds despite great fluctuations in the value of the dollar. As China holds the largest amount of American debt, it is natural for it to be concerned about the value of its holdings. The US dollar is the strongest world currency, which puts the United States in a position of great financial power. But with great power comes great responsibility. All nations, including China, expect Washington to carry out sound monetary policy to avoid the drastic weakening of the greenback. As America's largest creditor, China will expect the United States to exhaust every means to protect the safety of its investments. Otherwise, the Chinese public will voice their objection loudly and exert great pressure on Beijing to reverse the policy, even if that might harm China's own interests in the short run.

Furthermore, the new US administration should open doors to Chinese investment. Although there is no written

prohibition of Chinese companies merging with, or acquiring American companies, Chinese investors have certainly felt unwelcome. Many companies are interested in acquiring US ventures in hi-tech and energy sectors; however, their overtures have encountered all kinds of obstacles, many of which have been unreasonable. The US needs to lower the protectionist barriers and welcome China's investment with an open door. It is a win-win solution and will greatly benefit both countries' economic futures.

The new president should also continue to strengthen existing dialogue mechanisms with China, especially the Strategic Economic Dialogue (SED). The SED provides a valuable platform for the two countries' economic leaders to



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deepen their understanding and mutual trust. It has contributed greatly and effectively to the stable economic relationship China and the US have enjoyed in the past several years despite major differences in domestic structures. One of the SED's major achievements is the Ten Year Energy and Environment Cooperation Framework. This framework provides a great opportunity to expand the export of US technology related to environmental protection, which could be another engine for balancing the US trade deficit with China. Moreover, the SED can become a forum for discussing all the issues on China's wish list. The two sides have no shortage of differences to work out, but they lack channels and platforms like the SED that can bring leaders to the discussion table.

My only criticism of SED is that Chi-

na could have taken more initiatives on this platform and the United States could have made more concessions. The US policy-makers have to answer to partisan interests and occasionally strong sentiments of protectionism. China understands the political reality in Washington. A stable world economy, particularly a stable US economy, is essential for China's own development. China is willing to coordinate and adjust its policy in order to help the United States help itself.

China always hopes to build a just, fair and representative international financial system. But it understands that the process must have a beginning and then move step by step. So it is willing to support the IMF and World Bank as well as the current international financial structure. China hopes the emerging economy will strengthen their influence in these international financial organizations, ranging from agenda setting, to the development of conditions for aid policy. It does not intend to challenge the United States or drag the IMF into endless fights, but does hope to increase its current representation in the IMF.

Finally, I do not think the Obama Administration will bring up the re-valuation of the renminbi again. Otherwise, I will completely lose faith in the president-elect's ability to navigate US-China economic relations. China has done its duty by increasing its currency's exchange rate to the dollar from 8.3 to 6.85. In doing so, China bore a great economic and political risks, most notably increased unemployment and resultant growth in the country's migrant labor population. As Mr. Paulson mentioned many times, the threat facing the United States is not an economically successful China but a failed one. It is not in US interests to try to push China further. The US-China economic relationship is a life-and-death issue for the United

States, especially in this time of crisis. That is why China's wish list should find its way to the top of President Obama's agenda as early as possible.

Zha Xiaogang is a researcher at the Department of World Economic Studies at the Shanghai Institute for International Studies.

Going Green

Niu Jitao

On November 4th, Senator Barack Obama won a decisive victory in the US presidential election, opening a new chapter in American politics. With Democrats set to assume power in both the White House and Congress, the United States appears ready to part ways with the policies of the Bush years. The Democrats, however, should not expect smooth sailing. The US financial system is battered by the fallout from the sub-prime crisis, Iraq continues to stretch the military and national budget beyond capacity, and the US image as a responsible world leader is at its worst in decades. It would seem the environment would represent the least of the new President's worries, but now is a critical time to put energy and environment at the center of the US national agenda. By prioritizing Green, the Obama administration can stabilize the economy and redeem its image as a responsible global leader. This also presents a great opportunity for China and the United States to jointly explore solutions to environmental problems, bringing the two countries' economies and governments into a closer partnership.

The Obama campaign's platform on Energy and Environment is the cornerstone of his strategy to free America from its dependence on fossil fuels. His plan calls for the United States to invest \$150 billion over ten years in renewable energy, implement an economy wide cap-and-trade program and re-en-

gage in UN climate talks. Though the new energy plan's \$150 billion price tag has caused critics to question whether Obama can maintain his commitment to such a costly program in the midst of a worsening financial crisis, it incorporates income-generating mechanisms that would offset most, if not all of the costs associated with making America green.

As a starting point, the Obama plan calls for an economy wide cap-and-trade program that will encourage enterprises to find innovative and efficient ways to cut greenhouse gas emissions. With strong support from the new administration the bill seems likely to be passed by the end of 2009. The revenue generated through the cap-and-trade program will fund the \$150 billion investment in green technology, spread over ten years and thus would be self sustaining.

A greater challenge for Obama will be ensuring that climate protection and energy efficiency initiatives at home will proceed in tandem with substantial commitments from developing countries, most importantly China. Obama said as much when he declared that climate change was a "common challenge" that had seen little progress. "For too long [the United States and China] have pointed a finger at the other's attitudes as an excuse for not itself doing more," he wrote this September in an essay for the American Chamber for Commerce in China. Indeed, the US rejection of the '97 Kyoto Protocol and the failure of the UN-sponsored 2007 Bali climate change conference can be partially blamed on the inability of the United States and China to come to an agreement on each country's responsibilities towards addressing climate change.

Energy and climate change will likely be the defining issue of China US relations for years to come. As the United



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States and China account for almost half of the world's energy use and greenhouse gases emissions, both countries have high stakes in pushing forward an energy revolution to address energy security and climate change. In the area of greenhouse emissions, both countries must reduce their reliance on coal, which accounts for 78 percent of electricity production in China and 50 percent in the United States. Similarly, both countries face enormous challenges in the transportation sector as America accounts for 25 percent of world's oil consumption, more than 60 percent of which is used for transportation. Meanwhile, the International Energy Agency predicts that car ownership in China will rise from the current 50 million to 270 million by 2030. A February 2008 *Science* policy brief cautioned that by 2030, China's CO₂ emissions will reach eight gigatons a year – equaling the entire world's today – given current rates of growth.

Although China has clearly been reticent in addressing climate change, it has also made strides to improve. Chinese officials have, in recent years, been acting like climate change converts. Facing constant energy shortages and environmental degradation, the government has set an ambitious efficiency target to cut energy use per unit of GDP by 20 percent from 2006 to 2010. China will raise the share of renewable energy from 7.5 percent to 15 percent by 2020, and lo-

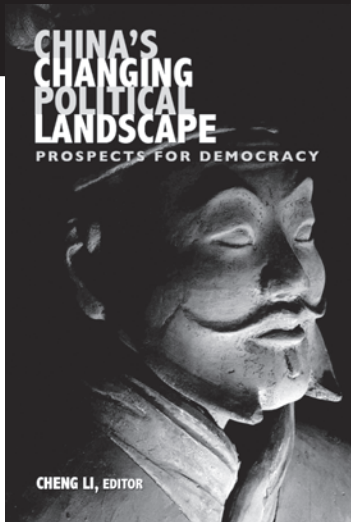
cal government officials will be held accountable if the energy efficiency targets are not met. As a result of these policies, hundreds of small, inefficient coal-fired power plants in China were shut down last year. The shift towards clean energy has encouraged the growth of China's renewable energy technologies: the country's solar PVs topped world production last year and a slew of new wind farm projects have led the Global Wind Energy Council to predict that China could be the world's largest wind power producer by 2020.

The progress of energy and environmental policies on China's end is an effective antidote to the accusation – often lobbied by US politicians – that it is holding up global action on climate change. In fact, a study compiled by a German environmental NGO last year found that

China performed better on climate protection than the United States. The study, which ranked 56 of the world's top CO₂ emitters based on combined index that evaluated emissions trends, levels and the efficacy of its climate policies, placed the United States at 55th, second only to Saudi Arabia. Both the US and China have made recent strides in engaging the climate change, yet both remain massive polluters of the environment. The key, as Obama argued during the campaign, is to recognize that the challenges posed by climate change are global in scope and use this as an opportunity to establish a stronger bilateral partnership. 

Niu Jitao is a Master of Public Administration student at the Harvard Kennedy School of Government. He previously worked for China's Ministry of Foreign Affairs and served as Climate and Energy Campaigner for Green Peace.

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China: Creditor to the Rich

Brad Setser

China's government is now by far the largest creditor of the United States. Never before has a country as poor as China lent so much money to a country as rich as the United States. And never before has the United States relied so heavily on another country's government for financing.

China reports \$1.9 trillion in foreign exchange reserves – roughly two times as much as Japan and four times as much as Russia or Saudi Arabia – the majority of which is denominated in US dollars. This total leaves out the \$200 billion in “other foreign assets” that are on the balance sheets of the People's Bank of China, the \$100 billion or so in foreign assets of China's sovereign wealth fund (the China Investment Corporation) and the roughly \$150 billion in foreign assets managed by China's large state commercial banks. The foreign assets of China's government sum to at least \$2.35 trillion – and could easily rise to around \$2.5 trillion by the end of 2008. That works out to over 50 percent of China's GDP or roughly \$2,000 per Chinese citizen.

The pace of growth of China's foreign assets is nearly as unprecedented as their total size. Over half of China's reserves were added in the last two years – and during

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the last four quarters (q4 2007 to q3 2008) China added around \$700 billion to its foreign assets. That is more than shows up in the official data, as about \$300 billion of the growth came from China's hidden reserves (the PBoC's "other foreign assets" and the CIC). The rise in China's foreign assets during the last four quarters exceeds the combined foreign assets of the world's oil exporting economies over the same period – a period when oil averaged over \$100 a barrel. It also roughly matched the size to the United States' current account deficit. Once China's purchases through London and Hong Kong are taken into account, it is likely that China added around \$400 billion to its dollar portfolio over the last four quarters. By any measure it is a stunning sum.

Managing the RMB

These flows stem directly from China's policy of managing its exchange rate, and more specifically its policy of holding the value of its currency, the renminbi, below its market price. Back when the dollar was appreciating – from say 1995 to 2002 – China didn't have to intervene in the currency market on a huge scale to maintain its peg to the dollar. China's overall trade surplus was modest and inflows of direct investment were offset by other kinds of capital outflows. In 2000, for example, Chi-



1918 Liberty Bond poster by Z.P. Nikolaki. Accessed through the Library of Congress.

na only added \$15 billion to its reserves. But the dollar's course changed in 2002, entering into sustained slump that lasted until early 2008. So long as China pegged to the dollar, the dollar's fall translated directly into a fall in the China's currency. Even after China moved away from a pure dollar peg, the depreciation of the dollar against many currencies – notably the euro – generally exceeded the renminbi's appreciation against the dollar.

Exacerbating these trends were a series of policies including tight fiscal approach and limiting domestic lending by the state banks that restrained domestic demand growth in order to try to offset the inflationary impact of China's depreciated currency. It isn't hard to see why China's trade and current account surplus soared to 11 percent of China's GDP in 2007. One additional factor further complicated the problem. For most of the last year, Chinese interest rates were higher than US interest rates and the renminbi was rising against the dollar. Thus, speculators, not surprisingly, found holding renminbi more attractive than holding dollars with the overall result that far more foreign exchange was coming into China than was going out. The government had to constantly buy up foreign exchange to keep it from sloshing around in the market.

Table 1. Estimated foreign assets of China’s government

	Q3 2008
Fx Reserves (managed by SAFE)	\$1900b
“Other foreign assets” of PBoC (managed by SAFE)	\$210b
State banks	\$150-200b
CIC (excluding assets managed by state banks)	\$100-120b
TOTAL	\$2350-\$2400b

This is how it works: Everyday, the People’s Bank of China buys foreign exchange from China’s state banks. China’s new sovereign wealth fund – the China Investment Corporation – buys some of the foreign exchange from China’s central bank. But most of the foreign exchange is still handed over to China’s State Administration of Foreign Exchange (SAFE) to be invested abroad. SAFE consequently faces a daily challenge to find new assets to add to China’s portfolio. It likely sells some of China’s dollars for other currencies. But it generally uses the dollars it receives from the central bank to buy US bonds. Day after day, it is the single largest buyer of Treasury bonds in the market. And day after day, it is – or perhaps was – the largest buyer of so-called Agency bonds (the bonds of Freddie Mac, Fannie Mae, Ginnie Mae and the Federal Home Loan banks – all initially “Agencies” of the US government).

Obtaining an accurate picture of China’s purchases and its total foreign portfolio is a puzzle. China neither discloses the currency composition of its foreign exchange reserves nor participates in the IMF’s global survey of the currency composition of reserves. The CIC discloses even less information. Piecing together a picture of China’s foreign purchases includes data from the US Treasury data on foreign portfolio investment in US securities. But the Treasury’s monthly data systematically understates China’s actual purchases. The best figures come from the Treasury’s annual survey of foreign portfolio holdings of US securities, which consistently shows a far larger increase in China’s holdings of US assets than implied by the monthly data on China’s purchases.¹ Unfortunately, the last survey was in June 2007 – when China had far fewer foreign assets than it has now.

Getting a reasonably accurate picture of China’s current holdings of US assets consequently requires a bit of educated guess work. Arpana Pandey of Council on Foreign Relations and I have estimated that China accounted for 55 percent of Treasury purchases through London from mid 2006 to mid 2007 and 70 percent of Agency purchases through London and Hong Kong. We consequently estimate that China now holds roughly \$700 billion of Treasuries and \$600 billion of Agencies. That is

close to 10 percent of the United States GDP, and over 25 percent of China's GDP.

Table 2. Chinese holdings of US assets, as of August 2008

	Known US holdings	Estimated undercount	Estimated US holdings
Short-term bank deposits	35		35
Treasuries (including short-term)	541	130	670
Agencies (including short-term)	451	135	585
Corporate bonds	74	100	175
Equities	39	20	59
Total	1141	385	1525
Chinese foreign assets	2380		2380
US share (estimate)	48 percent		64 percent

China's holdings of risky US assets are also rising (whether mortgage-backed securities that lack an Agency guarantee, the bonds issued by non-financial firms like GM or the bonds issued by financial firms like Lehman or US equities). Total Chinese purchases of US corporate bonds over the last five years amount to approximately \$140b -- and that likely leaves out some corporate bonds bought through London.² SAFE is also thought to have about 5 percent of its portfolio in equities. Given its enormous size, this sum would imply that SAFE already has around \$100 billion of equities, including \$50 billion of US equities. Or rather it likely *had* about \$50 billion of US equities, since equities purchased in 2007 and early 2008 undoubtedly have fallen in value.

Reducing Risk

In some ways, though, the most interesting story that emerges from the data isn't China's (modest) shift toward risky assets over the past two years. Rather, it is the dramatic shift out of risky assets – even slightly risky assets – over the past couple of months. During that time, the available data suggest that China has moved conservatively, investing almost entirely in Treasury bonds. In August (most current data) China is known to have added at least \$22.3 billion to its Treasury bond portfolio while reducing its exposure to other forms of US debt. Its Agency holdings – including short-term Agency paper – may have fallen by as much as \$10.4 billion. Moreover, New York Fed's custodial data indicates that foreign central banks, including SAFE, continue to shift away from Agencies toward Treasuries.³

The sharp fall in China's purchases of Agency bonds in August clearly contributed to the US Treasury's decision to recapitalize the Agencies. However, the Treasury's steps have failed to stabilize the market. Even after the "bailout," the interest rates

Fannie and Freddie have to pay to issue new debt remains relatively high, far higher than the interest rate the Treasury now pays. The current flight to safety by foreign central banks is rational from their point of view. In the current environment, central banks now want only the safest and most liquid assets, as the political cost of any loss far outweighs the gain from picking up a bit more yield. At the same time, foreign central banks sudden shift out of Agencies added to the instability in a key segment of the US market and by keeping the Agencies cost of funding up, it has kept mortgages higher than they otherwise would be, only worsening the distress.

China Investment Corp.'s Portfolio

Both the size and composition of the CIC's foreign portfolio remain a mystery. The total amount of bonds that were sold to raise funds for the CIC are known – and it is known that \$67 billion of these funds were used to buy SAFE's stake in "Huijin" (the bank recapitalization vehicle created in 2003 when two of the state banks were recapitalized with PBoC reserves) rather than to buy foreign assets. Another \$23 billion has been used to recapitalize the China Development Bank and China Everbright Bank in December 2007 and the CIC recently announced that it would inject \$19 billion into the Agricultural bank of China. That leaves an estimated foreign portfolio of between \$100-110 billion.

The impact of the fall in China's purchases of Agencies is important for another reason. Such a move is the first concrete demonstration of China's financial leverage. It is often argued that China's large-scale purchases of US bonds aren't an effective political tool because China cannot scale back its purchases of US debt without hurting itself. This argument has a grain of truth. If China stopped buying US debt, Americans would not be able to buy as many Chinese products, and China's exports would suffer. But this argument also neglects two crucial points.

First, China's US portfolio is now so large and growing so fast that China can shape US markets by simply shifting from buying one kind of US financial asset to buying another kind of US asset. China didn't have to stop buying US debt or allow the RMB to appreciate against the dollar to push the US government to make its guarantee of the Agencies more explicit. All it had to do was shift from buying Agencies to buying Treasuries.

Second, China has interests other than just subsidizing its exports. Financially speaking, China would be better off if it allowed its currency to appreciate and stopped adding to its dollar portfolio. The longer China buys dollars (and euros), the more dollars it will accumulate, and the bigger loss it will eventually take on its foreign currency portfolio. China's leaders should know this; these losses are the financial price China has to pay for subsidizing its exports. But that doesn't mean it will accept losses on its dollar portfolio happily. It is likely that China will eventually push the US to adopt policies that maintain the value of China's investment in US securities. Creditors rarely see eye to eye with debtors. China's leaders are already starting to express concern about their potential exposure to the dollar – and frustration with US economic and financial policies.

Right now, the risk that China will reduce the priority it attaches to supporting its export sector and scale back its purchases of US bonds seems modest. The global slump is now causing real trouble of China's exporters and China's government seems committed to avoiding any further appreciation in the renminbi against the dollar. The third quarter data indicates a modest slowdown in the pace of China's reserve growth, as "speculative" inflows fell. But so long as any fall in China's exports is offset by a fall in imports, China's overall surplus will remain large. In the near-term, China's government consequently will still need to intervene to keep its currency from rising, and will continue to buy US bonds.

Excessive Dependence

But in the long run, it is not in the interest of China to rely so heavily on the US market to support its growth. China's current export based growth strategy has reached its natural limit. US households simply cannot afford to keep on buying more Chinese goods even with access to subsidized credit from the government of China. Moreover, too much of China's savings has already been invested in the United States on terms that imply large future losses for China. Plausible estimates suggest that the real financial cost of China's exchange rate policy could now approach a stunning 5 percent of China's GDP. Rather than subsidizing US consumption, China should aim to put more of its savings to work in China.

Similarly, it is not in the long-run interest of the United States to rely so heavily on a single country's government for financing. Certainly that financing comes on very generous terms, but it also is the byproduct of an exchange rate policy that discourages investment in key sectors of the US economy. Cheap financing for Washington comes at the expense of more competition for the goods made in Milwaukee, Indianapolis and even Seattle. The US runs the risk that it could need China to add to its foreign exchange reserves more than China actually needs more reserves – an asymmetry that potentially gives China the ability to influence US policy. In the short-run, the first priority of the US government has to be to avoid a sharp fall in US demand that pushes the country into deeper recession. But in the long-run the United States shouldn't hope to return to a world where Chinese lending finances excessive US borrowing, but rather look to transition to a world in which more US investment is financed by the United States' own savings. ☞

Notes

¹ The June 2006 survey revised China's estimated holdings of Treasuries up by \$37 billion and its estimated holdings of Agencies up by \$50 billion; the June 2007 survey revised China's estimated holdings of Treasuries up by \$74 billion and its holdings of Agencies up by \$70 billion.

² The TIC flow data implied a \$32 billion increase in China's holdings of long-term US corporate bonds between June 2006 and June 2007. The survey data indicated a \$31 billion fall (from \$58.5 billion to \$27.6 billion). In effect, the survey shows smaller Chinese holdings of corporate bonds than would be implied by the monthly TIC data and far larger holdings of Treasury and Agency bonds than would be implied by the monthly TIC data.

³ While the foreign central banks making use of the New York Fed's facilities are not disclosed, the size of China's holdings of Agencies in particular makes it mathematical certainty that China accounts for a large share of the custodial holdings.

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A Crisis of Faith

Liu Peng

It is a common belief that Chinese do not embrace religion and regard it as dispensable and insignificant. However, a recent survey by East China Normal University shows that 31.4 percent of Chinese aged 16 and above hold religious beliefs, equaling a religious population of about 300 million.¹ The rising popularity of religion in a country that promoted atheism until the late 1970s has presented new challenges for believers and the ruling Communist Party alike. In broad strokes, the government's acceptance of each religion in China depends on the degree to which it ultimately fits within China's political system and society. Of lesser consideration to the government is whether or not the believers practice their own faith to their satisfaction, whether a religion itself can develop or whether it has encountered any difficulty. Over the past half century, a prolonged, fierce and little-known struggle has been fought between authorities at all levels of the government and religious organizations. There are no signs it is letting up. Public security authorities have

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continually tried to strike down unofficial religious forces with the primary result being an expansion of unofficial religions.

The reason that China's mode of managing religion has remained unchanged for years is not because its policies have been effective, but because its leaders know that relinquishing control over religion would allow nongovernmental organizations to gain more power. The debate over the government's role in religious affairs is really a struggle over the division of power. In fact, the Communist Party (CPC) does not regulate and prohibit certain religions because it objects to their philosophical outlook; it does so because religious forces present a potential threat to Party authority. As Lenin said, all issues concerning organizations are political issues. Throughout its history, the CPC has approached religious issues from the perspective of political pragmatism. Under this agenda, what matters most is whether religion submits to the Party's leadership.

Thus, for the Party, any change in administering religion is not only an issue of its approach to beliefs, but is also connected with the CPC's survival. This paradigm affects whether China is willing to grant freedom of speech and association, relinquish control over its citizens' ideology and beliefs, and whether the overall role of the party should change. Religious groups often espouse ideas that counter communist and socialist thought, and they have tight-knit and effective systems of organization that vaguely mirror the functions of a political party. These groups pose an even greater threat to the ruling party if their support networks extend abroad and attract international support. Communist leaders identified this as a threat from an early stage and still fear such forces may challenge the reign of the Party.²

The Politics of Religion

Officially, the CPC espouses a policy of "freedom of religion." This is not only reflected in Party documents and speeches by government leaders at all levels, but is also written in the Constitution.⁸ Since the Party historically promotes atheism, its attempts to assure religious freedom may seem contradictory. However, at its founding, the Communist Party had to appeal to a broad spectrum of interest groups in order to seize power. Therefore, while it shared power with the Nationalists in the United Front government, the Party explicitly indicated its intention to permit religious freedom. In other words, monks, Taoists, priests or pastors were all friends so long as they supported the CPC. The Party's ascendance to power in 1949 did not result in the purge of religious believers from China, as Communist leaders understood that religion was a reality that could not be changed. Instead, the Party kept freedom of religion as a political strategy. Li Weihai, who was then in charge of religious affairs in the CPC, said straightforwardly at an internal meeting that a policy espousing freedom of religion does not aim at promoting religion. The policy of freedom of religion is just a political consideration.⁹

In drawing up its policies on the freedom of religion and handling of religious affairs, the Party referred to the practices of the Soviet Union and other socialist

countries. Generally, this meant attempting to control religion while transforming it from the inside. At the end of 1950s, while allowing the legal existence of religion, the Party tried to mold the old religious forces. Although the theological basics of a religion could not possibly be changed by the Party, the organizational elements were completely placed under its control. The control methods included the establishment of the State Administration for Religious Affairs (SARA) and its local offices and the formation of official religious groups, e.g. the Buddhist Association, Taoist Association, Islam Association, Three-Self Patriotic Movement/Chinese Christian Council (TSPM/CCC) and the Patriotic Association of Catholicism. Mirroring the control it exercises over State-owned enterprises, the government administers all religious sites, adherents and religious activities. Chinese religion has essentially become another State-run enterprise managed by the Party.

Religion has essentially become another State-run enterprise.

Even though the State appeared content with the control mechanisms in place, religion could not escape disaster during the Cultural Revolution. In 1966, all religious organizations, including the “patriotic” religious organizations, stopped their activities as religion was expunged from Chinese society. In some places, locals went as far as to completely tear down temples and religion was eliminated thoroughly - at least in its physical manifestations.

After the Cultural Revolution, religion came back to life. In 1982, the CPC Central Committee issued the No. 19 document, a 30,000-word guidebook describing the strategy and methods for the Party’s religious administration policies.¹⁰ It stressed the need for religion to assimilate and coordinate with the socialist society, but the Party’s basic attitude towards religion remains unchanged. Essentially the document is a collection of well-worn platitudes, reiterating government strategy for control in the period of the planned economy and stressing the continued subordination of religion under government. Although the party’s approach towards administration in other fields changed greatly after the reform and opening of the 1970’s, no such changes have taken place in the realm of religion. As the 21st century sees China accelerating its reforms, the contrast between religion and other areas looms large.

The Strong Hand of the State

Religious organizations differ with the government on many core issues. Common to all groups is the dissatisfaction with the lack of autonomy given to believers. Religious groups recognized by the government receive support and financial subsidies. Of course, support is contingent on the organization’s willingness to accept the government’s supervision. Once an organization is recognized, SARA exercises control over a wide range of issues including: recruitment and administration of clergy; income and expenditures; the scale and methods of religious activities; publication of religious literature; the restoration and development of religious sites; and the administration of religious colleges. In other words, almost every activity conducted

by “patriotic” religious groups - as these government-recognized organizations have come to be known - is subject to the CPC’s approval. This mode of administration is hard to accept even for the “patriotic” religious groups. In his speech at a session of the Chinese People’s Political Consultative Conference, Zhao Puchu, former president of the Chinese Buddhist Association, said, “The leading system of religious work that was shaped over time carries the drawbacks of excessive concentration of power and monopolization. Therefore, it is necessary to separate church from government.”³

Although the issue of autonomy drives at the very core of what it means to be a truly religious body of people, for those not sanctioned by the government, the more immediate concern is the issue of official recognition. At the end of 2004, the State Council promulgated the Regulations on Religious Affairs, which outlines the

*The true sources of authority are
the documents of the Party.*

basic requirements for unofficial religious groups wishing to register with the government through SARA.⁴ In order to proceed with registration, unofficial organizations’ clerics must first be recognized by the “patriotic” religious organizations, a requirement that is difficult to fulfill in China’s religious-legal climate. Unofficial religious organizations and “patriotic” religious organizations are often in competition for members, thus making their mutual approval highly unlikely. In addition, despite their desire for legal status, unofficial religious groups recognize the drawbacks of a heavy-handed State administration. The overall environment drives the unofficial religious organizations to maintain a degree of autonomy from the government and the “patriotic” religious groups, effectively precluding recognition.

The third issue relates to the nature of certain religious restrictions. This is an issue that applies to both official and the unofficial religious groups, for they both hope that the government will allow the unimpeded development of religion. As surveys show, Chinese interest in religion is growing rapidly. Religious groups count on the government to satisfy the increasing demand for religion by lifting the ban on religious assemblies as well as the restoration and establishment of religious sites and buildings.⁵ Furthermore, they want religious literature to be treated as common publications, and for more religious personnel to be permitted to participate international exchanges. Religious groups also carry out important charity and public welfare activities, such as setting up clinics, helping AIDS patients and disabled people, advocating environmental protection and poverty alleviation, among others. The current practice is that, while the State welcomes religious organizations to donate money, they cannot publicize their charitable work. These obstructions to believers fulfilling their religious obligations are in conflict with the Constitutional promise of religious freedom.

Religious adherents in China believe that the above issues are all symptomatic of the lack of legal protection placed over their rights and interests. Indeed the Constitution is very basic in its provisions on religion. There are also administrative regulations and departmental rules of the State Council, as well as rules and regulations of

local governments. Problems relating to religion are mainly handled and coordinated through SARA and by departments of the government. When a problem arises, it is typically directed to legal channels. The problem, however, is the courts generally do not accept or handle religious issues, especially issues involving the division of power between religion and the government. Furthermore, the National People's Congress has not enacted a single comprehensive law that addresses how religious disputes should be handled. Instead, there is merely a hodgepodge of rules and regulations set by various levels of government. A court needs consistent and comprehensive laws in order to decide cases. If there are only a few regulations, how can the courts settle disputes?

In reality, behind the administrative rules and regulations, the true sources of authority are the documents of the Party. This should not be surprising as this is how the Party administered other areas of society in the past. But documents are not laws. In an age that emphasizes the rule of law, social contradictions should be regulated through laws rather than administrative means. Therefore, the religious community hopes very much that a comprehensive law clarifying the rights and obligations of religion and government can be enacted in order to protect the legitimate rights and interests of the religious community.

Going Underground

Of all the religious groups of China, the underground Catholic Church and house churches associated with other denominations of Christianity are the thorniest issues for the government. As the government sees it, they are both the unwanted product of naturally developing domestic interests and the infiltration by foreign hostile religious forces from abroad. Their very existence is a serious threat to the "patriotic" church and a challenge to the government's grip on religious administration. Consequently, the departments of religion and public security have taken joint action to curb their development.⁶ Over the course of the struggle, the house churches and the underground church have encountered substantial government opposition. Key members have been arrested while their followers were fined, taken into custody or banned from practicing religion. Places of worship have been closed down and underground seminaries banned. Local authorities have confiscated publications, including Bibles.⁷ But, all these efforts have failed to extinguish their expansion. On the contrary, containment policies have merely led to greater growth and a strengthening of the underground movement. After decades of fruitless struggle, no one, including those in government, believe that the State can prevent or stop the development of house and underground churches. They have become an undeniable presence that the government is unwilling to permit but cannot eliminate.

In consideration of its diplomatic relations with other countries, it is impossible for the government to take harsher measures to completely expunge unofficial churches. At the same time, it deviates from traditional administration policy not to target them. This puts enforcement officials in a difficult position, as it must balance between cracking down and turning a blind eye. When authorities do intervene,

it usually is in the form of suppression, even though such a measure is clearly futile. In most situations, government interventions are conducted with moderation, but are often intensified following any incident.

Reformed Administration

Both history and the current reality prove that China's religious problems cannot be solved by brute administrative force. Ultimately, the solution is to return to the rule of law. But administering religion on the basis of law first depends on China truly separating religion from the State. The government should never intervene in the internal affairs of legally registered religious organizations nor use public resources to support or suppress any religion or sect. This means canceling the financial subsidies and special support given to existing religious organizations. In turn, religious adherents should not involve themselves in governmental affairs in the name of their faith (though they may take part in the government in a personal capacity).

Additionally, China must enact religious legislation, which will form the basis of administration and improve the legal handling of religious issues. China must make it clear that the aim of the legislation is to protect freedom of religion, not through abstract concepts, but through concrete systems and measures. This would reflect a modern, civilized country's respect for and protection of human rights. The State must not intensify the control over religion exercised by the religion administration department in the name of legislation. The establishment and improvement of religion-related laws aims to relax, rather than rigidify administration. The State should gradually deregulate religion and allow citizens to form religious groups through registration according to laws. Religious organizations should be encouraged to enter the religious market under conditions allowed by laws to compete freely for adherents. The United States has a large number of religious organizations, but no serious problems have arisen because of that, which is thanks to a mature free market of religion governed by a complete legal system.

In this spirit, Article 36 of the PRC Constitution should be revised. The article currently says, "The State protects normal religious activities." Since the word "normal" is not defined therein, it can be broadly and unpredictably interpreted by the State. The article also prescribes that "No one may make use of religion to engage in activities that disrupt public order, impair the health of citizens or interfere with the educational system of the State," and that "Religious bodies and religious affairs are not subject to any foreign domination." All these provisions reflect the government's worries about religious activities and what restrictions should be imposed. They even smack of political discrimination. Article 36 of the Constitution should be rewritten as two simple sentences: "The citizens of the People's Republic of China enjoy the freedom of religion and of practicing their beliefs. The State implements the separation of religion and government." The Constitution only needs to contain

these two points and all other matters can be left to religious legislation. If this revision is made, the legislation and enactment of laws related to religion will be far easier.

The government is certainly the executive manager of society. It is responsible for maintaining social order but it is also responsible for supporting all of society, including religious groups. Allowing greater latitude for religion entails political risks, but religion can also play a hugely positive role. In the future, solutions to religious problems should be based on the rule of law. The rule of law is not simply transforming the rules and regulations of the administration departments of the government into laws. Rather, it is to set basic boundaries. Once that is done, the government should divest itself of administrative control. But this shift from administrative management to the rule of law will require a major paradigm shift for China and its approach to dealing with religion. ☹

Notes

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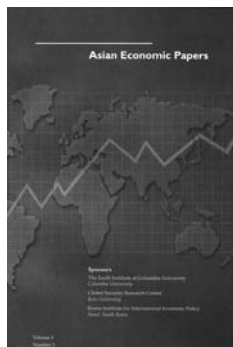
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Cures that Kill: Biosecurity and the Dual-Use Dilemma

Michael Barr

In a laboratory in southern China, a lone researcher sits hunched over a microscope. He stares intently into the microbial world teeming within the petri dish, barely able to contain his excitement. After many months of toil and countless lost hours of sleep, he and his team have created a new strand of the H5N1 virus, the “bird flu,” in order to better understand the emerging global health risk. This new discovery is a landmark breakthrough on the process of reassortment – the exchange of genetic material between human and avian viruses which could fuel a pandemic. Wrapped up in the excitement of the moment, the research team rushes to publish their results online and then goes in search of both Chinese and English language journals that will publish the results. But what they are slow to recognize is that the same knowledge that could save lives could harm just as many if it falls into the wrong hands.

This story is fictional, but the possibility that well-intentioned scientific research could be misapplied or purposely misused is a very real concern to policymakers in the United States and United Kingdom. In Washington and London, one of the foremost issues of biosecurity is stopping the dual-use of scientific equipment and

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findings to prevent harm to society. Concern over dual-use dangers gained prominence during the recreation of the 1918 Spanish Flu. In 2005, US scientists identified the sequences for the virus's genome and described its reconstruction.¹ The study enabled scientists to test the function of certain genes in the transmissibility and virulence of the disease. However, while the successful recreation marked a major scientific advance, it entailed the risk that the recreated strain might escape, or that the publication of the full genome sequence could give a rogue nation or criminally motivated group enough information to make their own version of the virus. Another widely cited example of a dual-use dilemma occurred when Australian researchers modified the virus that causes mousepox in an attempt to make mice infertile. The hope was that they could limit the millions of dollars of damage mice inflict on Australia's grain belt. But when they inserted a gene that helps regulate immune system reactions into the virus, they inadvertently created a recombinant virus, which killed the mice, including 60% of those which had been vaccinated. The implications of the Australian case worsened when a US team duplicated the study with even greater lethality and conducted similar experiments with cowpox, a disease that can afflict humans.²

The Dual-Use Dilemma

In many ways, biosecurity and the dual-use dilemma provides a new angle on an old question: if a researcher's intentions are good – to contribute to scientific progress and to save lives – can we hold him responsible for the unintended and unforeseen malevolent use of his discoveries?³ At present, much of the effort to regulate the life sciences focuses on proposals for a protective oversight system that would potentially block projects and publications posing security risks. Such evaluations would be based on the type of pathogens being handled and the possible consequences of the research being undertaken.⁴

These issues are of great importance to China for several reasons. First, China represents a key player in biosecurity negotiations, as it has been both the victim of one of the worst biowarfare campaigns of the 20th century, at the hands of the Japanese, and has been a source of numerous emerging and re-emerging diseases, SARS and H5N1 being the best known. Of equal importance to China's role as an international biosecurity actor is the burgeoning growth of its life science and biotechnology industries. Massive government investment and incentive schemes have helped lure back overseas trained scientists. The OECD puts China's investment in scientific research and development at \$115 billion, behind only the United States and Japan, with a sustained annual growth rate of 18% from 2000 to 2005.⁵ Coupled with this, however, are international concerns over the effectiveness of China's regulatory environment. While government regulations may be centrally decreed, they are often open to local interpretation and uneven enforcement.⁶ The recent case of contaminated powdered milk is only one issue in a list of problems stemming from

inadequate oversight and questionable science. There are similar worries in regards to the life sciences since government regulations are often open to local interpretation and uneven enforcement.⁷ But beyond regulatory capacity, there is a fundamental difference in the way that China perceives biological threats.

This paper contains observations from an ongoing study into biosecurity in China. It is based on interviews and discussions in Beijing, Shanghai, and Guangzhou with life scientists and policy makers in infectious disease hospitals, district level Centers for Disease Control (CDC) offices, university research labs, the Chinese Academy of Sciences and the Ministry of Health.

More than Terms

One way of illustrating the difference between Chinese and Western perceptions of biosecurity is to examine the language used to describe the phenomena. In the Western scientific community, there is a distinction between the terms biosafety and biosecurity. The first term is concerned with laboratory procedures and policies aimed at reducing accidental exposures. This includes instructions on how to work with, store, and export pathogens and toxins properly in order to avoid accidents that could be harmful to people, animals and the environment. Biosecurity, on the other hand, includes efforts to prevent and contain infectious disease outbreaks. It includes researchers' choices and behaviour, as well as society's collective responsibility to safeguard a population from the dangers of pathogenic microbes. Specifically it refers to the protection and control of pathogens and toxins to prevent their deliberate theft, misuse, or diversion for the purposes of biological warfare or terrorism. There is a similar dichotomy in Chinese between the terms *shengwu anquan* (biosafety) and *shengwu anbao* (biosecurity). However, as Chinese Foreign Ministry official Wang Qian notes, proper use of the terms tends to create some confusion amongst scientists and policy-makers, in part since *shengwu anbao* is a newly created word.⁸ In practice, I found that many scientists I questioned were not familiar with the new term and offered widely varying opinions about what they thought it referred to. Often when *shengwu anbao* is used, it is meant to refer to issues of safety, not issues regarding dual-use or biosecurity per se. In addition, there seems to be a divergence in awareness depending on where one works: compared to scientists at smaller hospitals and district level CDCs, I found that scientists at large academic facilities tended to be slightly more aware of the new phrase and the issues associated with it. Usage of these terms reflects the fact that while lab safety is improving in China, there remains very little knowledge about the issues of dual-use or about the general security implication of biological research.

China's investment in scientific R&D is \$115 billion, behind only the United States and Japan.

The difference in terminology points to another fundamental issue – that is, how Chinese microbiologists define a biorisk or a biosecurity concern. While there is much fear, especially in the Anglo-American world, of a bioterrorist attack, the biosecurity worries in China are somewhat different. The present discourse in China is less about potential attacks than about dealing with the current and present danger of naturally occurring infectious disease outbreaks. One scientist, only half jokingly, told me that while America has many enemies, China did not – the implication being that concerns over bioterrorism were far down their list of priorities. This view was echoed by a senior director in the Ministry of Health, who had responsibility for emergency planning. He believed that infectious disease was an “every day” concern and that the main challenge for his office was not bioterrorism but rather raising both public awareness and the necessary resources to develop effective systems of disease prevention and outbreak response.⁹

That disease constitutes the main biorisk in China is not a surprising finding given the history of outbreaks in the country. Much has been written about the 2002/03 SARS epidemic, which infected over 8,000 people worldwide and killed approximately 800. Since then, Chinese authorities have established a sophisticated disease

SARS was as important to China as the September 11th terrorist attacks were to the United States.

surveillance system and a public health network that links national authorities to rural areas, where many of the vulnerabilities lie. This system allows authorities at the Center for Disease Control and Prevention in Beijing to monitor sickness and disease patterns across the coun-

try so little intervention time is lost should an outbreak occur. The countryside is an important front in China’s war on disease since the rural health care system has been weakened by twenty years of privatization and fiscal decentralization.¹⁰ This means that over a hundred million migrant labourers lack basic health coverage and may be reluctant to seek treatment if unwell. This, in turn, increases the risk that a disease could be transmitted from rural to urban areas since outbreaks of many conditions tend to start in rural areas, due to live animal markets and consumption patterns.¹¹ These twin facts – inequitable service delivery and a floating population – pose significant biosecurity related risks, which the government has finally begun to address through greater investment in public health and rural development schemes.

China’s new disease prevention systems were full display when I visited the Beijing CDC in spring 2008. There, I learned that nearly one half of the eighteen district labs (including both urban and rural regions) were in the process of constructing new facilities. Many of these upgrades include the installation of higher level biosafety labs, which will allow for more dangerous pathogens to be handled and stored.¹² The construction of these new labs means that an increasing number of researchers will have access to potentially dangerous materials and research findings. Given the potentially lethal nature of some of the pathogenic agents being studied in high level labs, their proliferation would unleash greater consequences should something

go awry. Beyond Beijing, the national government has recently devoted one billion RMB to establish the new Shanghai Public Health Clinical Center of Fudan University. Formerly known as the Shanghai Infectious Disease Hospital, the Centre was expanded, renamed and relocated to 33 hectares of land, one hour outside the city (its move was, in part, because of urban residents' concerns about living next to such a facility). The Centre boasts a staff of more than 700 and houses Shanghai's highest level biosafety lab as well as a 500-bed capacity infectious disease hospital, with an extra 100 beds available in case of emergencies.

China's recent growth in advanced, well-regulated labs signifies the depth of the impact SARS has had on Chinese biosecurity concerns. One microbiologist and biosecurity expert at the Chinese Academy of Medical Sciences explained to me that SARS was as important to China as the September 11th terrorist attacks were to the United States. He felt that the events were comparable in terms of their political, economic and psychological fall out. Although the Chinese economy continued its pattern of overall growth for 2002-2003, the outbreak hit service industries such as retail and tourism particularly hard and temporarily damaged investors' levels of confidence in the country.¹³ It is helpful to bear these points in mind when considering which issues the Chinese attach priority to, what they decide to invest in and, crucially, how they assess and handle emerging national security risks.

Building Security Consciousness

Though China has invested heavily in its capabilities to study and contain pandemics, the sudden growth in this sector has also opened serious gaps in biosecurity. In 2004, a batch of the SARS virus at the National Institute of Virology in Beijing, mistakenly thought to have been inactivated, was moved from a high level storage container to a non-regulated lab where medical students were working on diarrhoeal diseases. The breach of security subsequently resulted in eight infections and one death, as well as the temporary closure of the Institute and quarantine of over 700 individuals suspected of coming into contact with the virus. The problem was not a failure of equipment, technology, or insufficient regulations – instead, it was the result of human negligence.

One microbiologist at Fudan with an interest in security issues refers to this problem as a laboratory without “software” Her meaning is that much attention has been paid to the so-called “hardware” – the building of hi-tech labs, autoclaves, cabinets, locks, doors, and so on – while the human element has been neglected. That is, the behaviour, management skills, expert knowledge and duties of care needed to safely operate high level laboratories have not kept pace with the introduction of new facilities.

A key point, however, is that the element of human “software” includes much more than lab safety. Yet statements by the Chinese Delegation to the Biological and Toxin Weapons Convention Meeting of Experts in August 2008 show that their

focus is almost entirely on safety, not the wider issue of dual-use. According to their declaration, biosecurity “education and awareness raising” refer solely to “laboratory safety management and technical training, biosafety licensing, preparedness for health emergency and response and veterinary biosafety.”¹⁴ These efforts are obviously important and are to be supported, as argued above. However, like other countries with growing biotechnology sectors, China has yet to fully embrace educational measures and codes of conduct aimed at addressing a broader agenda of oversight of the life sciences and how biological research might be exploited for illegitimate purposes.

As China is a partner in the so-called “War on Terror,” there is significant cooperation between authorities at many levels, including the military. But in terms of raising biosecurity/bioterrorism awareness at the level of hospital labs, it seems there is some distance to go. It is useful to note, for example, that a 141-page biosafety/

biosecurity booklet distributed to Beijing area hospital labs shortly before the Olympics is dedicated entirely to *shengwu anquan* (biosafety) and disease control.¹⁵ No mention is made of biosecurity (*shengwu anbao*) or the dual-use potential of facilities and research. A small number of top uni-

There is a fundamental difference in how China perceives biological threats.

versities and scientific associations have sought to establish internal codes of ethics which aim to promote scientific responsibility, as well as the integrity and moral character of staff. The Chinese Academy of Sciences, for example, has published guidelines which state that scientists should “exercise strict self-discipline in science morality and the style of study, to become the examples of scientific and technical circles”.¹⁶ These types of codes are to be encouraged and broadened to specifically promote dual-use awareness.

Indeed, the objective of a protective oversight system is to provide reassurance that scientists pay attention not only to biosafety in their labs, but also to the broader public health and security implications of their research. The point of tension, however, is that scientific norms emphasize openness in the communication of research methods and findings. Without this, it is impossible for experiments to be reproduced and results verified by third parties. In the course of presenting biosecurity lectures to staff and students in China, it was clear that they regarded openness as a key factor in scientific progress, and that they had given very little thought to their own responsibilities in the dissemination of their work or to the wider agenda beyond disease control. In this way, my findings support Rappert and Dando’s study which found that academic life scientists in the UK are generally ill informed about dual-use potentials and did not consider security issues to be of great importance to their work. Similarly, many of the Chinese life scientists I interviewed were not particularly concerned about the dual-use implications of their work and did not regard bioterrorism or bioweapons as substantial threats. The reasons for this varied, but

as in the West, many scientists in China tend to view scientific progress as inevitable and generally thought that pressures to publish and present findings meant that research would, one way or another, be conducted and find its way into the public domain. These findings are also reflected in a recent survey of over 300 Asian life scientists, which found that there was better awareness of laboratory biosafety issues compared to biosecurity and that overall, awareness levels and perceived threats about biological terrorism remained very low.¹⁷

Again, it is revealing that the Chinese Delegation at the recent BWC meeting defined “training in biosecurity” as “knowledge of relevant laws and regulations, licensing systems and protective skills.”¹⁸ This is important of course, but knowledge of relevant laws is not enough. A further “software” problem is the challenge of legal enforcement. This is not a new problem, nor is it unique to China. But there are no less than 53 government-sponsored regulations and laws pertaining to biosecurity and biosafety in China, the vast majority of which were passed after the SARS outbreak.¹⁹ With seven different government ministries publishing regulations and laws related to infectious disease, there is arguably a need for officials in Beijing to decide how best to streamline the system. As Julie Fisher argues, the implementation of new biosafety and biosecurity regulations in China poses numerous challenges. New rules must be applied to the full range of laboratories that work with highly contagious infectious diseases. Yet “without a well-designed plan and resources to ensure effective implementation of regulations and oversight of practices at all levels in China,” advances in biosecurity and biosafety will, “quite frankly, serve no purpose.”²⁰

As I indicated in the opening scenario, health experts are worried that the H5N1 virus could eventually mutate into a form that passes easily between humans, leading to a major flu pandemic. As I write, researchers in China (indeed, across the globe) are studying the virulence, transmission, and possible vaccination of viruses such as H5N1. For these researchers, the fight against infectious disease is best encapsulated by the Shanghai Public Health Clinic’s motto to serve as “rapid response troops” in the war on disease. Thus, while U.S. policy-makers promote an international agenda against bioterrorism, they also need to be sensitive to the context in developing nations such as China where disease, and not terrorism, constitutes the main biorisk.

And yet at the same time, China has much ground to cover in realising that biosecurity is more than just lab safety.²¹ Good biosecurity practice entails a need to promote responsibility for the outcomes of research and the development and effective implementation of codes of conduct, which address issues far wider than mere lab procedures. It is not difficult to imagine research findings falling into the wrong hands, whether intentionally or by accident. Nor is it hard to imagine a lab accident causing a major disease outbreak. Thus, developing security awareness amongst the Chinese life science community and ensuring that regulations are enforced in all labs and areas of biological research is an urgent task for China. ☪

Acknowledgements

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Notes

¹ Jeffery K Taubenberger, Ann H. Reid, Raina M. Lourens, Ruixue Wang, Guozhong Jin, Thomas G. Fanning, "Characterization of the 1918 influenza virus polymerase genes," *Nature* 437, 2005 pp. 889–893; Terrence M. Tumpey, Christopher F. Basler, Patricia V. Aguilar, Hui Zeng, Alicia Solórzano, David E. Swayne, et al, "Characterization of the reconstructed 1918 Spanish influenza pandemic virus." *Science*, No. 310, 2005, pp. 77–80.

² Ronald J. Jackson, Alistair J. Ramsay, Carina D. Christensen, Sandra Beaton, Diana F. Hall, Ian A. Ramshaw, "Expression of Mouse Interleukin-4 by a Recombinant Ectromelia Virus Suppresses Cytolytic Lymphocyte Responses and Overcomes Genetic Resistance to Mousepox," *Journal of Virology*, No. 75, 2005, 1205-1210.

³ Maureen Kelly, "Infectious disease research and dual use risk." *Virtual Mentor: Ethics Journal of the American Medical Association*, No. 8, 2006, pp. 230-234.

⁴ For example, The US Fink Committee has named seven 'experiments of concern' that would, in their view, warrant, stringent review for dual use implications. These are projects that would do any one of the following: demonstrate how to render a vaccine ineffective; confer resistance to therapeutically useful antibiotics or antiviral agents; enhance the virulence of a pathogen or render a non-pathogen virulent; increase transmissibility of a pathogen; alter the host range of a pathogen; enable the evasion of diagnostic/detection modalities; enable the weaponization of a biological agent or toxin. See the National Research Council, *Biotechnology Research in the Age of Terrorism*, National Academies Press: Washington DC, 2003.

Similarly, the Controlling Dangerous Pathogens Project has recommended that after a detailed questionnaire, the proposed project would be classified as either potentially, moderately or extremely dangerous. It is thought that most proposals would fall under the potentially dangerous category and would thus be reviewed at the local level. The other two categories (moderately and extremely dangerous projects) would require national and international scrutiny for their security implications. See John Steinbruner, Elisa D. Harris, Nancy Gallagher, Stacy M. Okutani, "Controlling Dangerous Pathogens: A Prototype Protective Oversight System," 2007.

⁵ OECD, 2005. Organisation for Economic Co-operation and Development. Economic Analysis and Statistics Division, Science Technology and Industry Scoreboard. Paris, Organisation for Economic Co-operation and Development.

⁶ See Evan S. Medeiros, "Chasing the Dragon: Assessing China's System of Export Controls for WMD-related goods and technologies." RAND National Security Research Division, 2005.

⁷ Ibid.

⁸ Qian Wang, "Efforts to Strengthen Biosafety and Biosecurity in China." In: Smithson A, *Beijing on Biohazards: Chinese Experts on Bioweapons Non-proliferation Issues*, Monterey Institute of International Studies, pp. 71-90.

⁹ As the attacks in Xinjiang by separatists have shown, Chinese strategic planners face their own criminal and politically motivated groups. While terrorism in general may start to receive greater attention amongst Chinese policy makers, there is little indication to date that these relatively small attacks have had any impact on dual-use perception or on how the life sciences are governed. See also Bates Gill, "Reading the Nonproliferation Tea Leaves," In: Smithson A,

Beijing on Biohazards: Chinese Experts on Bioweapons Non-proliferation Issues. Monterey Institute of International Studies, pp. 137-141.

¹⁰ Joan A. Kaufman, "China's Health Care System and Avian Influenza," *Journal of Infectious Disease*, No. 197, Suppl 1, 2008, pp. S1-S13.

¹¹ SARS, for instance, is widely believed to have begun in civet cats, a delicacy in some parts of China

¹² International biosafety levels for labs are determined by the materials intended to be researched. A BSL 1 lab is for working on materials not known to consistently cause disease in healthy adult humans, but of minimal potential hazard to laboratory personnel and the environment, whereas a BSL 4, the highest level, is required for work with dangerous and exotic agents that pose a high individual risk of aerosol-transmitted laboratory infections and life-threatening disease.

¹³ See Thomas G. Rawski, "SARS and China's Economy," *In SARS in China: Prelude to Pandemic?* Eds. Arthur Kleinman and James L. Watson, 2006, pp. 105-121.

¹⁴ Chinese Delegation to the Biological Weapons Convention Meeting of Experts, 2008. Poster on China's Practice on Biosafety and Biosecurity.

¹⁵ Beijing Center for Disease Control, 2007. Selection of Biosafety related Legislation, Regulations and Standards. Ministry of Health: Beijing.

¹⁶ John Scott, "China introduces codes for scientists." *Science*, Dec. 15, 2001, accessed 11/09/08 via <http://www.scidev.net/en/news/china-introduces-ethics-code-for-scientists.html>.

¹⁷ Sandia National Laboratories, 2006. One exception stands out, however. A senior microbiologist at Fudan University in Shanghai supported pre-project and pre-publication review boards and has led efforts within China to implement a national review system for dual use implications of recombinant DNA research.

¹⁸ Chinese Delegation to the Biological Weapons Convention Meeting of Experts, 2008. Statement made on Biosafety & Biosecurity Capacity Building.

¹⁹ Although none of these regulations deal explicitly with bioterrorism, some of them do so indirectly by regulating the export of pathogenic materials and providing rules for the handling of toxic substances and so on. But again, a vast majority of these regulations pertain to either disease control or biosafety. This may plausibly be taken as an indication of what China considers its main bio risks to be.

²⁰ Julie E. Fisher, "Observations on China's New Biosafety and Biosecurity Framework," In: Amy E. Smithson, *Beijing on Biohazards: Chinese Experts on Bioweapons Non-proliferation Issues*, Monterey Institute of International Studies, 2007.

²¹ It is obvious of course that codes are limited and not some sort of panacea. A code of conduct, for instance, would not have stopped who was responsible for the anthrax attacks in the US in 2001 from sending their letters. But codes can and do at least help create a greater security consciousness amongst researchers and provide a basic reference point.



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Challenges to American Dominance in Oil Finance

Ronald Tong

Energy security is rising as a theme in world affairs. US interventions into the Persian Gulf began this trend and the recent conflict between Georgia and South Ossetia has further heightened concerns over geopolitics and energy. However, energy security involves far more than the strategic control of oil supplies. The most important confrontations over energy are shaping up in the economic arena. In an event that passed largely without comment in the press, Russia officially launched the St. Petersburg Petroleum Exchange this March. Through the new exchange, oil will be priced by Russian standards and paid for in rubles. On the surface, this may sound like an insignificant addition to the major oil bourses, such as the New York Mercantile Exchange (NYMEX) and London ICE where the majority of oil futures contracts are traded; however, the Russian trading system is meant as a challenge to US economic hegemony and part of a growing global dissatisfaction with a dollar based financial system.

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Dollar Addiction

The key to American economic power is the dollar's dominance in international trade, particularly in oil transactions. Under the 1944 Bretton Woods Agreement, the American dollar, backed by gold at the time, was established as the global benchmark for currencies. Countries pegged the value of their currencies to the dollar because it was literally "as good as gold."¹ This system collapsed in the early 1970s as the number of dollars in circulation greatly outnumbered the corresponding value of gold the United States held in reserve. For several tumultuous years, it looked as though the American economic empire was on the verge of collapse, until in 1975, OPEC stepped in and agreed to use American dollars as the sole pricing and settlement currency for oil. With OPEC only accepting dollars, the oil producers accumulated huge stacks of dollars, and oil importers needed dollars to purchase oil.² As a result, the dollar was reestablished as the backbone of the world economy. In the three decades since, the number of dollars held in foreign reserves has risen 2,500 percent, as Washington has exercised its ability to export its debt. Today, nearly half the world's exports are priced in dollars, as are roughly 80 percent of all foreign exchange transactions and the majority of International Monetary Fund loans. With the globe addicted to the greenback, the United States could print money virtually free of consequences. No matter how unsound US fiscal policy became, trading partners couldn't abandon the dollar without risking their sizable reserves. Other countries are of course upset by the devaluation of their reserves, but are helpless to intervene, given pervasiveness of the US system.

But the reign of the dollar may be drawing to an end. The emergence of the Euro as a major reserve currency, and the eruption of the US subprime crisis have undermined the position of the dollar, and with it, the prospects for future American economic prowess. Meanwhile, five years of high oil prices have fattened countries defiant of US power; Iran and Venezuela are cases in point. Taking advantage of its position as the second-largest oil exporter, and following the proven formula of American hegemony, Russia has created its own pricing and payment system for oil and gas. This March, Russia established the St. Petersburg Oil Exchange and began using the ruble as the settlement currency for its oil and gas transactions.³

Two factors served as an impetus for Russia creating the new system. To begin, there is the issue of oil pricing. All oil is not the same and there are roughly 180 recognized blends of crude, each with different qualities and requirements for processing. Pricing the supply and demand for each blend is not expedient in the market place, so a handful of major oil blends are priced as benchmarks, with the rest of the prices set in relation to them. This relative valuation is primarily set by Platts, an energy and resources research company which constructs formulas to compare the qualities of oil blends. In the Platts pricing index, the Russian URALS blend of petroleum was priced in relation to a basket of three oil blends from the North Sea. The problem, Russian critics said, was that formulation of the value of URALS no longer reflected the market demand, with the Russian blend consistently priced lower, despite grow-

ing demand for oil of its specific qualities. In 2006, Russia reported it was losing US\$4 billion per year under what it saw as unfair pricing in relation to the North Sea blends.⁴ Simply put, Russia's plans to boost its economy rely on earning more money for its oil, and the established pricing system was holding it back.

The United States, on the other hand, has considerably more power to manipulate oil prices. One of the most important benchmarks for crude oil prices is the US produced West Texas Intermediate (WTI) blend. However, the price for WTI is highly influenced by local US market conditions which may not reflect the global market. Thus, the US government can potentially alter prices by changing local supply conditions. Earlier this May, Congress voted to temporarily suspend the 70,000 barrel per day shipment of petroleum to the nation's strategic petroleum reserve. Later in July, US politicians once again considered using the SPR (roughly 700 million barrels) to dampen high oil prices. While these interventions into the market place may seem insignificant given the scale of the global oil trade, they are greatly magnified in the current pricing system.⁵

The second reason for Russia's attempt to restructure its oil market is its desire to transform the ruble into an international reserve currency. Russia has declared plans to turn Moscow into a global financial center, establishing the ruble as a regional currency and then an international settlement currency by 2020. At this time, Russia estimates that its natural gas exports will reach 280 billion cubic meters. If the ruble is used to settle all transactions, the demand for Russian currency will rise sharply, aiding the Kremlin's long-stated goal for the ruble's appreciation. Of course, the dollar-based system is well-entrenched and oil importing countries will not be easily convinced to stockpile rubles. Therefore, in order to build momentum behind its currency, Russia is relying on government-to-government agreements, rather than open markets, to promote its use. For instance, Russia and China arrived at a historic agreement on the ruble-to-renminbi mechanism for bilateral trade.⁶ Still, Russia's ability to upset the current oil finance system is doubtful. As most buyers still insist on paying in dollars, the URALS system remains immature and Russia is incapable of unilaterally overturning the current pricing and payment system. Meanwhile, with the recent sharp drop in oil prices, Russia's oil income will dramatically contract, rendering it even less influential in oil markets.

*Five years of high oil prices
have empowered countries
defiant of US Power.*

In the short term, while Russia's plans look unlikely to materialize, the growing discontent with the status quo by other countries may add up to enough to affect change. The unpleasant reality for the United States is that high oil prices have empowered governments defiant of American power - such as Venezuela and Iran, each of which have tried to move away from transactions in dollars. Iran, is trying to sell oil only in euros, thus weakening the influence of the dollar. Zuhai Zhenrong Trading Co., a Chinese state-owned enterprise and the world's largest importer of Iranian

crude, disclosed that it began paying Iran in euros, under pressure from Tehran. The Japanese company Nippon Oil reports similar pressures, but says it has not acquiesced and still pays in dollars.⁷

More importantly traditional allies are considering jumping ship on the dollar as well. In late 2005, Norwegian Bourse director Sven Arild Andersen advocated an alternative mechanism in which Norway's oil would be priced and paid for in euros.⁸

OPEC countries are also disenchanted with the dollar, as their coffers fill up with

ever depreciating dollars. Though OPEC countries are still only using the dollar for pricing and settlement, they are often exchanging the dollars as soon as they receive them, diversifying their central bank holdings into other currencies. The Qatar Investment Authority had total assets worth US\$60 billion in 2006. But it reduced the percent-

OPEC members would like to move to a diversified payment system.

age of its American dollar assets from 99 percent to around 40 percent over a two year period, increasing the percentage of euros to 40 percent, and British pound to 20 percent. The decrease of dollars in the foreign exchange reserves of many countries will lead to its further depreciation. OPEC members would like to move to a settlement system that includes a basket of currencies with an equal division of US dollars, euros, yen and perhaps a Gulf currency such as the Qatar dollar. If enough countries dump the dollar, the United States will lose its ability to foist its debt upon other nations and its influence in the global economy will wane.

China Enters the Fray

As the world's second highest consumer of oil, and the foremost holder of US dollar reserves, China is deeply enmeshed in international oil and financial markets. China's foreign reserves total nearly \$1.9 trillion, much of it invested in US Treasury bonds and other US assets. As the renminbi continues to appreciate against other currencies, particularly the dollar, those reserves lose value. Yet, any major selling off of the dollar by China would only exacerbate that trend, thus China is forced to maintain its dollar investment in order to preserve the value of its holdings. In 2000, America's national debt has nearly doubled, reaching \$10.6 trillion this fall. Through Wall Street's complicated financial investment products, the United States successfully shifted its financial and trade deficits to other countries. China, as the United States' primary creditor, absorbed much of the blow, as it was left holding subprime bonds with lowered credit ratings when the bubble burst. The financial crisis has since turned into an uncontrollable wide-scale epidemic over the whole world through transformation of and encroachment into financial institutions. The IMF estimates that, to pull through this crisis, the global financial system needs to inject 610 billion euros, twice the national budget of France.⁹ This amounts to an unprecedented global economic earthquake.

Accordingly, there is news that China is accelerating its moves to shift towards non-American dollar assets due to the worsening performance of American enter-

prises. Though China does not disclose the makeup of its foreign reserves, it is widely agreed by experts that China has increased the percentage of other currencies, such as the euro, in its reserve since the American dollar sharply depreciated in the second half of last year.¹⁰ This is the first of many steps for China to become independent of the US-centric financial system.

The dollar's dominance, backed up by American military might, has also given the United States access to major oil producer's supplies and influence over their governments. This means that while China is in a precarious financial situation due to the dollar-based system, the future of its energy security is even more uncertain.

As China's oil and gas needs have grown, it has felt increasingly cornered by US influence. Today, roughly 60 percent of China's oil comes from the Middle East, and by 2020, this total is expected to rise to 70 percent. This of course raises the possibility of competition between the United States and China, hints of which are evident

Four-fifths of China's imported oil is carried on non-Chinese ships.

in Beijing's pursuit of relations with Saudi Arabia. Riyadh has long been in Washington's sphere of influence, but China has made efforts for several decades to get its foot in the door. During Jiang Zemin's 1999 visit, the two countries announced a "strategic oil partnership," and Beijing offered to sell the Saudis intercontinental ballistic missiles, though the deal never went through.¹¹ To date, the Saudis have been wary of cooperating too closely with China, for fear of angering Washington. However, as US-Saudi relations have deteriorated over the last decade, the security relationship between the two has begun to look less exclusive, and a window of opportunity may be opening up for China and Saudi Arabia to greatly improve ties.

China must be aware that the United States will not cede its dominance over oil without resistance. Drawing on its economic strength and military prowess, the United States can coerce countries into adhering to its global framework. In the 1980s, Japan endured poor US economic policies in part because it was a close strategic ally of Washington. A similar dynamic is apparent in US relations with OPEC countries, with whom the United States shares key military technologies. Whether the US military is applied directly or not, many countries will be hesitant to anger even an economically weak America.

In view of the competition for energy resources that is emerging, China has become increasingly aware of a number of strategic vulnerabilities. A key issue for China is the diversification of its oil imports and transportation modes. The most alarming bottleneck in China's oil supply is the Malacca Strait. This narrow passage in the Western Pacific is the conduit for 80 percent of China's oil imports, making it prone to piracy and naval blockades. Moreover, China's capacity to ship oil has not kept pace with growing demand. According to officials in the China Ocean Shipping Company (COSCO), as of late 2007 China only had 10 very large crude carriers (VLCCs) in service, with a further seven under construction.¹² Experts stressed that China would need 70 VLCCs in order to carry 50 percent of its imported oil in

the coming years. Currently, four-fifths of China's imported oil is carried by non-Chinese ships.¹³ By relying on foreign contract vessels for its oil supply, China risks global shortages of spare tanker capacity and the possibility of other countries blocking shipments during a time of conflict.

In the economic arena, China has already taken basic steps toward creating an independent energy market. Similar in concept to the new Russian oil bourse, China already has small oil exchanges in Shanghai, Dalian and Hong Kong, and it will soon open the Beijing Oil Exchange. The new mechanism will mainly focus on petroleum and industrial chemical products, thus it is primarily an exchange for downstream products, and will not directly affect crude oil markets. China's state-owned resources enterprises plan to inject resources worth RMB 50 billion to 80 billion every year, and make a purchase of RMB 80 billion to 100 billion.¹⁴ Though limited in scope, the exchange will help expand China's influence over market rules and pricing as it expands internationally.

A New Era

Though the result of the economic crisis is uncertain, it is clear that the dollar's day of unchallenged dominance is coming to a close. As energy trade and the global economy move toward a more multipolar system, China needs to take steps become a more prominent player in the global energy economy. Learning from the US model, China needs to push forward its own market rules, build alliances with countries with common security interests and secure its energy supplies.

One bold move in this direction for China would be to apply its substantial foreign currency reserves to aggressively invest in the international oil markets. Considering the certain decline of its reserves as the RMB appreciates against the dollar, China can afford to dedicate US\$100-200 billion to a sovereign oil fund invested oil futures markets. This would not only give China greater influence in the oil industry, but would allow it to generate profits at the same time. Such a use of its foreign reserves would not be unprecedented. During the 1997 Asian financial crisis, the Chinese government successfully used its reserves to back up the Hong Kong government in beating back foreign attacks on the Hong Kong dollar.¹⁵

Finally, China needs to work with other countries to build a more transparent financial system, particularly in the oil markets. With the elevation of China's position in the international economic community, the United States and the IMF are increasingly willing to cooperate with China in the investigation of malicious oil speculation. In such an amicable atmosphere, with the participation of the third largest economy in the world, and American anti-terrorism surveillance technology that monitors flows of funds over US\$10,000, a global financial regulation agency, with China having a prominent role, is now feasible. Much of the manipulation of oil markets has been made possible by lacking transparency. Cooperative international oversight could effectively guard against malicious speculation and manipulation and create an equitable system of oil trade that would protect both the global economy and the energy security of all countries. ☪

Notes

¹ Under Bretton Woods, the US dollar was designated as the international reserve currency, meaning that other countries would peg their currencies to the dollar, and would buy and sell dollars to keep market exchange rates within plus or minus 1% of parity. Thus, the US dollar took over the role that gold had played under the gold standard in the international financial system. Meanwhile, in order to bolster faith in the dollar, the US agreed separately to link the dollar to gold at the rate of \$35 per ounce of gold. Therefore, foreign governments and central banks were able to exchange dollars for gold.

² Whether countries collect dollars on a day to day basis does not ultimately matter. What matters more is what currencies their central banks choose to hold. Many Gulf countries in fact change some of the dollars into other currencies as soon as they receive them to diversify their assets. However, in a time of crisis, such as the current troubled status of the dollar, oil exporters can only dump their dollars at a significant loss.

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Big Brother is Watching: China's Intentions in the DPRK

Timothy Savage

Recent reports of Kim Jong-il's death may have been, to quote Mark Twain, "greatly exaggerated," but they did reveal a great deal about South Korean thinking regarding the future of North Korea. Anonymous officials leaked information that the government was looking at operationalizing ConPlan 5029, the contingency plan for joint US-South Korean intervention in the North that had been suspended under the previous administration. Given the lack of any signs of unrest in Pyongyang, the urgency of such planning was questioned by critics.¹ But it reflects an ongoing concern that has been building in South Korea over the years: that if North Korea ever does collapse, the opportunity to determine the future of the peninsula may not fall to South Korea, but rather to China.

When South Korea and China first normalized relations in 1992, it was widely seen as a diplomatic coup for Seoul. Gaining official recognition from North Korea's most staunch supporter and Korean War ally signaled that, for all intents and purposes, Seoul had won the ongoing battle for legitimacy on the Korean Peninsula. Coming so soon after the fall of the Berlin Wall, few doubted that a reunified Korea under the Southern system was on the horizon, with at least tacit acceptance from Beijing.

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Despite North Korea's stubborn refusal to prove the prognosticators right by collapsing, economic relations between South Korea and China have grown at a rapid pace. In the last decade, the PRC has emerged as the number one destination for South Korean investment, while also surpassing the United States as Seoul's leading trading partner. An increasing number of South Korean students are favoring the study of Chinese over English and staffing the language programs at top Chinese universities. South Korean pop stars and soap operas have gained wide popularity in China. President Kim Dae-jung spoke of reorienting South Korea away from the Pacific Ocean and toward mainland Asia, while his successor, Roh Tae-Woo, advocated moving the country away from its reliance on the US alliance and toward the role of a regional "balancer." So close have the two countries become that, until the election of the unabashedly pro-American Lee Myung-bak, many Washington observers were expressing fear of Seoul falling under the Chinese "orbit."

Recent events have shown South Koreans a less benign side of China's rise, however. Like the citizens of other countries, South Koreans have been disturbed by revelations of the safety problems with Chinese-made products. Disputes over fishing rights in the Yellow Sea (known as the West Sea in Korea) have been on the rise, with over 2,000 Chinese fishing boats detained over the last four years.² The situation turned violent in early October when a South Korean coast guard officer was killed trying to board a Chinese boat that had allegedly strayed into South Korean territorial waters. South Korean missionaries working with North Korean refugees in the Chinese border regions have been harassed, arrested, and sometimes deported by Chinese authorities, while the refugees themselves have been sent back to North Korea to face imprisonment, torture, and sometimes execution. Protestors demonstrating against such actions during the Olympic torch relay in Seoul were set upon by flag-waving Chinese students whom unconfirmed reports suggested may have been bussed into the city by the PRC embassy.

These demonstrations of the darker side of Chinese nationalism have reinforced concerns over Chinese territorial ambitions that were stoked by competing historical interpretations between the two countries. At the heart of the disagreement is a dispute over the "ownership" of the history of Goguryeo, an ancient kingdom whose territory covered large parts of both Manchuria and northern Korea. While the arguments on both sides are anachronistic, since Goguryeo predated the emergence of either China or Korea in their modern incarnations, it speaks to the competing visions of nationalism. China, concerned about ethnic separatism in its hinterland, points to Goguryeo as evidence of the existence of "minority" kingdoms within ancient China. South Korea, which clings to a myth of 5,000 years of ethnic homogeneity, sees Goguryeo as an integral part of the "Three Kingdoms," along with Silla and Paekche, that came together to form the Korean nation.

Many South Koreans were alarmed when China in 2002 launched its "Northeast Project" to promote research aimed at supporting its version of history. Both the government and private groups have responded by establishing their own centers

for studying the history of Goguryeo. For its part, China sees its actions as defensive moves against claims by South Korean nationalists (not supported by the government) that the “Gando” region north of the Tumen River, which is heavily populated by ethnic Koreans, rightfully belongs to Korea. According to this interpretation, the Sino-Japanese border agreement of 1905 illegitimately “gave away” Korean territory to China, whereas Chinese maintain that the border was already well established by earlier Sino-Korean treaties.³

In the two decades since it decided to ignore Pyongyang’s call for a boycott of the Seoul Olympics, China has singlehandedly disproven the previously widely held notion that relations with the two Koreas are a zero-sum game. In a way that no other country has managed, it has skillfully maneuvered between Seoul and Pyongyang, building strong economic ties with the former while retaining the latter as a buffer zone against the US alliance system in the region. This has led many in Seoul to begin questioning whether Beijing would ultimately be supportive of unification. If the current situation gives it the best of both worlds, why would China want to see a change?

In many respects, China has played a positive role in the attempts to promote dialogue and reconciliation between the two Koreas. China has willingly served as the host of the six-party talks on reversing North Korea’s nuclear development, as they did with the earlier four-party talks on replacing the Korean War Armistice with a peace agreement. It has even been willing to twist the screws a bit, as it did by briefly shutting off oil shipments to signal its displeasure with Pyongyang’s nuclear test. China has also sought to gently nudge its ally down the road of economic opening and reform, but with little success to show for its efforts. Both China and South Korea would prefer to see gradual change and development in North Korea over a sudden, East German-style collapse, which would put a major strain on both countries’ economies.

China has disproven the notion that relations between the two Koreas is a zero-sum game.

But when it comes to the question of unification, their interests begin to diverge. While support for unification, and particularly rapid unification, has waned somewhat in recent years, most South Koreans still see it as the logical and inevitable end-game on the Peninsula. In China, however, reunification poses a potential challenge. Will a reunified Korea be pro-Chinese, or at least neutral in its outlook? Or will it join with the United States and Japan in forming the northeastern curve of a strategic encirclement of China?

Both South Korean and American scholars who have studied Chinese strategic thinking on the Korean Peninsula have found that in fact China is not opposed to Korean reunification, but are rather worried about the possibility of joint US-South Korean intervention in North Korea. For this and other reasons, China would be willing to intervene in North Korea to protect its own vital interests, including pre-

venting a refugee crisis, securing loose nuclear weapons, or restoring order out of chaos.⁴

While the Chinese may view such actions as benign, many South Koreans see them as a threat to Seoul's vital interests. In an interview I conducted for an International Crisis Group report, Yun Hwytack, a researcher at Seoul's Goguryeo Research Institute, warned that if the United States and South Korea were to intervene in case of a North Korean collapse, China might use a historical claim to the northern part

The possibility of a Chinese-supported coup looms large in the South Korean imagination.

of the Korean Peninsula to justify an intervention of its own.⁵ With the continued uncertainty over who will succeed the aging and apparently ailing Kim Jong-il, the possibility of a Chinese-supported coup looms large in the South Korean imagination. Speculation has focused on Kim's eldest son, Kim Jong-nam, who has been living in virtual exile in China since being arrested by Japanese immigration authorities trying to sneak into the country on a fake passport to visit Tokyo Disneyland. Many observers fear that China would react to Kim Jong-il's death to prop up either Jong-nam or a China-friendly military junta to serve as a virtual puppet ruler in support of Chinese regional interests.⁶ Chinese experts deny that China would have any intention of helping to install a pro-Chinese leader in Pyongyang, which would go against China's longstanding opposition to one country intervening in another's national sovereignty.

Regardless of the likelihood of such a scenario, however, it weighs heavily on the minds of South Korean policymakers. In Seoul, scholars and government officials have begun to more openly admit that fear of Chinese intentions is a major motivating factor for South Korea's continued engagement efforts. China's response to North Korea's nuclear weapons development has lent credence to this view, as it has become clear that, regardless of North Korea's bad behavior, China will never entirely cut off its supply of vital food and energy. Recognizing that, Seoul feels compelled to push its own economic cooperation with the North to maintain some degree of leverage and avoid letting its estranged brother become entirely dependent on Chinese support. As one researcher at a government-funded think tank put it, "If we isolate North Korea, they'll have to rely more heavily on China, which increases the possibility that North Korea will become a pawn in a regional game."⁷ This explains why the current South Korean administration of Lee Myung-bak, despite its oft-repeated skepticism of its predecessors "sunshine policy", remains reluctant to allow a full break in inter-Korean relations.

It is quite likely that South Korean concerns in this regard are largely overblown, the result of a historical perception of victimhood, of being a "shrimp among whales." In actuality, aside from the sticky question of Seoul's alliance with the United States, its interests and that of Beijing's are closely aligned when it comes to North Korea. The Lee administration's stated policy of promoting the DPRK's denuclearization and opening in exchange for large-scale development aid fits in neatly with China's

own interest in a nuclear-free North Korea pursuing economic reform. Both sides would prefer to see gradual change and avoid chaos in the North. Opening up a trade route through North Korea by rebuilding the rail link with the South would also help increase Sino-South Korean trade.

All this strongly suggests the need for better communication between the two countries on North Korea's future. Chinese analysts have already indicated a desire to open such discussions with the United States.⁸ But any Beijing-Washington dialogue that excludes Seoul would only further exacerbate South Korean concerns of strategic isolation, which are growing, as inter-Korean relations remain stalemated while US-North Korean dialogue moves forward. Furthermore, it is not feasible to carry on an open dialogue on the possibility of regime collapse in North Korea while retaining Pyongyang as a dialogue partner, so that any discussions would have to be *sub rosa*.

But if the question of North Korea's future is too delicate to breach, it may still be possible to address some of the sources of mutual distrust. In particular, a new peace regime to replace the 1953 Armistice Agreement is on the agenda for a future stage of the six-party talks process. When negotiations reach that stage, China and South Korea can directly address the question of restructuring the US-South Korean alliance in a way that will address South Korean security concerns while at the same time alleviating Chinese fears of encirclement. North Korea in the past has hinted at a willingness to accept a continued US troop presence if doing so would help constrain South Korea or Japan from moving in a more aggressive direction, suggesting that they too may be amenable to a new arrangement.

In the meantime, the two sides need to constantly work to reduce bilateral tensions. China needs to realize that economic relations are not a substitute for diplomacy; it must directly address the historical and territorial disputes that divide the countries. For its part, South Korea should attempt to restrain the more virulent nationalistic sentiments of its citizens and constantly reassure China that it has no designs on any parts of current Chinese territory.

None of this will solve the vexing questions of North Korea's future direction, which in any case will be ultimately determined not in Beijing or in Seoul but in Pyongyang. China and South Korea cannot meet in a smoke-filled room and decide the fate of North Korea. But the more they can overcome their own mutual distrust, the less likely it becomes that whatever does happen in North Korea will lead to a broader regional crisis. ☹

Notes

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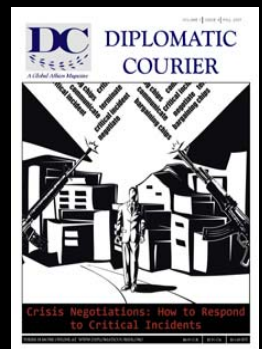
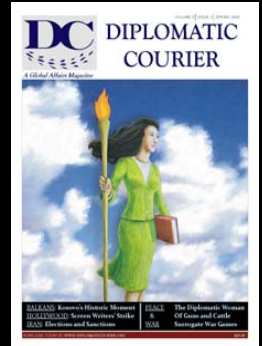
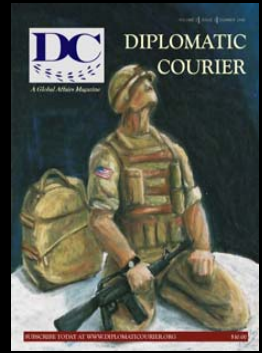


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