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CHINA'S DEVELOPMENT CHALLENGE

DRAFT REPORT

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* Until this document has been approved by the Economics and Security Committee, it represents only the views of the Co- Rapporteurs.

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TABLE OF CONTENTS

I.	INTRODUCTION.....	1
II.	RURAL DEVELOPMENT: A REDISCOVERED PRIORITY IN BEIJING.....	2
III.	DEMOGRAPHICS, INTERNAL MIGRATION AND HEALTH CARE IN RURAL CHINA.....	5
IV.	THE RISE OF RURAL DISCONTENT AND PROTEST	7
V.	FOREIGN INVESTMENT AND DEVELOPMENT	9
VI.	CHINA'S ENERGY NEEDS.....	10
VII.	CHINA'S RELATIONS WITH THE DEVELOPING WORLD AND THE INTERNATIONAL DONOR COMMUNITY	12
VIII.	TENTATIVE CONCLUSIONS	15
IX.	BIBLIOGRAPHY	16

I. INTRODUCTION

1. It is something of a challenge to think of contemporary China as a developing country. After all, this nation of 1.4 billion people has a business cycle that is literally shaping macro-economic conditions around the world. Its growth over the past two decades has averaged 9.5% a year, one of the most sustained and rapid economic transformations the world has seen in the last fifty years. (*OECD Economic Survey of China, 2005.*) China's demand for all manner of commodities is colossal, and it has become a "price-maker" in everything from steel to energy. China has developed a huge and increasingly sophisticated military upon which the government is lavishing billions of dollars worth of new equipment; its diplomatic corps is active the world round; and its coastal cities are visibly prospering. How then is one to conceive of China as a genuinely developing country?

2. In the first place, one must first come to grips with the sheer enormity of China, both geographically and demographically. Indeed, most of China is far removed from the bustling coastal cities that have literally opened this country to the world, although vast internal migration, commodities demand and a powerful central government still ensure that linkages among China's regions remain. The income gap among Eastern, Central and Western China is wide and growing ever more so. And while the ranks of millionaires swell in the Eastern cities, the narrative of the great bulk of those living in the West is of the daily struggle to subsist. The World Bank estimates that more than 100 million Chinese live below the poverty line, and that 18% of the world's impoverished people live within China's borders. (Memorandum IBRD) At the same time, China's explosive development has pulled millions of people out of poverty at an astounding pace, making it a model for many other impoverished countries. Clearly then the new China is rife with contradictions that can befuddle those casual observers convinced that they have somehow come to grips with it.

3. Of course, part of the intellectual problem is that China is a moving target. The pace of economic and social change in China has been staggering, and while millions have been brought out of poverty as a result of rapid growth, millions of others have not. This dynamic, in itself, is highly consequential because it has fundamentally altered the dynamics of Chinese society and challenged one of the supposed precepts of the ruling regime's ideology. Although wealth disparity was a reality in China even during the worst days of the Cultural Revolution, contemporary China is characterized by an extraordinary gap between the well off and the impoverished. China's Gini coefficient, which measures income disparities on a scale between 0, or perfect equality, and 1 representing perfect inequality, had already risen from .3 during the Maoist period to .5 in 2002. (Dreyer) This is a level of disparity that many would argue puts China in danger of serious social instability. This socio-economic division has fomented ideological tensions within the party and among Chinese intellectuals.

4. This inequality has an unambiguous geographical dimension as well. Income levels and physical and social infrastructure vary widely between rural and urban areas and between coastal and interior regions. Workers in regions like Manchuria, the economy of which is dominated by ageing, "rust belt" state-owned firms, have undergone mass layoffs. Millions of Chinese rural workers and farmers have fared even worse, and many in western China continue to live on subsistence incomes.

II. RURAL DEVELOPMENT: A REDISCOVERED PRIORITY IN BEIJING

5. The Chinese state is perfectly aware of its genuine development challenge. Ching Li, a China scholar, noted in a recent study of the 22 leaders closest to President Hu Jintao that all began their careers in rural politics and are therefore viscerally cognizant of conditions beyond the bustling cities of China's east coast.

6. Not surprisingly, China's leaders appear increasingly focused on developing China's hinterland. Chinese Premier Wen Jiabao made this the central focus of his address to the National People's Congress this past March. In that widely reported speech, the Premier called for a 14.2% increase in rural spending to \$42 billion, promised nine years of free and compulsory education for every rural child and the abolition of what is, in effect, an ancient agriculture tax – a decision that if implemented could save farmers as much as \$15 billion a year. Jiabao also pledged a seven-fold increase in spending on rural health insurance, new outlays on rural flood control systems, water purification, roads and other infrastructure and a 14.5% boost to spending on the unemployed. (Browne, March 6, 2006) Mr. Jiabao also vowed to increase grain subsidies to farmers, spend 20 billion yuan to improve the badly degraded rural hospital network and double the government's contribution to individual health insurance plans. Although food security remains a top priority, rural income support and environmental concerns are attracting ever-greater attention. (OECD Briefing to the NATO PA, February 2006)

7. China's leaders have called this initiative the "New Socialist Countryside" and promised that it will have a rapid and profound impact on life in rural China. The government's new policies have already provided a degree of poverty alleviation in some regions, but some economists worry that this essentially statist approach could also nourish aid dependencies without providing the micro-economic context for more sustainable, long-term economic growth. Liu Fuyuan, a government development expert has argued that the "the only way out of this corner is not to subsidize farmers but make sure that we have fewer of them." (McGregor, February 28, 2006) The new leadership is not emphasising market solutions to poverty issues and, in fact, has embarked upon a mass campaign to reacquaint party cadres with Marxist fundamentals. Some of its proposed policies could further distort some rural markets, although any advances in global agriculture trade talks could lead to greater liberalization of these markets. It is also important to consider China's producer support as a percentage of gross farm receipts is only 6% as opposed to an EU level of 34% and US and Canadian levels of 20%. China's total supports as a percentage of Gross Domestic Product (GDP) are very high relative to the EU and the US. (OECD PSE/CSE databases 2005)

8. Poverty is not only measured in income terms. Social education and health care indicators are also critical. The health system in rural China has all but collapsed due to large reductions in central government public health outlays and the inability of local governments to pick up the slack. China currently spends less than one fifth of the developed country average on health and education, and in the countryside, nearly 90% of health care is funded by the patients themselves. Health problems have become the leading cause of personal bankruptcy in contemporary China. Although China has made huge strides in educating its young people, rural China has not made the same advances as China's more developed regions.

9. The new leadership's focus on rural China represents a sharp contrast with the previous government of Jiang Zemin which was highly technocratic, particularly rooted in Shanghai, and essentially dedicated to reorienting China to the world economy. Some also see these new development initiatives being borne not only out of genuine concern for the plight of China's huge peasant population, but also as a play to reassert party control over a society which is increasingly claiming its own degree of autonomy. Chinese and Western economists worry that this rhetorical dedication to poverty issues might slow down the roll back of a still ubiquitous state, a move which

could ultimately exacerbate rather than remedy China's still serious poverty problems. The health care, education and farm sectors, for example, in some respects are hampered by too much bureaucracy.

10. President Hu Jintao has called for a more even balance between consumption and investment, more environmentally sustainable development models and a degree of social justice in a society that has embraced a growth at all costs mentality. Chinese leaders now invoke the notion of a "harmonious society" that balances growth with social fairness and environmental protection. Wen Jibao has announced that the government hopes to slow growth to 8% this year from the 9.9% achieved last year, although there is little to indicate that the economy is slowing down at all. The government is also boosting military spending by 15% to \$35.1 billion, the largest increase in four years. The projected budget deficit in 2006 will be \$36.7 billion. (Browne, March 6, 2006) All this represents a clear shift in priorities, particularly in comparison with the views of the previous leadership.

11. This reorientation is partly inspired by economic logic. Chinese leaders are concerned that the national economy has grown overly dependent on export markets and lament pervasive over-investment in some leading sectors. They feel that greater balance might be achieved by stimulating domestic demand and moving into lower energy intensive and higher technology sectors. Increasing the incomes of China's 800 million rural residents would stimulate domestic demand and take some of the burden off the export sector.

12. The Chinese leadership also sees rural development in security terms. This certainly features in its efforts to squelch potential separatist movements in regions like Xinjiang in the far West. Although endowed with still unknown quantities of coal, oil and natural gas, this vast Muslim region bordering the republics of Central Asia is impoverished and has harboured a separatist impulse. In response, the government has established an ubiquitous security presence in Xinjiang. Through the "Go West" policy it initiated five years ago, the state has encouraged the mass migration of Han Chinese into the region through massive infrastructure projects, easier bank credit, tax preferences and simpler land development approvals. Although labour costs in the West are some 25% lower than in the East, the productivity and skills of workers are lagging behind and so the jobs being created in the region are often low skilled, labour intensive activities. Another problem is that the region is so under-developed that there are few obvious industrial clusters; getting final goods to market pose a logistical nightmare. (Yeh, November 8, 2005.).

13. That said, the effort has begun to pay off. China's far west is showing signs of genuine economic change, and the separatist movement that so concerns central authorities seems to have weakened significantly there. The region's residents both Uighur and Han Chinese have benefited from growing trade, mining, energy exploration and even tourism, but there is a sense among some Uighurs that they are being pushed aside on their own land.

14. Because 70% of the Chinese population live in the countryside, conditions in rural China are very likely to have a powerful impact on the country's broader political stability. (Gang Lin) Still it is misleading to speak in general terms about rural China. In the first place, the level of development tends to drop the further from the coast one travels. Rural industrialization in the coastal regions has significantly bolstered rural and farm incomes in these areas, in part because of the rise of village enterprises and because of easy access and good transit infrastructure to move produce to market. Real rural incomes in 2004 grew by 6.2%, while urban incomes last year rose by 9.6 % (The Economist, March 25-31, 2006).

15. The central belt of China, or "Agricultural Rural China" including the regions of Hebei, Henan, Shaanxi, Hubei, Hunan, Anui, Jiangxi, northern Jiansu and parts of Sichuan has grown far more slowly. These are also the regions that, broadly speaking, have faced the highest rural tax and administrative burdens, and where the incidents of rural protest are most frequent. Economic

take off has eluded these regions because of poor market access, the relative dearth of investment capital, poor infrastructure and social services and meagre natural endowments.

16. Western and south-western China, including Gansu, Ningxia, Qinghai, Inner Mongolia, Tibet, Guizhou and another part of Sichuan are characterized by the Chinese scholar Xiabo Lu, as "subsistence rural China". This broad area has lagged even further behind in developmental terms. For this reason the government has elaborated an array of unique developmental programmes like the "Go West Strategy" designed to ease some of the pressures. The government has lowered fiscal burdens and transfer payments to these poorer regions while bolstering infrastructure and education spending.

17. Although there are millions of labourers effectively roaming the country in search of work, restrictions on labour mobility persist. Bureaucratic registration requirements even for temporary moves are cumbersome and costly to the economy as a whole. Education, health care and other local services are often not extended to migrant workers in booming urban areas. When residents of the countryside move to urban areas, they also effectively forfeit the rights to the land they worked without compensation. This is a genuine hindrance to labour mobility and imposes high hidden costs to residents in rural China. The government has sought to reduce restrictions, but further deregulation and land reform is needed if the urban-rural welfare gap is to be narrowed. (*Economic Survey of China 2005*, OECD) One problem is that the ruling elite state sees rural land as a social safety net. Their overriding concern is that if it were possible to do so, farmers might be tempted to sell off land whenever they needed cash, leaving them with no means of sustenance over the longer term. The problem with this logic is that the farming sector is so inefficient that keeping workers on the land, actually impedes China's productivity growth. (OECD Briefing to the NATO PA

18. Indeed, land ownership remains a sensitive issue in ostensibly Marxist China, and its munificent economic effects are not always appreciated by the country's political elites. One problem is that anything short of land ownership rights tends to hamper incentives to improve land. In 2003 the government extended leasing rights to thirty years, but the law has yet to be fully implemented and one might still question whether this is a sufficient length of time to encourage full economic utilization of the land—something that either longer leases or outright ownership would tend to encourage. For over a decade China's city dwellers have been able to sell their homes on commercial markets; yet rural land has remained under collective ownership and generally cannot be traded. Local power brokers, however, frequently seize collectively owned land, reclassify it as commercial land and sell it off, often leaving the peasants with nothing. Compensation for those who actually worked the land is frequently diverted to local and regional bureaucracies where it is skimmed, leaving nothing for the dispossessed farmers. Thus just as millions of workers in state-owned firms are losing jobs due to restructuring, many farmers have also suffered dislocation. (Friedman) Although central authorities have acknowledged the problem, they fear change that might alter the social and economic buffer provided by the traditional rural economy.

19. In post-Mao China, many township and village governments have relied on local taxes and land use fees in order to finance those basic community services once provided by the communes and underwritten by the central government. These burdensome fiscal arrangements have triggered a serious degradation in the political and social comity between farmers and local authorities. (Lu) The burden on China's rural population in much of Central China has been ratcheted up since the decollectivization of agriculture. Villages in particular have lost funds once provided from the collectives. Fees for service for everything from healthcare to education have replaced the old revenue stream once used to underwrite basic local services and local government salaries. But these fees have eroded the incomes of countless farmers. This system has proven highly intrusive and costly and in many instances has represented a step back in

developmental terms. Indeed, it is a contributing factor to the great migration toward China's urban regions as many families are finding it increasingly difficult to make ends meet in the countryside.

20. The central government has been trying to remedy the problem and to ease the grave social tension it has unleashed. For example, it has permitted village council elections, and thereby taken a first if very tentative step toward democratic local government. Moreover, those wishing to serve as Village Party Secretary must now demonstrate their local appeal by first being elected to a local Village Committee.

21. Central government officials are also demanding transparency in village accounting systems and have implemented auditing procedures to cut down on pervasive corruption problems. How this system can be squared with the rise of village elections is still not clear because the latter implies greater decentralization of decision making while the former suggests a modicum of recentralization. Some experts also point to the mounting tensions between the villages and the townships over how basic services are to be financed. (Jean C. Oi)

22. The central government's wager is that increased rural economic activity should eventually generate sufficient local income to compensate for the financial hardships associated with the decline of the commune system. Yet, revenue declines in many villages as well as falling grain prices, rising fertilizer costs and unfair tax burdens have only generated hardship and continue to foment social tensions on peasants sparked a precipitous fall in farm incomes from the mid 1990s.

III. DEMOGRAPHICS, INTERNAL MIGRATION AND HEALTH CARE IN RURAL CHINA

23. China's population is at once the driving force of its economy and a potential source of grave problems. According to the UNPD's projections, between 1975 and 2025, China's population will have increased by half from roughly 930 million to over 1.4 billion. (Eberstadt) But there is no universal agreement on the rate of China's demographic growth. The government in Beijing estimates that the population is expanding by less than 1% a year and suggests that China's population will peak in 2030. Some demographers, however, argue that official figures are significantly understating population growth rates. These experts put the annual rate of increase somewhere between 2 and 2.3%. This rather vast discrepancy has arisen because of alleged underreporting of births due to the country's one child policy. Vaccination data tend to support the more dynamic growth forecasts and confirm a pattern of systematic underreporting. Although the government has announced an amnesty on penalties against those having a second or third child, many Chinese harbour fears of reprisal and instinctively do not report these births. This is particularly common in rural areas.

24. These higher growth numbers have several potential implications. On the one hand, they suggest that the aging crisis in China may not be as severe as some have suggested. There may be more young people than expected to help underwrite the pensions and health care of the retired. The more common view has been that the one child policy has been a factor in a looming pension crisis that could adversely affect China's productivity and finances over the long run. The one child policy's "demographic bonus" will already be lost in next decade as the dependency ratio rises. (The Economist, March 25-31, 2006) That policy has also skewed the ratio of males to females. In rural cultures that place a greater value on male children, statistics suggest that the policy has led to high rates of female embryo abortions and even female infanticide or neglect. With a male to female ratio somewhere between 113 and 119:100, social stability is threatened because of the growing reservoir of single men with few prospects for marriage or employment. (Dreyer)

25. The one child policy also became a rather paradoxical source of revenue for village and township governments that levy fines on those families that have exceeded the one child limit. Curiously this deterred local officials from taking other measures to discourage childbirth simply because the fines had become an important source of income for cash strapped community governments; there was little interest in drying up the sources of this bounty. Indeed, local officials continued to exact these levies even after the central government announced that they should no longer tax families for having additional children.

26. The OECD has suggested that the public pensions system, which only covers 14% of the active population (at present only one third urban employees are covered, and rural residents enjoy no coverage at all), could be spared if part of it were transformed into a fully funded individual account system with balances invested in capital market instruments. This is happening as a pilot project in several provinces; yet because the payout to retired workers is already so high, the government has had to step in to subsidize the equities investment share of the funds. The OECD is thus also recommending that China both equalize and raise retirement ages for men and women, phase out early retirement schemes and bring benefits into line with life expectancy at retirement. The government is committed, in principle, to deploying proceeds from privatisation to create a fund to help underwrite the pension system. Because state assets are worth roughly 80% of GDP, this could help turn around what is, in effect, a broken system, provided a range of financial and banking reforms are also undertaken. Another set of obstacles to a market-based pension system are the low domestic yields on China's bond and equity market. (OECD)

27. Under Mao, most Chinese enjoyed access to basic health services and guaranteed employment. This system began to fall apart once Deng Xiaoping embarked upon a liberal reforms agenda structured to bolster Chinese productivity.

28. The health care crisis is most evident in China's rural areas. Diseases that had been all but eradicated some forty years ago have reportedly begun to reappear in the countryside. Many rural physicians, once known as "barefoot doctors", have lost state subsidies and have moved from public service to private practice. Their fees are now beyond the means of many Chinese rural workers. Hospitals are also increasingly compelled to charge high fees for services that were once very inexpensive. Many Chinese living below the poverty line are impoverished, in part, because of ballooning medical costs.

29. China's health care system is thus extraordinarily stressed and without major changes could worsen as the society ages. The public's health care needs will invariably mount just as the working population wanes. This dynamic is already underway. Government figures reveal that whereas there was one retired person to 30.3 workers in 1978, by 1999 this ratio had fallen to 1:3.7 and could reach 1:2.4 in 2030. (Dreyer) But as suggested above, government figures are not totally reliable, and the situation may not be as compelling as these figures suggest. Still, the trend lines point to mounting stress on the system.

30. So far, government efforts to remedy the situation have met with little success. For urban dwellers, the government has devised a system of mandatory contributions whereby workers pay in 2% of their salaries and employers 6% of the salaries for health care. Workers, and employers are together supposed to underwrite individual health accounts to help cover outpatient treatment and medication. The remainder of the employee contribution goes into a general medical trust fund. The benefits of the plan, however, remain limited. Moreover, there are millions of mobile workers labouring in very precarious circumstances who simply do not have access to the kinds of benefits enjoyed by those working in firms complying with regulation. Nor does it cover the millions of unemployed workers, many of who have recently been laid off from positions in state-owned enterprises.

31. The problem is even more dire in rural areas where old social safety nets are in tatters and where there are few resources available to reconstitute it. Farmers and rural workers are now supposed to enrol in health co-ops, and both the central and regional governments are supposed to pay into the system. But how treatment facilities are to be staffed and financed in practice remains an open question.

32. There are other structural problems complicating public health care management in China. These include the migration of trained doctors to urban centers and the reluctance of the national and local government to share public health information – a tendency that goes a long way to explaining the problematic approaches authorities have taken to epidemic outbreaks. These deficiencies are not only consequential for China, but have potential global implications. This was made apparent during the SARs epidemic and could yet be a factor in the growing threat posed by Avian Influenza.

IV. THE RISE OF RURAL DISCONTENT AND PROTEST

33. The increasingly dire situation in the countryside has been one of the primary factors in the rise of rural protests about which central authorities have grown terribly concerned. In 2000, the Communist party identified rural unrest as the single greatest threat to national stability. China's police reported a 268% rise in so called "mass incidents", from 8700 events in 1993 to 32,000 in 1999. Police in Central China registered a 40% increase between 1999 and 2001. (Tanner) Zhou Yongkang, the public security minister, recently reported that the annual number of "mass incidents" had risen from about 10,000 a decade ago to 58,000 in 2003 and 74,000 last year— involving a total of some 3.6 million people. (*Financial Times*, September 8, 2005) In the relatively small south-western province of Guizhou, for example, there were more than 21 incidents engaging a thousand protestors or more in 2001 alone. These protests are certainly not restricted to developing regions; indeed incidents have occurred even in China's richest cities including Shanghai. (Tanner)

34. The reasons for these demonstrations vary as do the numbers participating, the sophistication of organization, the type of demands made and the degree of violence employed both by the protestors and by the police.

35. One fundamental question is whether these protests are a natural side effect of China's development. In other words, could they simply reflect a crisis arising out of ever higher expectations among millions who will see only minimal if any improvement in their material condition despite China's galloping rate of growth and the rags to riches narratives that have so captured the imagination of the Chinese public? That is certainly part of the story; rapid development often can precipitate a crisis of expectations among people once willing to accept their lot in life. But, in China's case, protests are also fuelled by a range of tangible problems including corruption, pollution, taxation, the closing of local plants and the expropriation of farmland. The fact that these hardships seem intrinsically linked to different aspects of China's growth and development raises deep concerns about the potential for a backlash.

36. As suggested above, farmland cannot be bought and sold in China, while commercial land is. The government wants to prevent peasants from selling farmland that it views as the very heart of China's rural safety net. Paradoxically, however, a climate of insecurity has become evident in many rural areas. Expropriations designed to turn farmland into commercial property can leave the suddenly landless peasants with nothing, while local real estate brokers stand to make windfall profits by playing the commercial real estate market. Local officials themselves face conflicting signals as they are increasingly rewarded for their capacity to generate commercial economic

activity in their area of responsibility; active real estate markets can help register sharp increases in the local growth even when they are the product of ruthless expropriations. ("Cultivating the countryside: Hu takes pains to keep China free from a peasants' revolt, *Financial Times*, September 8, 2005.) This apparent commercial real estate bias, locked in by the differential treatment of farming and commercial land, could also be a factor in China's problem with industrial overcapacity. In other words, there are in China powerful strong legal and financial incentive to develop property for commercial use, while few incentives exist to upgrade farmland itself. This distortion of price signals is leading to speculative commercial development that could well produce a real estate and commercial bubble.

37. There are also signs that some protestors are focusing on the lack of democracy in the countryside and are thus pushing into areas the Communist Party sees as potentially threatening to its political hegemony. Some influential party members see even discussing rural land marketization as a challenge to party ideology. This could be one reason why Beijing seems increasingly willing to blame local authorities for derogation of their obligations to rural inhabitants; doing so implicitly absolves them of responsibility for difficulties in rural regions.

38. Rural protest has a long history in China, and peasant uprisings in China's long history have sparked broader upheavals that have shaken dynasties. For a leadership with a refined millenarian sensibility, rural uprisings are not to be taken lightly, although there are clear indications that the government is approaching them with far more subtly and flexibility than in the past. Where once these protests were characterized simply as anti-communist conspiracies to be harshly suppressed with mass arrests, some protests are now understood as reflecting genuine social inequities that legitimate the public's overt sense of grievance. Indeed the police and national authorities, on occasion, have been willing to meet some of the protestor's demands. Both now more willingly express sympathy to mass complaints of corruption, exploitative levies, and blatant disregard for local environments, poor working conditions and illegal expropriations. Indeed protestors often appeal to the central government to correct the misbegotten ways of local government and party officials. (Gang Lin) Calls for measures against corrupt local officials and even some demands for the rule of law are no longer simply dismissed at the center. Accordingly, local officials can find themselves facing pressure not only from the local population but also from the central government.

39. The central government has also responded by reducing the tax burdens, bolstering commodity prices, and encouraging a degree of open political participation through village level elections. But they are also vigilantly preventing farmers from linking up either across regions or across social classes (ie. by forging alliances with workers, students and the urban elite in order to build broader anti-regime movements). This has helped the regime keep a lid on rural discontent, although this selective dialogue may constitute more of a holding pattern than an attempt to resolve these tensions in a more profound manner. (Yawei)

40. Harsh crackdowns are still part of the government's policy, particularly when protestors target the central leadership of the Communist Party. Recently in the fishing village of Dongzhou, security forces killed at least twenty people while suppressing violent protests over the construction of a nuclear power plant. The village was then cordoned off and residents were warned that they were to explain the deaths as the consequence of bombs thrown by the protestors. Family members that complied were apparently promised 50,000 Yuan or (\$6,193), but many were still willing to speak with the press. The bodies of the dead were withheld from the families because they were, in fact, bullet ridden. (French, December 19, 2006)

41. Over the longer term, the governments' monopoly on political power and the absence of democratic dialogue will, in itself constitute a continuing source of instability, particularly insofar as single party government invariably tends to corruption and arbitrary local rule making. This is precisely why many analysts suggest that only by achieving a higher degree of pluralism can the

system generate genuine accountability in decision-making, which, in turn, may be one of the prerequisites to ensuring a more politically tranquil and ultimately a more prosperous countryside over the longer term.

V. FOREIGN INVESTMENT AND DEVELOPMENT

42. Foreign direct investment along with domestic economic reforms have been critical elements of China's explosive growth since 1978. Foreign investors have financed the construction of new plants and industries that are capable of competing in the global economy. They have introduced new technology, generated millions of jobs, spread new managerial skills and helped finance both imports and exports. All of that said, Foreign Direct Investment (FDI) inflows to China are still well below those of the OECD on a per-capita basis. In 2000, FDI to China stood at US\$30.1 as compared to an OECD average of US\$1,320.9. That year, Argentina attracted US\$314.8 per capita and Chile US\$241.6. (IMF, October 2002) Moreover much of this FDI is concentrated along the coastal regions of the country. One of the keys for broader development in China will involve attracting greater foreign and Chinese capital to the country's interior regions.

43. Investors are a fickle lot and extraordinarily sensitive both to political risk and to the quality of the policy environment. China has made great strides on both fronts and World Trade Organisation (WTO) accession promises even more advances on a range of governance matters. The country is opening up its services and financial sectors to greater competition, which invariably will spark productivity gains and new growth opportunities. But risks and governance challenges appear more problematic in the central and western regions of China. Development here will partly hinge on the capacity of local officials working with central authorities to establish rules-based governance systems, coherence between local and national legislation and regulation, transparency, reduced corruption, and physical and financial infrastructure needed to attract and to support investors. China's vast hinterland suffers from shortcomings in all of these areas. (*OECD Policy Brief*, 2003)

44. The Chinese state, however, hopes to remedy the situation. Foreign firms operating in China are now offered the same investment incentives as domestic firms in the impoverished regions of Central and Western China. So far, this and the fact that wages in these regions are lower have not been sufficient incentive for many firms to take up the offer. The problem is the still poor business climate in these regions, the lack of infrastructure, distance to market, low productivity rates and relatively lower skill levels in these regions. The Chinese state is also embarking upon an impressive effort to build up infrastructure in these regions; this could help at the margins. But the regulatory and governance issues are more intractable and will be the real measure of the region's capacity to attract, absorb and sustain investment.

45. Of course, regulatory problems persist at the national level as well although here the improvement has been greater. The government has categorized investment into four categories: *encouraged*, *restricted*, *permitted* and *prohibited*. While the great bulk of investments now fall under the *permitted* heading, there are persistent barriers that are probably impeding investment in Western China. For example, China prohibits FDI in traditional crafts ostensibly to protect their Chinese essence. But such restrictions might just as well be the death knell of industries that will otherwise find it very difficult to carve out a place in an ever more globalized and competitive market. (*OECD Policy Brief*, 2003) The Chinese have had to loosen up these categories as a result of WTO accession, and even the once protected financial sector will be exposed to ever more foreign competition. Still approval process for FDI projects remains cumbersome, bureaucratic and opaque. China will also need to open up its domestic market to international service providers in order to galvanize a vital sector that is lagging well behind the industrial

sector. Domestic and international firms alike need these services and are penalised when the local offering is so paltry and the international presence is artificially restricted.

46. The legal system poses another set of problems. Chinese judges, particularly in the remote provinces, are often very reluctant to lay down coherent legal rulings when such verdicts go against the wishes of local party officials. This is to be expected in a system in which the Communist Party and the government it ultimately controls, and not the courts system, are the final arbiters of law. The central government, however, has recognized at least part of the dilemma, and is seeking to strengthen the court system in order to provide a more stable investment climate. The problems mount in more remote regions where such changes are unwelcome and often openly restricted. The contradictions become even more onerous when matters of local corruption are involved. Moreover, there are often conflicts between provincial and national laws. Provincial laws, for example, are sometimes inspired by anti-market concepts that impede economic development and contravene national policies. Though conflicts between national and provincial law are supposed to be settled in favour of national law, this is not always the case in practice. (Yardley, November 29, 2005)

VI. CHINA'S ENERGY NEEDS

47. Energy poses one of the primary constraints to the country's development. The problem is multi-faceted and obviously touches upon China's very serious environmental problems as well as both its strategic posture and its foreign policy. Currently increasing at roughly 12% per annum, China's demand for petroleum is outpacing the rate of GDP growth. This dynamic has taken hold at a time of global supply uncertainty, energy price rises (for which rising Chinese demand is partly responsible), and global warming (a serious threat to a country that already is suffering from chronic water shortages and desertification). All pose long-term development challenges to China.

48. China once met most of its energy needs with domestic sources. Until 1993 its huge oil field in Daqing ensured oil self-sufficiency, and China was, in fact, a net exporter of that commodity. Its extensive coal deposits met two thirds of its overall energy requirements. These endowments, however, were either quickly depleted or insufficient to meet the energy needs of an economy in the midst of genuine "take off." By 2003, China had to import one third of its oil. This figure will mount inexorably as the Daqing fields yield ever less oil just as the country's overall energy demand is soaring. By 2015 imported energy will account for more than half of China's energy use and will likely rise further thereafter. (Dreyer)

49. For China, this is a very sudden and consequential change, one laden with developmental implications. In the summer of 2003, for example, two thirds of China's provinces were compelled to announce energy use restrictions. Fearing a replay of that supply crisis, China's leaders have embarked on a massive effort to achieve a degree of energy security on both the supply and demand sides in order to power economic development. The government has announced automobile fuel efficiency standards that are already more stringent than those of the United States and hopes to match European standards within the decade. (Chen and Rong) Making gains on this front is critical because China, like many underdeveloped countries, needs twice as much energy to generate a unit of GNP than does the United States. Its capacity to reduce this ratio will not only be an indicator of its own developmental progress but will, by extension, enhance its own national security. (*Shanghai Daily*, October 25, 2004)

50. The burning of low quality coal to power Chinese industry has contributed enormously to the country's dreadful pollution problem. Five of the ten most polluted cities in the world are in China, and it is estimated that the welfare costs of China's poor environment are between 3% and 8% of GDP. (Economic Survey of China, 2005, OECD) The last two five year plans have provided a road

map for environmental improvements and some small progress is evident. Much of this is due to the fact that the Chinese economy is growing ever more sophisticated and "developed". Sulphur emissions, for example, increased by only 5% between 1993 and 2003 despite a doubling of GDP in that same period. Still, pervasive coal burning combined with soaring petroleum use for automobiles and a high energy to GNP ratio have combined to make China's air quality among the worst in the world. In 2003, the government increased the penalties paid for the emission of air and water pollutants, but many coal driven plants lack clean technology, and wide scale evasion of regulations is apparent. This has had incalculably adverse effects on public health.

51. Environmental degradation is a problem that respects no borders. China's contribution to the phenomena of global warming is growing ever more consequential particularly as it uses far more energy per unit of output than more developed countries. The consequences are tangible. Dirty air from Asia, for example, is allegedly affecting the air quality of North America's west coast and its green house gas emissions, not yet regulated under the Kyoto Protocol, are doubtless contributing to the global warming phenomena. Chinese environmental regulators are now warning that air pollution levels could quadruple over the next 15 years given the growing rate of demand for electricity and automobile use and the fact that at least half of currently operating coal fired power plants violate national regulations. The government is now planning to implement a US style cap and trade emissions control system to encourage further emissions reductions. (Baston)

52. China's incredible growth is coming at a terrible long-term cost to its environment and public health. The problem is both developmental and political. Although China has passed numerous Western style environmental laws, these are very poorly enforced. To take one small example, there are some 50 idium factories along the Xiang River in Hunan that have turned the river and the ground water system into dangerous chemical stew. Nothing is done to correct the problem because many local officials are also shareholders in these firms. Fines and penalties are often too low, and even when plants are shut down, they quickly reopen in something akin to a shell game with national environmental authorities. It is not surprising that 300 million Chinese have access only to contaminated drinking water. (McGregor and Harvey)

53. On matters related to the Kyoto Protocol, China flirts with both the American and European positions, cooperating with the American technology sharing pact and the Asia-Pacific Partnership on Clean Development and Climate while working with the EU on coal power emissions reductions. Both sides have sought to win China over to its particular interpretation of Kyoto. Not coincidentally perhaps, China has been one of the largest beneficiaries of environmental funding from developed countries. It is exempted from the strictures of the Kyoto protocol until 2012, but afterwards it is likely to face more pressure to accede and to accept international strictures on emissions. (Harvey, January 27, 2006)

54. China is also engaged in an all out effort to meet current energy needs and to insulate itself from a possible blockade were it ever involved in an international crisis over Taiwan that closed the sea lanes. (Pala) It is doing so through a combination of new pipeline construction, such as a proposed 3,100-km line from Kazakhstan's Aktyubinsk field to Xinjiang's Tarim basin in Northwest China, massive hydroelectric development including the Three Gorges dam, (among the largest development projects in history), nuclear and coal plant construction and the aggressive pursuit of oil development deals in Central Asia, Africa, the Middle East and South America - a strategy that closely linked to and indeed partly driving China's increasingly ambitious foreign policy. There are political, financial and environmental stakes in many of these initiatives. The Three Gorges dam project, for example, is so massive that some scientists are concerned that it will precipitate localized climatic changes as has happened with several other hydro projects in China and could have a range of other unintended environmental consequences. The Chinese have apparently decided that this risk is worth taking given the potential contributions of plentiful electrical energy to regional development. Finally, The Russian gas monopoly Gazprom has just concluded a deal

with China to build two major new pipelines into China that many fear could draw gas away from Europe unless Russia's capacity is significantly expanded. Moreover, the deal suggests to some that Russia is creating for itself an opportunity to play Europe and China off of each other.

VII. CHINA'S RELATIONS WITH THE DEVELOPING WORLD AND THE INTERNATIONAL DONOR COMMUNITY

55. China's economic rise is not only a story of that country's internal economic development. Indeed, it has implications for much of the developing world as well. China has become a critical commodities consumer, and as suggested above, its demand has driven up the price of a range of raw materials produced in the developing world. For mineral, metal and energy exporters this has had a very positive effect on terms of trade and current account balances. Chinese demand in 2003 drove nickel prices to a 13-year high, zinc to a seven-year high and platinum to a 23 year high. China has also become extraordinarily active diplomatically and economically in regions that supply it with much-needed raw materials. But the news is not all good, at least from the perspective of China's competitors in the developing world. China's cost structures are so competitive that developing country producers, particularly in certain manufacturing sectors, have faced worrying competition from the Chinese and China has also recently sought to leverage its purchasing power by demanding commodities price reductions.

56. China's relations with the developing world are thus economically and diplomatically complex and dynamic. Relations with Africa provide a case in point. Between 2000 and 2005 trade between China and the countries of Africa increased from \$10 billion a year to \$28 billion. (Alden) China is providing increasing amounts of foreign aid to the region and has deployed troops to several conflict-torn countries like Liberia. Part of this activism is driven by China's need for energy and raw materials, but there is more at stake from the Chinese perspective. The Chinese leaders are also motivated by their quest both for new markets and investment openings as well as for new strategic and diplomatic opportunities including recognition of the "One China" principal. Because Africa is relatively under invested, the Chinese feel that building a presence could ultimately prove financially rewarding.

57. Relations with Africa also offer a field on which China can contribute to development in a concrete way, thereby validating its claim to be a peacefully ascending great power with global economic and political interests. Africa has the largest block of states in the United Nations, and China sees its relations with these countries as providing important political and diplomatic rewards as well as economic ones. Its stress on non-interference in internal affairs has a degree of resonance among some African governing elites and is yet another foundation of this rapidly evolving relationship. China has also directly appealed to African elites by constructing new foreign ministry buildings in Uganda and Djibouti, football stadiums in Mali, Djiboutia and the Central African Republic and parliaments in Mozambique and Gabon. This represents a relatively low cost way both to win approval for the one China policy and to demonstrate in a very tangible manner that China is now a player on the world stage.

58. China is also providing more traditional forms of development assistance, although as a developing country itself, its own resources on this front are limited. It has nonetheless helped underwrite the civil service of the Central African Republic and Liberia and provided a range of loans to oil rich Angola. China has developed a range of technical training programs as well, most notably in the agricultural sector. At the 2003 China-Africa Cooperation Forum, China also announced that it would forgive a total of \$1.27 billion in debt from African countries while providing additional financial assistance.

59. Meeting China's energy and raw material needs however is clearly the top priority for the government. In Angola, Chinese workers are refurbishing old rail lines, government buildings and a new airport in Luanda all with \$2 billion in credit from China's import-export bank. (Reed) The China National Petroleum Corporation, (CNPC) is playing a very active role in Gabon, Algeria, Angola and Sudan, and the Chinese state has supported this effort through a range of complementary policies including financial aid, construction projects, arms sales and close diplomatic ties. Sudan, which has rapidly earned pariah status throughout much of the world because of the genocide in Darfur, has become China's largest overseas investment target, its primary source of off shore oil, and a base for other oil operations in the region. (Alden) Sudan is thus a critical link in China's strategic aspiration to provide an uninterrupted supply of oil to domestic consumers. A number of oil sector analysts, however, have noted that China is overpaying for some of the assets it is purchasing. If oil and gas prices remain very high this may not matter, but a price fall could expose a degree of financial vulnerability. This suggests that the Chinese are playing as much a strategic energy security game as an economic one.

60. China is also concerned about domestic food security as more and more of its prime farmland is being lost to industrialization and urbanization. This has led China to invest in both agricultural and fisheries industries in Africa. It has, for example, leased extensive farmland in Zimbabwe, Zambia and Tanzania.

61. China also sees Africa as a large and untapped market for many of its basic low cost products. It has sold a considerable amount of advanced military equipment and light arms to a number of countries in the region. Chinese companies have set up an array of textile and agricultural joint ventures with African producers which have been a vehicle for selling additional product in both the US and European markets. This has been made easier because of market access granted to African states through the America Africa Growth and Opportunity Act (AGOA) and the European Union's Cotonou Agreement.

62. China enjoys a significant trade surplus with Africa despite its imports of oil and raw materials from the continent. Its prices in a range of manufactured goods are very competitive and this has generated some friction particularly with South Africa. There has also been some unhappiness with the Chinese tendency to bypass local labour markets by hiring Chinese contract labour for large Chinese funded construction projects in Africa.

63. Chinese investment in investing in Africa is welcome precisely because the region has had so much difficulty attracting foreign investment. Moreover, Chinese investment is not focused simply on government owned enterprises. Smaller firms have also benefited, and the links to China have had a positive impact. Chinese tourists are also flocking to a number of African states like South Africa and Zimbabwe, which the Chinese government has officially approved as a tourist destination. This business is important for a country like Zimbabwe, which has been shunned by the West because of its appalling human rights record. China is also cultivating energy relations with a number of Latin American states and has readily exploited poor U.S. relations with Hugo Chavez to sign a number of energy deals with Venezuela.

64. China thus offers economic and diplomatic relations to developing countries without imposing the kinds of obligations that Western countries and international lending communities impose. Indeed Prime Minister Wen Jiabao has specifically renounced the notion of political conditionalities —a genuine contrast to the position taken by the West particularly towards countries like Iran, Sudan and Zimbabwe. This certainly opens up one pathway for gaining market access, something that the Chinese have readily exploited in the case of Venezuela which, while the largest supplier to the United States, is also in the midst of something akin to a Cold War with its northern neighbour. On the other hand, the Chinese approach goes against a general current in international relations in which matters of domestic governance and human rights are increasingly recognized as legitimate matters for the diplomatic and donor countries. It is certainly

a key part of reigning development paradigm, and many Africans have recognized this. The New Economic Partnership for Africa's Development (NEPAD), for example, makes good governance and human rights central to the development bargain, and many, although not all African states have accepted this. China's dilemma could become more daunting if African reformers begin to see its government as aligned with retrograde status quo forces that have actually contributed to the impoverishment of the continent.

65. Because China has grown at such a rapid pace, because it is becoming something of a donor country in its own right, and because of its increased spending on defence, there is an important discussion in the West about the degree to which it should continue to receive development assistance. Budgetary pressures in the EU, for example, are leading to a rethink of current aid policy toward China. Since 2000 the EU's trade deficit with China has increased from Euro 50 billion to Euro 80 billion in 2004. The EU provides about Euro 150 million a year in development assistance to China aimed at poverty eradication and environmental clean up. The Commission, however, has proposed gradual reductions in development and humanitarian aid to China over the next budget period. (Beatty)

66. China has extensive relationships with both the World Bank and the Asia Development Bank, borrowing approximately \$1 billion in FY2005 alone from the World Bank and averaging \$1.5 billion a year in loans from the Asia Development Bank. China's portfolio is the World Bank's largest, and the Bank has extended a total of some \$39 billion in loans and credits since China joined the Bank in 1980. It has overseen more than 263 projects in China, with about 90 ongoing projects. The Asia Development Bank has planned for \$4.5 billion in loan assistance from 2006-2008, excluding 'sub-regional' projects. Slightly less than half of that aid is earmarked for transport projects, 20% for agriculture and natural resource development, about 15% for social infrastructure projects, 12% for the energy sector and the remainder for multi-sectoral projects.

67. Unlike other countries, China's relationship with the World Bank has never been predicated on conditionality but rather on 'persuasion' and 'demonstration'. In other words political and economic matters have been treated separately due to Chinese sensitivities. While China constitutes the Bank's largest portfolio, Bank loans make up a very small proportion of GDP, reducing the amount of leverage that the Bank might exert over internal Chinese political developments. Even in the year of greatest Bank assistance, 1994, Bank loans of \$3.3 billion constituted only 0.6% of Chinese GDP. That said, World Bank assistance on poverty relief, infrastructure development, and environmental protection has made a small but useful contribution to Chinese development. In 1999, however, China "graduated" from the International Development Association (IDA). "IDA donors had decided that China was sufficiently creditworthy to dispense with IDA funding" although Chinese authorities did not welcome their exclusion. International Bank for Reconstruction and Development (IBRD) loans were also constrained by the Bank's limits on the total share of its overall portfolio in a single country. After 1999 the Chinese government decided to restrict IBRD loans to poorer provinces officially because their terms were too onerous. This somewhat complicated the Bank's poverty reduction strategy. Meanwhile, the Bank has shifted its strategy from a 'liberalisation' phase to a more difficult structural and institution-building phase, and is now very focused on the banking sector. The Bank will also devote more attention to infrastructure development, especially in the energy sector. (IBRD, Memorandum of the President)

68. The United States Agency for International Development (USAID) allocates paltry sums for development in the PRC. From FY2003 to 2005, aid assistance in the form of grants averaged about \$4.6 million a year, with almost all of those funds earmarked for environmental and socio-economic assistance in the Tibet Autonomous Region. For FY2006, there is no money earmarked for Chinese aid.

VIII. TENTATIVE CONCLUSIONS

69. An engaged China will own a stake in global stability and prosperity and is well positioned to contribute to both while an isolated and disengaged China would pose a much greater challenge to regional and global stability. The international community is looking to China to play a positive and engaged role in international relations and the Chinese leadership claims that this is precisely what it seeks to achieve. But for China to maintain its outward orientation and for it to raise its own stakes in global order, it will have to ensure that its less developed regions share this sense of ownership. That is its most daunting development task. If those living in this vast hinterland come to believe that China's reform agenda and its participation in the global economic order have only introduced suffering and impoverishment, then instability could cause an ever less open China to recoil from what it might come to see as a hostile world. But that retreat in itself could be destabilizing, and it would hardly produce a more open, pacific, and democratic society.

70. There are a number of ways in which the West can work to avoid this scenario. We must continue to engage China and encourage its economic, social and political evolution. Intrinsic to this approach will be support for the development of China's interior regions. Further liberalization of global agricultural markets within the Doha framework would not have a large impact on China's overall economic position but would boost Chinese farm income, and most rural households would gain as a result. It would help close the rural-urban income gap while integrating smaller farmers into market structures. Western know-how could also be put to use in enhancing the environmental sustainability of agriculture and encouraging implementation of best practices.

71. International support for China's development can take many forms. The West and multilateral donors needs to offer technical support in areas like governance, fiscal and legal reforms as well as in poverty reduction strategies and environmental clean up. Working with regional and local officials is particularly needed, as this is where China suffers the greatest deficiencies. These efforts must be extended to the provincial and township levels and engage non-state actors. The World Bank has already begun to focus on precisely these areas and in development terms, it may be here where donors can make the biggest bang for the buck.

72. For its part, China may need to further amend its overall development strategy, which has placed such a premium on overbuilding physical capital while imposing terrible burdens on the environment, the health care system and neglect for the poor. Rising social tensions in the country are the direct result, and there are yet no democratic means of expressing the public's exasperation. Oftentimes legal recourse is blocked in the muddled court system, and overt discontent is undermining the government's legitimacy. The problem is that the ruling elite may fear the democratic remedy more than persistent public discontent. But hewing to that logic does not, on the face of it, seem sustainable. China needs to clarify rural property rights, further liberalize labour markets, upgrade rural education, health care and social safety nets and find more sustainable solutions to financing these fundamental services. It should take these tasks on while its economy is booming rather than when growth slows.

73. China's environmental problems are increasingly a global concern, and addressing them must be a priority for Chinese society, the international development community and China's international interlocutors. China's internal stability could partly hinge on the state's capacity to cope with these daunting environmental challenges. It is not coincidental that many protests in China are focusing on this issue.

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