



# EDITORIAL

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May 2001

In hindsight, the 1990s may be remembered as the most crucial decade in East Asian history since the Second World War. Once the economic powerhouse of the region, Japan stagnated miserably – the most recent White Paper from the Ministry of Economy, Trade and Industry declares an end to Japan’s role as economic leader, and asserts that a new era of “competition” between Asian economies has commenced. China, the region’s ever-nascent superpower, recorded phenomenal rates of growth and became increasingly assertive in its relations with its neighbors and the United States. Yet, many questions remain about the sustainability of Chinese development and its widely criticized human rights record. The once venerated “Asian Miracle” turned sour in 1997-98, igniting a major global financial crisis and inviting humiliating intervention by the International Monetary Fund. The Asian Financial Crisis, however, also sowed the seeds for greater cooperation and integration within the region. The role of the United States, although still significant, appears to be in comparative decline.

In this inaugural issue of the Stanford Journal of East Asian Affairs, we intend to present a broad overview of the issues facing East Asia today, as well as historical issues of significant interest. As a matter of policy, we believe that the traditional definition of East Asia as encompassing only China, Japan, and the Korean peninsula is grossly inadequate to the emerging realities of the region. Therefore, we have included a section covering “Greater East Asia,” incorporating Southeast Asia and perhaps the Russian Far East in future issues. Our imperative for creating this journal rests on our firm belief in the increasing importance of the region – politically, economically, and academically – as well as our desire to serve as a focal point for the abundant resources Stanford offers as the premier institution of East Asian Studies.

This journal is roughly divided into six main sections. Our Current Affairs section briefly summarizes recent developments worthy of mention. The Research section provides a more in-depth analysis of pertinent topics by our staff. In this issue, we investigate the role of Theater Missile Defense and the historical development of Chinese technology. The four remaining sections contain submitted works and interviews divided by region – China, Japan, Korea, and Greater East Asia.

## China

The articles in this volume dealing with Chinese issues run the gamut from politics to health, Internet regulation to entrepreneurship. In his analysis of the U.S.-Chinese negotiations surrounding the Comprehensive Test Ban Treaty, William Chang argues that China’s concern with its international image is a crucial element in Chinese foreign policy. In many cases this concern overrides its otherwise realist norms of security as he notes in “China and the Comprehensive Test Ban Treaty Negotiations.” Charles Baum questions the efficacy of the American tactic of using trade sanctions to enforce intellectual property rights in “Trade Sanctions and the Rule of Law.” While generally improving the status these rights hold in China, this tactic has been counterproductive in engendering genuine support for the rule of law. Philip Sohmen’s “Taming the Dragon” navigates the swiftly shifting labyrinth of Chinese Internet regulatory bodies to lay out the Chinese government’s strategy to promote the growth of the Internet while at the same time reining in politically objectionable content. There is not only tension in the divergent aims of the strategy, but also in its implementation by potentially adversarial regulatory bodies within the Chinese government. In their article on “The Development of Modern Entrepreneurship in China,” Debbie Liao and Philip Sohmen examine what it means to be an “entrepreneur,” how that definition has changed, and what causes led to that change. In “Long March, Bitter Fruit,” Peter Hansen evaluates both the positive and negative effects that rural to urban migration have wrought on the urban and rural landscape as well as the migrants themselves. These articles reflect the profound transformation China has undergone in the 1990s and shed light on many of the problems the

new leadership will face in the wake of the upcoming succession of Jiang Zemin in 2003.

## **Japan**

The Japan section consists of two pieces, one dealing with recent problems in the Japanese economy and the other with a historical perspective on pre-WWII ethics. In "Japanese Entrepreneurship," Kenji Kushida examines the structural impediments facing entrepreneurs in the Japanese economy, drawing comparisons with the Silicon Valley model of the United States. He concludes that conditions previously conducive to rapid growth may be perpetuating incentives unfavorable to innovation, although gradual changes seem to be moving in the right direction. Jeffrey Wu examines the ethical convictions of Tetsuro Watsuji, an eminent wartime philosopher, in "The Philosophy of As-Is." Wu asserts that Watsuji's equation of moral goodness with the self-abnegation of the individual raises troubling questions about political ethics in the context of total war.

## **Korea**

Since the historic summit between the divided Koreas, experts have raised many questions regarding issues such as the new Bush administration's foreign policy toward the peninsula, Kim Jong-il's recent visit to China and prospects of economic reform in the North, and South Korea's struggle with a "second" economic crisis. This issue features an interview with Dr. Suh Sang-Mok, former member of the Korean National Assembly and Hoover fellow, who shares his thoughts on these and other issues.

## **Greater East Asia**

Economic integration in East Asia has been a keenly debated topic in the past few years, highlighted by recent global developments like the failure of WTO and APEC to make headway in further trade liberalization, closer economic integration in Europe and in North America, and a general feeling among the East Asian countries (after the experiences of the Asian financial crisis) that they need to be less beholden to Western institutions. Historically, there has always been a strong economic rationale for East Asian countries to be linked closer economically, but previous efforts at economic integration have always met with political obstacles, mainly U.S. opposition towards any proposals that would undermine its influence and interests in East Asia. Such U.S. opposition was recently demonstrated in its rejection of proposals for an East Asian Economic Group and for an Asian Monetary Fund. However, there have been some signs lately that East Asia is moving towards closer economic integration. These developments include the liberalizing of inter-ASEAN trade under the ASEAN Free Trade Area, the ASEAN Plus Three (China, Japan, South Korea) discussions, and an increasing number of bilateral and multilateral free trade agreements involving countries in the Asia-Pacific. In "Prospects for Closer Economic Integration in East Asia," Wei Kiat Yip examines these issues in depth from a historical as well as analytical perspective.

The editors would like to express our sincere thanks to the untiring efforts of all of our staff as well as our faculty sponsors, the Center for East Asian Studies, the Associated Students of Stanford University, and all of those who contributed to making this endeavor possible. We look forward to making this the first of many issues to come.

The Editors



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## News and Themes from East Asia

### *CHINA AND TAIWAN*

#### ■ CHINA TO GAIN ENTRANCE TO THE WTO

No significant barriers remain to China's joining the World Trade Organization sometime early next year, although currently several minor issues have arisen. The American government, while repeatedly praising China for opening its markets, continues to question whether China can fulfill its promises. Moreover, there is concern over China's regulation of Internet content. Also, the American government remains skeptical that China will firmly enforce intellectual property laws. On the other hand, to underscore their independence, Chinese leaders have been slow to accept American and European demands.

Despite this symbolic foot-dragging, China's leaders remain committed to joining the World Trade Organization as quickly as possible. They recently agreed to grant nine new licenses to European insurance firms and to further open China's automobile and retail sectors. China has also agreed to enter the WTO under intellectual property rules that would ordinarily apply to developed economies. At present, the most difficult issue preventing China from WTO membership is reconciling the more than forty bilateral trade agreements China has reached with other countries. American domestic politics may represent another obstacle to China's becoming a WTO member in the next several months. It is possible that the new American President and Congress may seek to delay the membership process to prove that they aren't "soft" on China. However, as long as China's leaders hold firm in pursuing WTO membership, current barriers will most likely prove temporary and easy to overcome.

#### ■ COUNTRYSIDE LEFT BEHIND BY NEW ECONOMIC DEVELOPMENT

China's rural population has been left behind by the rapid economic growth that has driven the coastal cities to relative prosperity. Per capita disposable income in urban China will soon pass one thousand dollars, a record in a country once characterized by mass poverty. However, the economic benefits, which have allowed for this landmark, have not spread beyond China's four hundred million strong urban middle class. Today, an urban worker in China makes 2.85 times more money than a rural worker. According to one of the United Nations' key indicators of relative wealth, consumption in China's cities is "comfortable," while rural consumption remains "barely sufficient." In the last few years, there has been an increase in the difference between urban and rural wages, with urban incomes rising 8.5 percent while rural incomes rose a scant 2.5 percent. The growing divide between China's prosperous cities and still underdeveloped rural areas has led to massive urban migration, creating a "floating population" of more than one hundred million peasants.

#### ■ RESPECTED HONG KONG JOURNALIST OUSTED

Editor-journalist Willy Wo-Lap Lam's decision to leave the South China Morning Post has raised concerns of censorship among Hong Kong human rights activists. Lam's decision came after he was relieved of his duties as the Post's China page editor, a position he had occupied for ten years. Lam was often an outspoken critic of the close relationship between Hong Kong elites and the Chinese leadership, and his articles caused Jiang Zemin to chastise the Hong Kong media. The Post has claimed that Lam's loss of duties was part of an attempt to expand and diversify the China section. However, many people in Hong Kong are deeply skeptical because Lam's dismissal followed closely after a bitter public exchange with the Post's majority shareholder Robert Kuok. The exchange centered around an article criticizing China's encouragement of Hong Kong's businessmen to support Beijing's handpicked chief executive, Tung Chee-hwa. Lam's article resulted in Kuok

publishing a letter to the editor in the Post attacking Lam's story as "distortion and speculation." Lam's replacement is a mainland journalist who once was employed at the official government newspaper China Daily. Many Hong Kong journalists fear that Lam is an example of increasing Chinese pressure that will eventually lead to the end of Hong Kong's free press.

## ■ CHINA'S INTERNET UNDER SIEGE?

Foreign companies are scrambling to sell China the newest products in law enforcement technology. Even U.S. companies, such as brand name corporations Cisco Systems and Sun Microsystems, are competing to fill China's demand for security and policing software. At a November 8<sup>th</sup> Beijing trade show, Cisco and Sun marketed their "firewall" technology to crowds consisting of police and security officials. The demand for law enforcement software has been driven by Communist Party officials who seek to counter the Internet's potential for political dissent. Recently, the Chinese government strengthened its crackdown on Internet content, saying that "sham" news might "mislead the masses, confusing public opinion and creating chaos." The foreign companies' software will be used as part of the "Golden Shield Project," the Chinese government's plan to construct a computer network linking national and local police agencies. The Golden Shield would consist of both a database and surveillance system, and allow quick access to records on every citizen as well as decrease police reaction time to public protests.

## ■ SPY PLANE INCIDENT CAUSES HEIGHTENED TENSIONS

The United States and China are set to begin negotiations to determine the fate of a U.S. EP-3 Aries II that made an April 1<sup>st</sup> emergency landing on a military airfield in Hainan province of China after a mid-air collision with a Chinese jet. After securing the release of the 24-member crew through a letter expressing regret for the incident, the American government has adopted a harder line, blaming China for the mid-air collision. China, however, continues to blame the U.S. for the death of fighter pilot Wang Wei, and has demanded that the U.S. end surveillance flights in the South China Sea. As discussion begins, China's bid for WTO membership and the 2008 Olympics is potentially at stake. Several members of the U.S. Congress have proposed ending China's most favored nation status, although the crew's return has diminished calls for economic punishment. China's holding of the EP-3 and crew threatens to further undermine relations between Washington and Beijing, and comes at a time of heightened tension caused by U.S. criticism of Chinese human rights and proposed American weapon sales to Taiwan.

## ■ NEW TAIWANESE PRESIDENT RELAXES CHINA RHETORIC

The inauguration of President Chen Shui-bian on May 20, 2000 ended over a half century of Kuomintang (KMT) rule on Taiwan. President Chen of the Democratic Progressive Party has since tried to distance himself from his party's pro-independence stance in an effort to ease Taipei-Beijing tensions. Beijing considers Taiwan a renegade province and threatens to attack the island if Taiwan declares independence from the mainland. The U.S. endorses the "one-China" policy, which accepts Beijing as the one government of the Chinese people and does not support Taiwan independence. The outspoken Taiwan Vice President Annette Lu rejects this policy because it commits Taiwan to eventual reunification with the mainland.

Due to a fiasco involving Chen's shelving of a fourth nuclear power plant started by the previous KMT administration, the opposition has taken the opportunity to lobby for a recall of the president. In addition, KMT officials demand that dealings with China should be handed over to the Nationalists (KMT). Although Chen's popularity has declined since his inauguration, it is not likely that the public will approve an impeachment. Taiwan could not withstand the resulting turmoil. While internal turbulence in Taiwan politics continues, it is important to keep in mind that official talks with China broken off last year have not resumed. Analysts say there is only an 18-month window of opportunity for talks to resume before China becomes embroiled in its 2002 Communist Party Congress.

## ■ TAIWAN'S ECONOMY SUFFERS

The Chen administration has been attacked for the mismanagement of Taiwan's economy, as the stock market has been

slumping and the level of consumption has fallen since his inauguration. Subsequently, Taiwan's economic growth rates are expected to be readjusted downward. Partly to blame is recent political uncertainty, news of bad loan problems, depreciation of the New Taiwan dollar against the greenback, and a waning of investor confidence. A poll by the United Daily News, a national Taiwan newspaper, found that 29 percent of respondents expect a financial crisis, though 41 percent deem it to be impossible. Analysts say that chances of an economic meltdown are slim as long as the government makes the necessary financial reforms to restore investor confidence.

— by Dan Kliman and Chuan-Mei Lee

## *JAPAN*

### ■ JAPAN'S ECONOMY STILL IN THE DOLDRUMS

Haunted by growing concerns over deflation and moribund domestic growth, Japan's economy remains in a slump. Despite signs of accelerating economic growth in 1999 and 2000, worries about the troubled banking sector, mounting government debt, rising oil prices, and corporate bankruptcies are dragging down Japan's economic growth potential. Faltering confidence has driven Japan's benchmark Nikkei 225 Stock Average down by a significant margin, and the unemployment rate hovers at record levels. With the notable exception of the high-tech sector, which is doing well (thanks to healthy domestic demand for mobile phone handsets and computers), corporate Japan is still plagued by overcapacity and the massive debts it ran up during its economic growth period more than a decade ago. Such high-profile bankruptcies as Chiyoda and Kyoei, Japanese life insurance companies that collapsed with \$26 billion and \$42 billion of debts respectively, have damaged consumer confidence and aggravated the financial industry's non-performing debt burden. The government has been largely ineffective in carrying out financial reforms necessary to overcome its public sector debt crisis and to bring about corporate governance in the private sector.

### ■ JAPANESE FACE POLITICAL UNCERTAINTY

Japanese politics is once again in turmoil after its Prime Minister finally gave up a lethargic struggle to cling to power. Mori Yoshiro (last name first), the widely unpopular premier of Japan, officially expressed his resignation on April 18, 2001. For a year, Mori had weathered a stiff challenge from many including those within his own party to step down. Mori's premiership was tainted by countless verbal gaffes and a lack of vision. His remarks that Japan is "a divine nation with the emperor at its center" and that voters not willing to vote for his party should sleep in on the Election Day were met by a plunging job approval rate and uproar from neighboring nations. The Parliament under his leadership remained sharply divided and unable to produce meaningful reform measures to resuscitate Japan's ailing economy. The ruling Liberal Democratic Party (LDP), which Mori himself belongs to, increasingly exhibits signs of internal fracture. A more liberal segment of the LDP is confronting the old, conservative leadership that upheld Mori. Although an earlier revolt by the reformist faction of Kato Koichi was effectively quelled, young members of the LDP continue to call for greater transparency and accountability. The next leader of the LDP will be chosen from among Hashimoto Ryutaro, Koizumi Junichiro, Kamei Shizuka, and Aso Taro. Party conservatives support Hashimoto, the former Prime Minister and chief of the largest faction, but the reform-minded and widely popular Koizumi appears to be garnering significant support.

— by Keun Lee

## *KOREA*

### ■ SPECIAL: NORTH AND SOUTH KOREA RAPPROCHEMENT

Last June 13, South Korean President Kim Dae-jung stepped off the plane in Pyongyang, North Korea, to greet his North Korean counterpart, Kim Jong Il, with a two-handed handshake. The gesture marked the beginning of a historic three-day summit, which was the first official contact between the two countries since the end of the Korean War. The groundbreaking talks effectively ended what had been a half-century of protracted hostilities, and touched off a wave of excitement about the possibilities for the opening of relations between the North and the South.

The Korean War ended in July 1953 in a truce and not a peace treaty, leaving the divided Koreas technically still at war, and on either side of the most heavily guarded border in the world. Many scholars saw the summit meeting as the symbolic end of the war, and by extension the first tentative steps towards reconciliation and reunification. Others warned against such heady optimism, pointing to fifty years of divergent history, that will make real reconciliation between the two countries a slow and perhaps decades-long process. Nonetheless, expectations were raised to new heights by what Kim Dae-jung called “the most important day in Korean history.” At the summit the two leaders agreed to promote South Korean investment in the North, facilitate the reunification of separated families, and to work towards reunification. The following month North and South Korea held Cabinet-level talks in Seoul and made plans to reunite separated families. Beginning in August, dozens of Koreans began crossing the border for four-day reunions with family members on the other side. It is estimated that there are as many as 10 million separated family members on both sides, many of whom have not seen each other since the Korean War.

At the opening ceremony of the Sydney Olympics in September, athletes from the two Koreas marched onto the field together in what seemed to many to herald the unambiguous beginning of a new era in North-South relations. In the months following the summit, the North and South remained in close contact, beginning plans for the reconnection of a cross-border railway line, and holding a first meeting between the countries’ defense ministers. The result of these steps was that, on October 13, 2000, President Kim Dae-jung was awarded the Nobel Peace Prize. In its announcement the Nobel Committee lauded Kim for his work on democracy and human rights in South Korea and East Asia, and most notably, for his so-called “sunshine policy” of working towards reconciliation with North Korea.

The thawing of diplomatic relations between North and South seems to signal the end of the long-time international isolation of North Korea as a pariah state. Vice Marshal Jo Myong Rok, a top aid to Kim Jong Il, visited the U.S. in October, followed by a reciprocal visit of Secretary of State Madeleine Albright to Pyongyang. Britain, Germany, Luxembourg, the Netherlands, Belgium and Spain all subsequently announced plans to begin opening diplomatic relations with North Korea.

Despite the lack of serious progress between the two Koreas, the momentum, which has gathered after the recent summits, promises that great changes are afoot. There are many who see the rapprochement between North and South Korea as one of the final chapters in what has been the long and tumultuous end of the Cold War.

— by Amy Chen

## *SOUTHEAST ASIA*

### ■ ASEAN PLEDGES TO FACILITATE REGIONAL INTERNET DEVELOPMENT

During its fourth informal summit in Singapore, the Association of Southeast Asian Nations (ASEAN) drafted a major agreement regarding regional Internet access and e-commerce. The eASEAN Framework, signed on November 25, 2000, by the organization’s ten member states, addresses online security, tariffs, and the creation of an “online marketplace for . . . goods and services.” The agreement is also designed to remedy Southeast Asia’s sharp digital divide: ASEAN, which includes the member states of Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam, has some of the world’s most technologically advanced nations as well as some of the world’s most technologically underdeveloped nations. Accordingly, the eASEAN Framework allows for the organization’s more advanced nations share their resources. Computer giant IBM will also serve as a technological advisor. ASEAN’s Internet agreement came a week after an Asia-Pacific Economic Cooperation (APEC) meeting where that organization sought to triple the number of people within the region with individual and community-based access by 2005.

### ■ INDONESIA – BEYOND EAST TIMOR: TROUBLE IN IRIAN JAYA, ACEH, AND THE MOLUCCAS

While East Timor has dominated headlines over the past few months, a handful of other Indonesian provinces have seen increased violence due to religious conflicts and separatist sentiment. Rocked by the recent Asian economic flu and still trying to form a democracy in former President Suharto’s wake, the Indonesian government has been struggling to deal with

these new conflagrations.

The eastern-most and poorest Indonesian province, Irian Jaya has a culture markedly different from the rest of the nation: its native population is of Melanesian descent and much of the island remained unknown to the outside world when it was incorporated into the Indonesian state in 1963. In order to integrate the province into the rest of the nation and ease overcrowding on other islands, the government encouraged Indonesians to resettle in Irian Jaya; by 1996, 200,000 people had moved to the island. Nevertheless, a strong nationalistic spirit persists amongst the native Irians. Tribal militia groups such as the 15,000-strong Task Force Papua have increased demands for autonomy since the end of the Suharto era. For Indonesia, maintaining control over Irian Jaya is a matter of economic importance. The province has offshore natural-gas deposits, an enormous supply of timber, the world's third-largest copper mine, and the world's largest deposit of gold. President Wahid is presently working toward expanding Irian autonomy, but his previous efforts have backfired: when he funded the First Papuan Congress in February 2000, the body convened and speedily passed a resolution to declare independence.

— by Dinyar Patel

COMMENTARY  
by Ryan K. Louie

## The Walking Ware of Science

A step into a Japanese laboratory, and one typically performs a daily ritual upon entering the world of academic research in Japan. A series of laboratory slippers neatly lined up in the lobby provides the first hints of a cross-cultural experience for the visitor. The exchange of walking-ware highlights elements of Japanese culture; shoes from the outside are placed inside a hierarchy of shoe lockers bearing the owner's names. The president's locker is at the top, followed by the lockers of the head professors, then assistant professors, and continuing down the ranks. A small plastic window in each locker reflects a curiosity of where these wares might have walked on the various paths leading up to this front door of science.

Science walks far and near, and it is often recognized as a universal discipline – a “one-size-fits-all” field. Ideas from the mind of an individual thinker transforms into the material fabric of our everyday lives. From one end of the Pacific to the other, we can now take our digital doggies with us on sidewalk scooters to make a pit stop at the next Play Station II machine. But in our exchanges of the “what's new” in science, are we quick to kick off the shoes of science culture in the name of creating technological universality?

Science revolves around the world and is particularly united every year as all eyes look for the year's Nobelists. Focus on Japanese academic research has enjoyed a new recent spotlight, with the awarding of the 2000 Nobel Prize in Chemistry. Hideki Shirakawa of the University of Tsukuba, along with American colleagues Alan Heeger of the University of California - Santa Barbara and Alan MacDiarmid of the University of Pennsylvania, were honored with the prize for their great scientific achievements in creating plastics that can conduct electricity. With what started out in the 1970's as a Shirakawa lab student's serendipitous experiment of adding too much catalyst to a mixture of plastic, a reaction arose to give rise to a new silvery film. And this silvery film served as the world's silver lining, which leads Shirakawa to join his two American colleagues in the United States to develop these new electronic materials for the future.

As for many Japanese scientists, the West has often been looked upon as the model majority – the shoes for which everyone else should attempt to fit into. Prestigious scientific journals are in English. Academic meetings are often held across the Pacific. Such are the views of many scientists who travel from Japan to become post-doctoral researchers in American laboratories. Cited as being some of the reasons for this cross cultural experience beyond the chance to join a cutting-edge lab, are social reasons spanning beyond the technical science details: building fluency in English, experiencing American freedoms of creative thought, having more equal opportunities regardless of gender or age. And meanwhile back at home Japanese scientists who have done research abroad in a Western country are hailed somewhat as being a step above the rest or being more forward-thinking.

But at the same time, perhaps our current multi-ethnic society might become even backwards thinking if we become desensitized to the notion of different cultures. Similar stacking of names on lockers might be setting the trends of which nation becomes the model, despite all serving equally valuable functions. And there may be self-complacency in the West

that “everything needed is right here.” But culture exists. And so does the science in every land. A look to countries such as Japan may lead to solutions on how to integrate an analogous science education into K-12 curriculums. Or perhaps a study of the strong cohesive network of social dynamics, which keeps a Japanese lab driving together, can reveal details about teamwork and leadership. Or even to a more basic degree, the sheer data of newly generated science can invite further discoveries. A Western admiration for the achievements in the East can go beyond the few words of Japanese language that come across the media, such as the “Pikachu’s and Pokemons” for kids and the “Wassup – Wa-saaaa-bi” beer commercials for sushi-loving grownups. Shirakawa has performed outstanding lifelong achievements with contributions resonating around the world. The case is a fine example of the West reacting with the East. The bi-directional walk creates a path benefiting both sides that attempt to reach out. New vistas of technology are created, as well as a greater appreciation of the talents of all people, in an increasingly globally diverse society both abroad and here at home.

It is without doubt that there are many curious inner workings of the academic science culture in Japan. Not all labs may have the same slippers. And the lockers may be arranged differently. But realize that a quick glimpse through the tiny plastic windows only gives a slightest notion of the paths traveled. The road of science starts out in many directions, from both the East and the West to be recognized. And the walking is not just determined by the “where,” but also the “ware.” For the destination to be sought will also be driven by the set of attitudes set foot on the ground.



# Theater Missile Offense?

Thomas Slayton

In modern East Asia, three letters can evoke more emotion in the minds of policy makers than their brevity would suggest: TMD. Theater Missile Defense (TMD) is the American answer to North Korea's long-range missile program, an integrated system of missile interceptors, radar arrays, and early-warning sensors designed to shoot down incoming warheads before they have a chance to do their damage. In a vacuum, it would seem the perfect solution to a potentially destabilizing development; however, East Asia is not a vacuum, and events on the Korean Peninsula have a way of pulling in a variety of actors from across the area. The American proposal to erect such a defense against the Democratic People's Republic of Korea (DPRK) is not simply an American-Korean affair, but involves all the major powers in the region from Russia to Taiwan. Moreover, the issue not only concerns a large number of actors, but a broad range of issue areas as well. Alliance politics, technological capabilities, and military strategies overlap in the TMD issue in ways that few issues could. Moreover, TMD's impact is dynamic, driving events and relationships even before its deployment. For these reasons, Theater Missile Defense will continue to be a source of pronounced controversy in the Western Pacific.

## *THE NUTS AND BOLTS OF THEATER MISSILE DEFENSE*

Before proceeding with this article, it is important to have an understanding of what Theater Missile Defense encompasses. Generally speaking, TMD is an integrated group of defensive systems designed to protect a limited area from ballistic missile attacks. The key difference between Theater Missile Defense and National Missile Defense is scope: National Missile Defense is designed to protect the entirety of the United States proper, while Theater Missile Defense is more limited. It is also a matter of perspective; for example, an American Theater Missile Defense system may be Japan's National Missile Defense system given the latter's smaller area. Nonetheless, the general term "Theater Missile Defense" incorporates a diverse number of el-

ements. Contrary to the rhetoric bandied about by the international community there is no one single TMD system.

TMD is actually collection of several different weapons systems, and although none have been deployed to the region nor even fully developed as of 2001, their impact is already apparent. In addition to the various sensors, radars, and satellites that comprise the warning systems, the currently envisioned system has 4 main subsystems: Navy Area Defense (NAD), Navy Theater Wide (NTW), Patriot Advanced Capability-3 (PAC-3), and Theater High Altitude Area Defense (THAAD). PAC-3 and THAAD are ground-based systems while NTW and NAW are ship-based. These are the so-called "active missile defense" components of TMD, and are generally what are referred to when most politicians use the term "TMD." In actuality, however, active missile defense is only part of the TMD architecture. In addition to the aforementioned early warning systems, the U.S. Department of Defense incorporates passive missile defense, active missile defense, attack operations, and supporting command, control, communications, computers and intelligence measures (C<sup>4</sup>I) to prevent missiles from hitting their targets. Passive defenses include camouflaging, hardening, or otherwise protecting the targets from being targeted by missiles. Attack operations are allied strikes on forces before they can even launch their missiles. This includes everything from attacks on missile research facilities to the missile launchers themselves.<sup>1</sup> The systems are designed to be mutually reinforcing so that the combined effectiveness is greater than the sum of all the individual parts.

## *THE SHIELD AND THE SWORD*

From an American perspective, TMD is a defensive system, and official U.S. statements reflect this belief. TMD, by their rationale, is designed to *protect* against a potentially devastating assault. There is nothing overtly threatening about this protection because unlike conventional military deployments, anti-missile batteries are not offensive in nature. They target missiles, not personnel or instal-

lations. Moreover, the Americans point out that the real threat that is driving the system's deployment is North Korea's ballistic missile program. However, it is not at all clear that TMD is definitively defensive in nature, a concern raised by the Chinese and Russians, among others. They see TMD as heralding a new age of American unilateralist policies, where American troops can travel about freely without fear of nuclear retaliation. The debate is extremely heated and very complex, and draws out many of the long-term concerns of all the major powers in the region.

On August 31, 1998 North Korea sent ripples through the American East Asian alliance network by launching a *Taepo-Dong II* missile over Japan ostensibly to put a satellite into orbit. The missile had three stages, and although it splashed down harmlessly into the Pacific, the effort demonstrated to the American intelligence community that the DPRK ballistic missile program was much further along than had been expected.<sup>2</sup> More importantly, the missile sent the Japanese Diet into a panic and led them to suspend payments to the Korean Energy Development Organization (KEDO), the implementing body of the 1994 Agreed Framework.<sup>3</sup> The Diet feared a DPRK attack on the Japanese islands, and had no intention of supplying a "rogue state" with foreign aid; however, if the KEDO plan fell through, the DPRK would have little choice but to resume its nuclear program, which had the potential to make weapons-grade fissile material. Fortunately, the U.S. and the DPRK resolved their differences in a summit in Berlin, where the U.S. agreed to lift certain sanctions in return for the DPRK's promise to suspend its missile tests.

Although it had long avoided a commitment to cooperate with the United States on TMD, Japan acceded to just such an effort in 1998 precisely because of the North Korean ballistic missile threat. It is unclear at this time what contributions Japan can make to the project given the technical disparities that divide the Japanese and American defense industries. Nonetheless, Japan's agreement to share some of the TMD burden as is heralded by some as a new chapter in the Japanese American Security Alliance (JASA). In the 1980s, at the height of the U.S.-Japanese trade disputes, many prominent American politicians disparaged Japan's role in the JASA as merely free riding. In their eyes, Japan was using the American security guarantee to free up considerable resources to challenge the U.S. economically.

As it stands, however, Japan is severely constrained to provide substantial direct support to American defense initiatives. Article 9 of its Constitution "renounces war as a sovereign right," causing difficulties for politicians wishing for Japan to be a more active partner in the JASA. Furthermore, there is an unofficial 1% GDP ceiling on Japanese defense expenditures, and to exceed that limit is to invite considerable domestic unrest if the past is any indication of the future. In fact, it appears to some observers that any time Japan tries to play a more active role in the

alliance, domestic opposition in the Diet resists so forcefully that they emasculate the initiative.<sup>4</sup> In many ways, joint development of TMD is an excellent way to bypass these constraints namely because it is not an overtly offensive system, and therefore not bound by Article 9. Joint development of TMD promises to change the nature of Japan's partnership with the United States, especially when combined with the new Japanese defense roles defined in the Security Guidelines Revision of 1998.

It is precisely this new activist Japanese role that concerns the Chinese. When Japan was demilitarized and weak, they viewed the JASA as rather positive on the whole. China saw the U.S. security guarantee as a cork in the bottle of Japanese militarism, but with all the talk of the changing relationship their support for JASA has turned into ambivalence. A resurgent Japan is threatening to China in ways that an American East Asian presence is not because of Japan's close geographic proximity. The Chinese memory of Japan's actions in the Second World War is very acute, a fact that comes up time and again in disputes over Japanese history books.<sup>5</sup> Should Japan play an active role in TMD development, it would only confirm China's fears of a militarily resurgent Japan as a TMD shield maximizes the benefits of a nuclear arsenal.<sup>6</sup>

China worries about TMD for reasons besides a resurgent Japan. Its leadership claims that TMD weakens its nuclear deterrent by making it more difficult for its missiles to penetrate such a shield.<sup>7</sup> This argument may be flawed, however, for two reasons: first, Japan currently possesses no nuclear weapons or even conventional weapons capable of sustained attacks outside the Japanese islands, so erecting a TMD over Japan would hardly hurt China's deterrent vis-à-vis Japan; second, a TMD system in Japan would not protect the continental U.S. from Chinese Intercontinental Ballistic Missiles (ICBMs) so it would not hurt China's deterrent vis-à-vis the U.S. However, China's other concerns about TMD may be more justified. The currently envisioned TMD architecture utilizes two naval components, NAW and NTW, which could be rapidly relocated in the event of a crisis. The introduction of a mobile TMD system would be highly provocative to China because it could be readily shifted to defend the area around Taiwan in the event of a cross-straits crisis.<sup>8</sup> Furthermore, Chinese and Russian diplomats both argue that American TMD deployments, along with the American transformation of NATO, are evidence of a current trend towards increased American unilateral actions, a dangerous sign in their eyes that threatens the current world order.<sup>9</sup> Russia and China feel that deploying TMD undermines the current security architecture by demonstrating a complete disregard for international treaties such as the 1972 Anti-Ballistic Missile (ABM) Treaty, which limited deployments of ABM systems in the United States and the USSR to only two sites. There are fears that erecting a TMD shield over

areas of American concern like the Korean Peninsula or Japan would be a first step in offensive action by the American military and its allies. For these reasons, both China and North Korea claim that TMD in East Asia will incite an arms race that would severely destabilize the region.<sup>10</sup>

### CONCLUSIONS

The perceptions of Theater Missile Defense range from a destabilizing, offensive weapons system to a stabilizing, defensive shield, and strategic thinking on both sides of the

East China Sea reflects this dichotomy. American and Japanese strategists hold to the system as the only means of staving off a North Korean missile salvo, while Chinese and North Korean leaders see it as yet another Western attempt to undermine China's security. The matter is complicated, wide-ranging, and above all, intense, making rational, constructive dialogue about TMD extremely difficult. Should the United States fail to address the concerns of the Chinese, the single-most influential actor in the area given its relationship to the DPRK, an Asian arms race is a very real possibility.

<sup>1</sup> United States Ballistic Missile Defense Organization, 1993 Report to Congress on the Theater Missile Defense Initiative (Washington: BMDO, 1993), 2-1.

<sup>2</sup> The 1995 U.S. Intelligence Estimate held that "no country, other than the major declared nuclear powers, will develop or otherwise acquire a ballistic missile in the next 15 years that could threaten the contiguous 48 states and Canada."

<sup>3</sup> The 1994 Agreed Framework was the compromise deal between the United States and the DPRK which pledged to replace the DPRK's current reactors with 2 light water reactors and enough oil to offset the dismantled reactors in the meantime. The main problem in 1994 was that North Korea's nuclear program seemed to be on a trajectory that would leave them with enough plutonium to make a handful of bombs. The Agreed Framework was the American answer to this threat: by taking away the DPRK's capability to make plutonium, the U.S. was transforming a potentially threatening nuclear program into a civilian power source. To implement this plan, the U.S. formed the KEDO to raise the necessary funds, which were supplied by Japan and South Korea.

<sup>4</sup> During the Gulf War, the Japanese response to the Iraqi crisis was grossly insufficient due to domestic uproar over the proposed deployment of even Japanese noncombatants. This forced the Kaifu cabinet to delay the measure until its successor government could pass the measure through the upper house. The actual troop deployment occurred two years after the initial proposal and was so hamstrung by parliamentary restrictions as to make the force almost useless. Japan was forced to rely on so-called "checkbook diplomacy," wherein Japan pays much of the costs of the actual conflict without risking its troops in action. Japan's contribution to the Gulf War effort was nonetheless substantial, standing at some \$13 Billion (U.S.), but checkbook diplomacy and troop commitments are very different things in the eyes of the international community. Edwin O. Reischauer, The Japanese Today – Change and Continuity, Enlarged Edition, ed. Marius B. Janson (Cambridge, Massachusetts: Belknap Press, 1995), pp. 420-421

<sup>5</sup> In 1982, China repeatedly criticized the Japanese Ministry of Education for a history book that downplayed Japan's actions in the Second World War, causing a considerable controversy both within Japan and the international community.

<sup>6</sup> Although Japan does not currently possess a nuclear arsenal, some see Japan's advanced civilian nuclear energy program as a potential source for fissile material. Japan's ability to launch satellites is not so technically different from launching ballistic missiles, which would dramatically reduce the time required for Japan to develop a nuclear capability if it so desired. If a TMD shield were erected, there would be a strong political incentive to develop nuclear forces, because lower numbers of missiles would be necessary to ensure a survivable strike capability with a TMD shield. Michael J. Green, "Theater Missile Defense and Strategic Relations with the People's Republic of China" in Restructuring the U.S.-Japan Alliance: Toward a More Equal Partnership ed. Ralph A. Cossa (Washington: Center for Strategic and International Studies, 1997), 113.

<sup>7</sup> This argument is premised along the belief that the destructive power of nuclear weapons is so great that nuclear states will be deterred from using them on other nuclear states for fear of a retaliatory strike. It is the same Cold War argument for maintaining nuclear parity between the U.S. and USSR, namely that so long as a nuclear standoff existed, neither side would use their weapons for fear that the other would devastate them in response.

<sup>8</sup> According to U.S. State Department Spokesman James Rubin, "[T]o the extent [the Chinese] expressed concern about Theater Missile Defense, it was in the context of Taiwan and not... for forward deployed troops." Source: James Rubin, "Briefing at Beijing International Club Hotel," *U.S. Department of State*, 1 March 1999, April 2000.

<sup>9</sup> According to the joint statement issued by the Chinese and Russian Defense Ministers, "The essence of NATO's new strategic concept is to turn NATO into an interventionist and offensive political and military bloc. Its implementation will

seriously impact the existing norms of international relations, affect international security and stability, and shake the position of the United Nations. It is necessary to maintain a high degree of vigilance against this new strategic concept. Some countries are developing national and theater anti-missile defense systems. This action is not conducive to the international arms control and disarmament efforts, and it will cause a reversal in the nuclear disarmament trend and trigger a new arms race. It will also have a disruptive influence on the global and regional strategic balance and stability in the 21st century.” Source: “Chinese, Russian Defense Ministers Hold Talks, Sign Memorandum,” *Inside China Today*, January 2000.

<sup>10</sup> In response to one missile defense test, the North Korean regime issued the following statement: “This [test] shows that U.S. policy to stifle North Korea has not in the least changed. We will build our defense capabilities with high vigilance against the perfidious acts of the U.S.” “N. Korea to Increase Defense Capabilities,” *Charlotte News and Observer*, 11 October 1999.



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# China's Technological Renaissance

David Havelin

*"... that long succession of technical discoveries which the West took over from China during the first thirteen centuries of the Christian era, often without the slightest realisation of where they had come from."*

—Joseph Needham, *Science and Civilisation in China*<sup>1</sup>

Compass ... paper ... printing ... gunpowder. These are the "Four Great Inventions" that every Chinese can recite as China's contribution to world technological development. It is a list that has not been updated in 900 years. Moveable-type printing, the most recent development of the four, made its appearance back in the 11th century. Though Joseph Needham's tireless scholarship has shown that this list greatly undersells China's contribution to scientific thought and technology, it is also true that China has long lost her pre-eminent position as a leader of innovation.

It is no coincidence that the most populous nation today punches far below its weight both economically and politically. The modern world order is defined by those nations wielding industrial, technical, and military superiority. China is not in that top tier.

But China may once again be ready to assume a leading position in scientific society, a position more commensurate with her size and illustrious history. As a consequence, that modern world order may need to be redefined.

Before we consider where China is today, let us take a brief look at how she arrived there, beginning with the decline of the imperial era.

## *DEVELOPMENT UP TO 1978*

A combination of an isolationist policy and a focus, perhaps because of cultural or political reasons, on the humanities and the arts, led to China's slumber throughout the Western flowering of science and discovery—the Renaissance, the Age of Exploration, the Age of Steam, the Industrial Revolution.

When, inevitably, a curious and expansionist West came knocking on China's door, a few short, sharp lessons, mostly delivered down the barrel of a cannon, demonstrated to the Chinese the considerable advances made during the years of their self-imposed isolation. A form of technology trans-

fer began to take place during the last years of the Qing dynasty and the first years of the Republic (roughly from the mid-19th century to the Second World War). The foreigners brought the telegraph, the railways, and their factories. But it was an imposed modernization and was confined to the trading concessions that the foreigners had carved out by force along the coast of China.

This path of development, such as it was, was interrupted by the Second World War and never resumed as, first, civil war wracked the country and then as the Communists took power. The freshly-minted People's Republic under Mao Zedong was intent on reversing the humiliations of the pre-war era, when China was powerless against foreign interests. This New China would establish parity with the West but without the help of a West that, anyway, was shunning the new government and its ideology.

With initial assistance from the Soviet Union, China set out to acquire a heavy industry (not to mention an atomic bomb) of its own. This it eventually achieved, but the massive social dislocations of the Mao era greatly hindered economic and technological development. The Great Leap Forward (1958-1960) promoted a wasteful diversion of resources. Agriculture and light industry suffered while farcical attempts were made to increase steel production and eradicate "pests," such as sparrows and rats. "Intellectuals," including scientists, scholars, and professors, were persecuted and forced to abandon their positions during the Anti-Rightist Campaign (1957) and the Cultural Revolution (1966-1976). The Cultural Revolution also saw a whole generation of youth denied education as schools and universities shut down.

## *THE MODERN PERIOD (1978 TO TODAY)*

Real economic and technological development thus began after the death of Mao Zedong. The pragmatic Deng Xiaoping became leader of China in 1978 and at once set about far-reaching reform. Of the "Four Modernizations" proposed in that year, Deng nominated science and technology as the key:

"Without modern science and technology, it will be impossible to construct modern agriculture, modern industry and modern defense, and it will be impossible

to have the development of national economy at high speed.”<sup>2</sup>

In pursuit of this goal, the China State Science and Technology Commission created a set of guidelines. One of these guidelines was:

“The learning, assimilation and absorption of foreign scientific and technological achievements should be taken as an important path for the development of China’s science and technology ... [but] with the aim of maintaining independence and keeping the initiative in her own hands.”<sup>3</sup>

From 1981 to 1987, state-controlled imports of technology were divided into two main categories: a “3000 item plan” which aimed to update technology in existing enterprises; and a “twelve production lines plan” which sought to jump-start certain industries in China, including color TVs, ships, clothing, and beer by importing whole production lines. The bulk of technology imports at this time came from Japan, the U.S., and Germany.<sup>4</sup>

Academic research institutes and universities assisted the production enterprises in the absorption of these new technologies. The government also allowed up to 20 percent of profits generated using imported technology to be used for assimilation of those technologies.

1988 to 1991 saw a decline in technology imports for two reasons. First, new, contractionary macroeconomic policies were designed to bring inflation under control. Second, the outcome of the Tiananmen Square protests in 1989 led to sanctions being imposed by Western nations. Recalling the state of affairs in the early 1950s, the countries of the former Soviet Union (along with Italy) became the main sources of imported technology during this time.

By 1992, relations with the West had more-or-less renormalized. Deng Xiaoping embarked on his now-famous “Southern Tour,” visiting the south of China and giving his blessing to renewed, rapid economic growth. A subsequent change in the constitution formalized the new goal of a “socialist market economy.”

The period after 1992 saw spectacular growth in Foreign Direct Investment (FDI). By means of FDI, multinationals could set up their own operations in China. There were inducements for doing so—low tax rates, for example. In keeping with government policy to retain control over development, the foreign companies were, until quite recently, hobbled by a requirement to form joint-ventures with Chinese firms. This, combined with poor distribution networks, a changing and arbitrary regulatory environment, bureaucratic entanglements and the various other difficulties of doing business in China, has meant that foreigners have, on the whole, not done particularly well. Nevertheless, they

poured money and ever-higher technologies into the country. Since 1993, China has consistently been the largest recipient of FDI among developing countries.<sup>5</sup> The ultimate prospect of a market of 1.3 billion people means that no multinational can really afford to stay away. No Western business leader wants to be remembered as the CEO that “lost China.”<sup>6</sup>

So, whether or not the Chinese government was pursuing optimal policies, the Americans, Europeans, Japanese, and Taiwanese continued to pour investment (and, just as importantly, technological know-how and management expertise) into China. Over the years, this investment has progressed from low-tech manufacturing for domestic sales to high-tech production for export. China is currently the low-wage production center of choice for flashy consumer electronics and the components that comprise them. This is the well-worn path to prosperity that has already been blazed by Taiwan and Korea, and before them Japan.

The central and regional governments of China, as befits a planned economy, have a large say in which particular technologies flourish. The Shanghai government, for example, has already decided that the Pudong area of Shanghai will be a center of excellence for the silicon chip industry.

### *TECHNOLOGICAL PARITY?*

It would seem that China is on the point of achieving its goal of attracting the most leading-edge technologies to its shores. And yet this last step might prove the most difficult. There are two reasons for this.

First, companies earn higher margins on the newest products. Competitors may be some way behind and so pressure to reduce costs is low. The higher wage costs of producing in the company’s home country are offset by the higher profit margins. As the technology matures and is replaced, the company will probably want to shift manufacture abroad, to a lower cost producer. China is often the recipient of such second-hand production lines.

By manufacturing at home, companies can also keep a closer watch on new production processes that may need to be tweaked as they are developed.

The second reason is political. The chip industry provides a good example of the limits of China’s import strategy.

Progress in the integrated circuit business is measured in line widths and wafer sizes. The finer the line width, the more components you can squeeze onto a single chip. The larger the size of the silicon wafer, the more chips can be etched at the same time. Every 18 months to two years, the chip industry upgrades its fabrication facilities (known as fabs) to work with a finer line-width and/or a larger wafer size.

The most advanced chip foundries in Taiwan are building fabs that will use 12-inch wafers and 0.18 micron line-width technology. In contrast, the most recently announced chip factory in China (a Taiwanese-Chinese partnership) will use 8-inch wafers and 0.25 micron line-widths. In general, China is considered to be two generations of technology behind Taiwan.<sup>7</sup>

It is not simply that Chinese manufacturing skills and support services are still inadequate, though this is true. The main reason is political. The United States will not permit what it considers strategic technologies to wind up in the hands of the Chinese. In doing so, the U.S. expects both to maintain considerable military superiority over a potential adversary and to prevent the latest technologies from filtering down to China's clients in the arms trade. These clients include Pakistan and Iran, among others.

The U.S. has also wrung its hands recently over the probable leak of missile technology to China during a collaboration in launching civilian satellites. And the U.S. Commerce Department, three years ago, was fretting over the diversion of a high-performance supercomputer from its listed export destination of Hong Kong to the Chinese People's Liberation Army. For export control purposes, the U.S. divides the world's countries into four "tiers". China is placed in Tier 3, for nations posing a security risk, only one notch above Tier 4—"terrorist" nations.

Since the United States and nations friendly to the U.S. (Britain, Germany, Taiwan, Israel, etc.) are the producers of the most cutting-edge technologies, it is relatively easy for the U.S. to prevent Chinese industry from ever catching up. This is a very real constraint. But it only remains a constraint if China continues to rely on the importation of technology.

#### RESEARCH AND DEVELOPMENT

The obvious next goal for China's technology policy is to develop an indigenous research and development capability. This does not imply that China has nothing more to gain from foreign expertise. On the contrary, multinationals in the last couple of years have been providing the industrial model for such an endeavor. Well-known companies such as Nortel, IBM, Agilent, and Intel have been joined by other equally notable firms in creating research facilities within China.

Intel's Beijing research center opened in November 1998. It was Intel's fourth research center and the first anywhere in Asia. Its function is to lead Intel's research effort in next-generation computer interface technologies—speech recognition, for example. It will collaborate with academic and research institutions worldwide, take part in standardization efforts, and generally make new technologies available to industry.

Originally employing 40 researchers, this will grow to 100 in 2001. According to the director, Dr. Robert Yung, who spoke at a seminar at Stanford University last winter,<sup>8</sup> there is no cost advantage to locating in China. With the same \$50 million budget (spread over five years), Dr. Yung claimed he could set up an identical facility anywhere in the world. When selecting China, Intel just went "where the talent is." Beijing has a high concentration of top-flight universities—Peking University, Tsinghua University, etc. Intel expects that its intake of engineers will come directly from these universities.

#### EDUCATION

Such research centers offering plum jobs to Chinese graduates will be necessary to stem the export of brainpower to the West. The flight of talent from Chinese universities to work and study opportunities overseas has been considerable. From 1978 to 1998, more than 320,000 Chinese went to 103 countries for further studies.<sup>9</sup> Fifty thousand of those were sent by the state, 100,000 by the government units they work in, and 170,000 at their own expense. Most of those who leave do not return.

China can ill-afford such generosity towards building the talent pools of other countries. Although China's third-level institutions are well-respected internationally, too few of China's young can take advantage of them. In 1998, there were 220,140,000 children enrolled in primary schools across China. In the same year, there were only 10,840,000 enrolled in "institutes of higher learning" which includes universities and other third-level colleges.

The competitive struggle to achieve a place in a good university ensures that those who graduate are of the highest standard. It is this that attracts the Intels and the IBMs. But it also means that a lot of talent has been discarded along the way. This waste is well recognized by the education authorities who are trying to increase the number of third-level places available. This is necessarily a slow process, however. Teaching staff must be trained and expensive facilities provided.

The top universities are already tapping a new source of income, one that is very familiar in the U.S. philanthropic foundations are bankrolling some of the recent expansion. Visitors from Stanford to Peking University's campus last summer would have recognized the familiar din and dust of summer construction work. Li Ka-Shing, the Hong Kong property tycoon, has provided a magnificent new library building housing the largest collection of any university in Asia.

If China's universities can supply the research talent, can Chinese industry tap it? Or will the benefits continue to flow to Western firms? The most interesting recent development has been the appearance of a handful of Chinese

companies that will truly establish China as a center of innovation.

### *INDIGENOUS R&D*

One entirely Chinese company blazing a trail for others to follow is Huawei Technologies.<sup>10</sup> Huawei is a young telecom equipment manufacturer with ambition. Founded in 1988, Huawei reported \$2.66 billion in revenue for 2000. This is some way behind the global industry leaders, but Huawei managed sales growth of 100 percent in 2000 alone. It anticipates revenues rising to \$5 billion in 2001.

Huawei's strategy for success is interesting. It is clearly a new breed of Chinese enterprise. Unlike most hi-tech operations in China, Huawei was never a joint-venture with a foreign multinational. For the first two years of its existence, it was a simple reseller of other companies' products. This enabled Huawei to understand the telecom business and gave its engineers experience with telecom hardware. After two years, it began to offer simple products designed and manufactured in-house. With experience, the products became more sophisticated, e.g. application-specific integrated circuits (ASICs). Today, Huawei offers a complete telecom product portfolio that includes digital switches, transmission systems, access networks, and so on. It can compete on quality and price with any Western manufacturer. Cisco recently lost a contract to Huawei to supply a 120,000-port Internet server in Shanghai.<sup>11</sup>

To achieve such rapid development, Huawei allocates 40 percent of its 16,000 staff to research and development (R&D). It hires 2000 to 3000 graduates from China's top universities each year. This intake of fresh talent keeps the average age of Huawei employees at 28.

For the moment, Huawei is heavily reliant on its home base, claiming to have captured over 30 percent of the China telecom market. Only 8 percent of its sales come from overseas but the company's intention is that 20 to 40 percent of sales should come from overseas over the next 3-5 years. It has already opened 35 branches outside of China, avoiding until recently the home-turf of Western telecom multinationals, i.e. North America and Western Europe. Instead, it has built up a healthy presence in Pakistan, Iraq, Iran, Zimbabwe, Ukraine, and other non-traditional markets. It can leverage the good diplomatic relations that China enjoys with less-developed nations. Now that it is comfortable overseas, Huawei is poised to enter the North American market.

In fact, Huawei is already in the U.S. An office in San Jose sources materials and components for the Chinese manufacturing operation. And a brand-new R&D facility has just opened in Richardson, Texas, joining other famous industry names—Ericsson, Alcatel, and Nortel among them—in Richardson's "Telecom Corridor."

Huawei is providing China with a new model for employee compensation. Performance-related pay, bonuses, and stock options for most employees are a way to attract and retain the most talented. This, combined with the lure of interesting work, should reduce the outflow of China's best students to foreign universities and companies.

### *THE NEXT STAGE*

China has achieved much in the 20 or so years since reform began. A modern industry was initially jumpstarted by the importation of production lines and manufacturing equipment. Then foreign companies were enticed to set up in China, first as manufacturers of basic commodities, then as producers of more sophisticated items for export. Lately those same companies that gained experience of operating in China through such ventures have begun to locate the critical R&D parts of their organization there.

Chinese companies themselves are beginning to establish global brands. Chinese-designed technology, such as that from Huawei, is already being sold to Western businesses. A visitor to the largest Chinese trade exhibition—the Chinese Export Commodities Fair held twice a year in Guangzhou—will be astonished by the variety and quality of Chinese-manufactured goods on sale. These range from the humble plastic shoe to agricultural machinery to radar systems.

The Chinese government can take much credit for this success. But what policies are most suited to this stage of development? There are several:

1. Use a hands-off approach to business. This may be the most difficult one. The legacy of a centrally-planned economy and an apparent record of success so far will encourage the bureaucrats to continue their micromanaging ways. But there is no reason to think that the Chinese government will be better at picking winners in business than the government of any other nation. Japan's once-admired MITI (Ministry of International Trade and Industry) has overseen a succession of national innovation programs which have had little impact.

Worryingly, China's leaders have expressed admiration for the Korean chaebol (or conglomerate) model.<sup>12</sup> The chaebol were once seen as the flagships of the Korean economy. As these government-favored giants expanded into ever more lines of business, small, entrepreneurial companies were denied the capital that they needed to grow. Resources were poured into prestige industries such as car manufacture. Kia, Hyundai, Daewoo, Samsung and Ssangyong all launched new car marques. When the Asian crisis struck in 1997, the heavily-indebted chaebol began to fall apart. But there was no safety net of smaller compa-

nies to absorb the workers being laid-off.

In an effort to create such bulky “national champions,” the Chinese government has been “encouraging” successful Chinese businesses to incorporate failing state-owned enterprises, crippling them with large payrolls and inefficient plants.

2. Continue to invest in infrastructure. One of the striking features of the Chinese countryside is the thin copper wire threading its way over hills and valleys, bringing telephone service to the remotest villages. Oasis towns in the Gobi desert can boast mobile telephony service. Several massive optical fiber networks already connect every major Chinese city. Likewise, road and rail links continue to be upgraded all over the country. This will enable the reliable distribution networks that are essential to business and will eventually bring greater prosperity to the lagging interior of the country.

3. Continue to invest in education. China already boasts high literacy rates. It needs to expand the opportunities for education at secondary and tertiary levels. Currently, only about 11 percent of students reach the tertiary level.<sup>13</sup>

Curriculum development is also important. From the next school year, information technology will be a compulsory subject in all senior secondary schools. Later, this will be extended to junior secondary and primary schools.<sup>14</sup>

4. Loosen restrictions on access to information. The Communist Party regards unfettered access to information as a danger to its own survival and to the stability of the country. The result is that foreign newspapers and magazines are, in general, not available to Chinese people. It also means an abysmally slow Internet, since every access to a site outside of the country must be screened for “harmful” content. The list of proscribed sites includes “<http://www.stanford.edu>”. It is harder for innovation to thrive under such conditions.

5. Strengthen the rule of law. Foreign companies have never been able to rely on the Chinese legal system for protection. Whatever rules exist are applied erratically if at all. However, as more privately-owned Chinese companies demand these same protections, the situation should improve. Foreign companies have long complained about the illegal reproduction of software, music, and movies. While this unlawful copying of intellectual property (IP) was all one-way, it suited China not to clamp down too heavily on the practice. But as China becomes a significant producer of IP, it will

suddenly find ways to protect copyright.

The imminent accession of China to the WTO will also help to foster a more transparent business environment.

6. Provide regulatory support for local technologies. This is an interesting tool in the hands of governments that is not often recognized as such.

The technocrats in government will pull whatever levers are available to them to support Chinese business. They will have to be increasingly clever in this as WTO rules seek to level playing fields between countries. One new trick is to promote home-grown technological standards. The most prominent example is in the race to define the coming third generation (3G) mobile telephony technologies.

China has embraced the mobile phone. It is already the world's second-largest market for mobile service and is on its way to becoming the largest. The benefit of this rapid deployment has largely gone to foreign manufacturers—Nokia, Ericsson, and Motorola, for example. The so-called second-generation mobile systems—GSM and CDMA—were designed in the West. It is known that the Chinese government is unhappy with foreign control of this important industry.<sup>15</sup> Thus, it intends to rectify the situation before the 3G systems are installed. China has submitted its own standard—known as TD-SCDMA—for 3G wireless to the International Telecommunications Union (ITU), the global standards-setting body. It was approved, the first time that a Chinese standard has achieved such recognition.

The benefit to Chinese industry is that the native equipment manufacturers will not have to license as many technologies from abroad. Indeed, given the size of the Chinese market, western firms will want to support any standard in use in China and so must obtain licenses from Chinese enterprises, a neat reversal.

Development of technical standards and ownership of the associated intellectual property (IP) are large components of Beijing's current industrial strategy. Expert groups are already working on other hot areas of development, for example digital high-definition TV.

7. Support basic research and development. Most governments believe that they have an important role in stimulating basic research. Such research shows no immediate prospect of financial return but, nevertheless, becomes the basis of future product development. Given that business expects a foreseeable return in the short to medium term, governments often take over the funding of “blue-sky” research. Universities have an obvious contribution

to make here. Less obviously, private companies can be funded to undertake basic high-tech research.

The American model of subsidizing industry might prove very attractive to China. In a world governed by WTO regulations strictly limiting direct government aid to industry, the U.S. disguises its subsidies as military spending. The U.S. military budget for 1998 was \$281 billion.<sup>16</sup> In the same year, China spent \$37.5 billion.<sup>17</sup>

The large disparity between the U.S. budget and that of any other nation accounts for a significant part of the United States' technical lead. Projects originally funded by defense spending often become commercially viable at a much later stage, the Internet and GPS being two famous examples.

## CONCLUSION

This article has argued that China's technological development has been motivated not only by the desire to increase prosperity but by a determination to stand as the economic and political equal of any world power. Technological self-sufficiency brings economic wealth, which provides political muscle. China's path will be different from the Asian nations that preceded it. Korea achieved great industrial growth but still relies on the importation of foreign

technology to sustain it. Japan achieved the status of economic superpower but chooses not to exercise that power politically. China, on the other hand, regards itself as the natural anchor power in Asia. Her size probably makes this inevitable but there is an element of reclaiming her historical position as well.

Development by importation of technology is probably reaching its limits. Foreign countries and companies will be reluctant to supply China with the very latest of techniques for competitive and political reasons.

But just as China is opening its markets to freer world trade, Chinese companies are ready and able to make their mark as innovators. China's research institutions and students will provide a steady stream of talent and ideas to these companies.

It will be interesting to see how those ideas take shape. China can draw on a very deep cultural well that stretches back thousands of years. It will stamp its own, unique impression on world progress. It has been in this position before but became distracted for a thousand years or so. For the last twenty years, just like one of its young students aiming for a coveted place in Peking University, China has kept its head down, studying assiduously all that the outside world had to teach it. The study has finally paid off. Once a leader of science and technology, China is becoming so again.

<sup>1</sup> Joseph Needham, *Science and Civilisation in China*, 1 (Cambridge: Cambridge University Press, 1954), 9.

<sup>2</sup> Deng Xiaoping at the First National Science Congress, 1978. Quoted in Q. Y. Yu, *The Implementation of China's Science and Technology Policy*, (Westport, Connecticut: Quorum Books, 1999), 9.

<sup>3</sup> Outline of the Report on the Guidelines for China's Scientific and Technological Development, created by the China State Science and Technology Commission and submitted to the State Council on 23 February 1981. Quoted in Yu, *Science and Technology Policy*, 12-13.

<sup>4</sup> *Chinese Technology Transfer in the 1990's*, eds. Charles Feinstein and Christopher Howe (Lyme, New Hampshire: Edward Elgar Pub., 1997).

<sup>5</sup> "China Continues to Absorb Foreign Direct Investment," *People's Daily*, 26 September 2000.

<sup>6</sup> Alex Trotman, former Chairman of Ford, stated "I did not want to go out as the chairman who lost China." Quoted in "Ford misses out again," *The Economist*, 21 September 2000.

<sup>7</sup> "Taiwan chip firms begin slow march to China," *South China Morning Post*, 25 November 2000.

<sup>8</sup> Dr. Robert Yung, "Smart Computing for the Future", 11 November 1999, part of US-Japan Technology Management Center seminar series on "The Transformation of R&D in East Asia and Japan".

<sup>9</sup> All education statistics taken from the China Statistical Yearbook 1999 available online at: <http://www.stats.gov.cn/>

<sup>10</sup> Data on Huawei is compiled from several sources: a visit by the author to Huawei America, San Jose in December 2000; "Huawei Technologies", a company information brochure; and online at: <http://www.huawei.com>.

<sup>11</sup> Grahame Lynch, "Telecom Planet: Sino' the times", *America's Network*, 1 October 2000.

<sup>12</sup> "China adopts the chaebol," *The Economist*, 5 June 1997.

<sup>13</sup> Linda Yeung, "Internet plan to increase learners," *South China Morning Post*, 16 December 2000.

<sup>14</sup> Polly Hui, "IT lessons on the way in China," *South China Morning Post*, 25 November 2000.

<sup>15</sup> *Economic Information Daily* cited by Raymond Li, "Telecom giants discuss made-in-China tech," *South China Morning Post*, 13 December 2000.

# Taming the Dragon: China's Efforts to Regulate the Internet

Philip Sohmen

The advent of the Internet has posed an unprecedented dilemma for the Chinese government.<sup>1</sup> By emphasizing ideas and human capital over pure physical capital, it is an area in which China has the potential to develop rapidly and to compete with the West, providing an attractive proposition to a leadership intent on fostering economic growth and achieving world power status. On the other hand, because of its global spread and open nature, the Internet also brings access to much that the government has attempted to insulate China from, whether independent news, pornography, or anarchic discussion. In addition, it provides a means of widespread and rapid communication, making the establishment and organization of potentially dissident groups considerably easier such as the notorious Falun Gong case. The dilemma the Internet poses is therefore essentially one between economic growth and political control. To assert that these are mutually exclusive, however, would be simplistic if not simply wrong. Indeed, they are in essence the two basic goals of the Chinese government. However, to deny any tension between the two, particularly in the case of China, would also be unrealistic. The question of how China deals with the Internet is therefore of considerable interest because it is one of the areas in which this tension is most explicit.

By examining how the Chinese government has approached the introduction and regulation of the Internet, we may be able not only to assess how China has reacted in this particular case but also to draw more general conclusions on the government's aims, attitudes, and policies.

The government has attempted to achieve both of these goals simultaneously, supporting rapid growth in usage through its heavy investment in Internet infrastructure via the state-owned networks, while maintaining strict control over users. This paper examines the attempt both to foster and to control, with specific reference to the legislation enacted. It analyzes the different bureaucratic entities involved in the regulation of the Internet, before examining the government's attempts to control the Internet domestically through controlling access, content, and commerce and its attempts to control foreign ownership and enhance

the position of domestic entities.

Several themes run throughout. The first is the uncertainty and vagueness of policy and legislation, especially concerning prohibited content and foreign ownership. Combined with unpublished regulations and inconsistent enforcement, this has created an uncertain regulatory environment, hindering long-term growth. Nevertheless, as with other industries in China, many companies, both domestic and foreign, have leapt into the market heedless of the possible legal risks with their sense obscured by the prospect of rapid commercial gain. It is likely that many of these firms will suffer dramatic failures, given the added commercial risk of Internet business anywhere, although it is still somewhat early to tell. Second is the battle between different state groups for control over policy making on the Internet, a problem that is characteristic of Chinese bureaucracy but is exacerbated because of the Internet's multifaceted nature. The Ministry of Information Industry, the Ministry of Public Security, the State Press and Publication Administration, and the State Administration of Industry and Commerce, among others, have all issued regulations governing the Internet. In some cases, ministerial level regulation seems to run counter to the goals and policies of the top leadership. Many of the seemingly incomprehensible policies of the 'government' can only be understood once the 'veil of government' has been pierced and actions are viewed in the light of power struggles between different bureaucracies and even different individuals. A third, related, issue is the lack of separation between ownership and regulation. As in almost all major industries in China, the dominant companies are state-owned. These are under the control of the relevant ministry, which is often the same ministry that is responsible for the regulation of that industry, leading to a strong conflict of interest. The ability of the controlling bureaucracy to generate significant rents partly explains the struggle between bureaucracies to dominate. An extension of this is the restrictive attitude towards foreign ownership and involvement in the Internet; the incentive for protectionism is higher when the legislating body stands directly to gain from the success of domestic firms.

One particularly interesting question to which only speculative answers can be given is whether the Internet and its related technology will be a catalyst of declining government power through its facilitation of communication and thereby dissent, or whether it will actually strengthen central control through enabling closer scrutiny of provincial and lower level government.

A caveat should be added: since the growth of the Internet is such a recent phenomenon, the subject matter of this paper is still in a state of rapid change. It is therefore difficult to approach the topic with the benefit of hindsight and much of the analysis remains preliminary.

### *REGULATORY AGENCIES*

The question of who controls policy concerning the Internet in China is not a simple one. As with many other areas of business in China, but particularly owing to its diverse nature and ramifications, the Internet is subject to regulatory oversight by several different agencies of the Chinese bureaucracy, both vertically and horizontally, resulting in a tangled web of control. The confusing network of agencies involved has been exacerbated by the frequent changes of name and responsibility that have occurred over the previous seven years, along with the rapid development of the Internet. As predicted in models of bureaucratic behaviour proposed by political theorists such as Niskanen<sup>2</sup> who suggests that bureaucracies will act to maximize the resources under their control and develop close patron-client ties with the participants under their oversight, many different agencies have laid claim to regulatory control over the Internet. Competition has developed between these agencies over responsibility for such a rapidly expanding and lucrative area of the economy.

At the highest level, the Economic Information Joint Committee was established in 1993, and as it began to concentrate increasingly on the Internet, it was developed into the State Council Steering Committee on National Information Structure (SCSCNII) in 1996. Such Steering Committees are established in China when several bureaucratic bodies are involved in a particular area and a coordinating body is required to oversee policy strategy. The major responsibilities of the SCSCNII are the formulation of strategy, principles, rules and regulations in developing national informatization, coordinating projects and establishing standards.<sup>3</sup> The SCSCNII therefore develops policy at the strategic level.

At the day-to-day regulatory level, the main body currently responsible for the Internet is the Ministry of Information Industry (MII). The MII was created out of the former Ministry of Posts and Telecommunications and Ministry of Electronic Industry in 1998 to serve as the primary body responsible for telecommunications and high-tech

industry. Its principle self-declared functions are:<sup>4</sup>

- i. The formulation of strategy, policy and plans for the information, telecommunications and software industries
- ii. To draft and enforce regulations governing these industries
- iii. To plan, build and manage public networks for government and military
- iv. To allocate and coordinate bandwidth
- v. To supervise telecommunications and information services markets and implement licensing
- vi. To assist the development of the information industry

From this list, it is clear that the MII plays a major role in policy, legislation, and regulation of the Internet. It is unclear to what degree exactly responsibility for policy-making is allocated between the MII and the SCSCNII. Although the SCSCNII is in theory a superior body to the MII, in practice it seems as if the MII is responsible for policy up to the highest level.

As well as being the regulator of the industry, the MII is also deeply involved in commercial operations in the Internet. It is closely involved with China Telecom, which owns ChinaNet, one of six network organizations operating internationally linked networks in China under permits issued by the MII. ChinaNet is the dominant network, with 83 percent of connections to the global Internet backbone at the end of 1999.<sup>5</sup> With such a high market share, it virtually has monopoly control over the market. Smaller ISPs may lease bandwidth from China Telecom, but the high leasing fees charged have prevented these ISPs from gaining any significant market share. Although the MII was forced to relinquish its direct ownership stake in China Telecom in order to separate regulatory and operational functions, it still maintains close links. The MII is also involved in the content side of the Internet. In March 2000, the Center of Computer and Microelectronics Industry Development (CCID), which is the research and development arm of the MII, launched its own web portal, directly in competition with Sohu and Sina, two of the three most popular and privately run Chinese websites. At the launch of the website, in explaining why CCIDnet would be superior to its competitors, the CEO picked out the company's close relationship with the government.<sup>6</sup> As the primary industry regulator, such commercial involvement has created a clear conflict of interest for the MII, which partly explains its efforts to prevent foreign investment. The separation of regula-

tory and operating functions should take place following China's WTO admission, but the current overlap remains an issue of concern.

The other main agency involved in Internet regulation is the Ministry of Public Security, which is responsible for the implementation and enforcement of laws. It is therefore responsible for the technical measures used to monitor and control Internet usage in China, including surveillance of computer networks, registration of all Internet users, investigation of crimes and prosecution. Numerous other agencies also play a role or have asserted a claim to regulate some aspect of the Internet.<sup>7</sup> The State Information Office, the State Council's public-relations agency and news office, is currently drafting regulation for Internet Content Providers. The Chinese Communist Party's Propaganda Department, which is responsible for print media, has issued unpublished rules governing news content and may deem these rules to be applicable to online media as well. The State Press and Publication Administration has also drafted unpublished regulations governing news content. In addition, the Xinhua news agency is responsible for approving all foreign content disseminated in China. The State Administration of Radio, Film and Television has plans to supervise online broadcasting. As the regulator of China's cable networks, which have 80m subscribers, it is a potential competitor of the MII for dominance over the Internet. Also involved is the State Administration of Industry and Commerce, which regulates advertising. In April 2000, it announced plans to regulate online advertising, beginning with pilot projects in Beijing, Shanghai, and Guangdong.<sup>8</sup> The China Securities Regulatory Commission is responsible for approving all public share offerings, an area of Internet business that has been of crucial importance in the rapid development of the Internet in other countries. Through its ability to approve or reject proposed public offerings, the CSRC is able to exert significant power over Internet businesses. The CSRC is also responsible for share trading, and in April 2000 issued regulations concerning online securities trading.<sup>9</sup> Lower levels of the Chinese government have also begun to issue regulations. The Beijing Municipal Administration for Industry and Commerce has issued several sets of regulations including rules governing registration of websites and protection of consumer rights in e-commerce.<sup>10</sup> The head of the BMAIC declared that these regulations were intended to clarify and remedy deficiencies in the existing regulation, but they might also be interpreted more cynically as an effort to assert another competing claim to regulatory power.

Companies that wish to engage in Internet business in China therefore face the daunting task of compliance with a number of different agencies and regulatory regimes. While the phenomenon of a number of bureaucratic agencies with overlapping jurisdiction is neither unique to China

nor to the Internet, the situation there is exacerbated by the lack of separation between state-owned operation and regulation. This means that agencies stand to gain directly from being able to assert regulatory power. As these agencies jockey for control over the Internet, the result is an increasingly complex and unpredictable regulatory environment for both foreign and domestic businesses.

### *CONTROLLING THE INTERNET*

While recognizing the considerable growth potential of the Internet, China has remained preoccupied with the risk to security and political control that it poses through facilitating rapid global communication and dissemination of information. The government has therefore attempted to maintain strict control over Internet usage, through a two-pronged strategy of controlling access and restricting content. The main regulations specifically governing the Internet are contained in various pieces of legislation dating back to 1994.

The 1994 "Rules of Security Protection of Computer Information Systems", which predated the widespread use of the Internet in China, established the basis for government control over and surveillance of computer networks. The provisions of the Act deal with two areas: security protection of systems and security surveillance.<sup>11</sup> The Security Protection regulations provide that work units that use computer systems connected to an international network must report such systems (Article 11), adequately protect them against unauthorized access (Article 13), and that transportation of computer media in or out of the country must be declared to customs (Article 12). The surveillance provisions allocate responsibility to the Ministry of Public Security for maintaining the security of the networks through surveillance (Article 17). The provisions also include the authority to issue special orders on matters related to computer system security in cases of emergency (Article 19).

The first regulations to deal specifically with the Internet however were the 1996 "Interim Regulation on Administration of International Networking of Computer Information Networks". These regulations were revised and added to in May 1997 as the "Computer Information Network and Internet Security, Protection and Management Regulations." This legislation, issued by the State Council Steering Committee, but in all likelihood drafted by the MII, are the center of the government's efforts to ensure its grip over the Internet. The provisions of these regulations provides for two means of government control: physical limitation of access, and outlawing of designated content.

### *THE GREAT WALL: CONTROLLING ACCESS*

The 1996 regulations provide for physical restriction of

access by setting up a three-tiered system consisting of international networks, interconnecting networks and connecting networks. International networks are those networks linking China to the global Internet, interconnecting networks are the national backbone networks that connect to the international networks, and at the lowest level are the connecting networks, effectively ISPs, which connect to individuals and businesses.

The regulations designate the former Ministry of Post and Telecommunications (MPT) – subsequently merged with the Ministry of Electronic Industry in 1997 to form the MII – as gatekeeper to the Internet. Access to the Internet by networks is restricted exclusively to channels provided by the MPT: “all direct international networking traffic must use international incoming and outgoing channels provided by the MPT’s national network” (Article 6). Thus the government is able directly to monitor and control access to the international network at the point of entry into China, not to mention the financial benefits that the MPT/MIJ derives from the monopoly power which it holds. This monopoly over international connection was confirmed in further regulation issued by the MPT in April 1996, the “Provisions Governing the Management of Internet Inlets and Outlets for the Computer Information Network.” The Interim Provisions further provided that the MII, the State Commission of Education, and the Chinese Academy of Sciences would administer existing interconnecting networks. Although other commercial networks have subsequently been licensed, notably Ninety, run by China Unicom, the backbone networks in China remain under the control of government bodies and state-owned enterprises, with foreign investment banned.

At the next level, users must connect to the national backbone networks through connecting networks, effectively Internet Service Providers. These connecting networks are required to apply for a license for connection to the backbone and in doing so must provide information on the location of its host computers as well as the nature and scope of its networks. At the lowest level, under a Public Security Bureau circular of January 1996, individual users of the Internet are also required to register with the local PSB. The registration process is undemanding; basic information on education and background is required, along with signature of compliance with the regulations, and a fee of 400 yuan.<sup>12,13</sup> However, this provides the PSB with information on the location of each computer connected to the Internet, as well as its owner, for surveillance and monitoring purposes. Failure to register is punishable under the 1994 provisions with fines or prison sentence.

Thus the government, through the MII, attempts to control physical access to the Internet by maintaining a monopoly on international links, a government oligopoly on the internal backbone networks, licensing system for ISPs,

and registration requirements for individual users. This vertical system contrasts sharply with the horizontal nature of the Internet elsewhere. The Chinese government has attempted to impose its own hierarchical system on the quintessentially egalitarian and center-less new medium of the Internet, reflecting both Confucian and more modern political traditions. This desire to interpose the state between the citizen and the outside world highlights the Chinese conception of relating to the rest of the world, reminiscent of the self-imposed insularity of Imperial times. However, the technical considerations discussed below suggest that such an effort to impose its worldview on an outside invention will be as unsuccessful as the Great Wall was in repelling outside influence.

### *BURNING THE BOOKS: CONTROLLING CONTENT*

The government’s second strategy is careful control over content published on the Internet through outlawing the publication of and access to objectionable content. Although the 1996 regulations outlined what constituted objectionable content, the 1997 “Computer Information Network and Internet Security, Protection and Management Regulations” provides the most extensive list of outlawed content. Article 4 of the 1997 regulations states that “no unit or individual may use the Internet to harm national security, disclose state secrets, harm the interests of the State, of society or of a group, the legal rights of citizens, or to take part in criminal activities.” Article 5 goes on to prohibit specifically content which is:

- i. Subversive of state power or the socialist system
- ii. Damaging to national unity
- iii. Inciting discrimination between nationalities
- iv. Disturbing to social order
- v. Propagating feudal superstition
- vi. Pornography, gambling or violence
- vii. Insulting or libelous
- viii. Violating the Constitution or other laws

Various supplementary regulations have also been issued by other parts of the Chinese bureaucracy. In January 2000, the State Secrecy Bureau issued the “Regulations for Computer Information Systems on the Internet”, which provides for further limits on acceptable content and more stringent requirements for approval. The regulations extend the prohibition on leaking state secrets to email, bulletin boards, chat rooms, and news groups and require websites to be officially approved before publishing previously unpublished information, as well as to undergo unspecified security checks.<sup>14</sup>

The wording of these regulations is, however, vague. No

definitions of state security state secrets or information that could be 'harmful to social order' are provided, with the regulations merely referring to the relevant existing regulations. It is therefore important to examine what these other regulations specify and how the concepts have been interpreted in the past. 'State security' is an extremely flexible concept in China, and the state security statutes have been used in the past by the government against those dissidents seen as threatening the regime in any way, with laws allowing for severe punishment, including long prison terms and execution. The National Security Law of 1993 specifies the sale of state secrets to foreigners for profit as a threat to national security, but in turn the Chinese government has interpreted 'state secret' broadly. This flexibility in interpretation is clear in some of the cases that have qualified as leaking state secrets. In one case, a reporter leaked the draft of a speech to be given by Jiang Zemin at the Party Congress to a Hong Kong newspaper, and was subsequently sentenced to life imprisonment. In another, a reporter for Hong Kong's *Ming Pao* Daily newspaper who published information concerning the level of China's gold reserves was arrested and convicted of leaking state secrets.<sup>15</sup> In such cases, public explanations for convictions are not required, meaning that officials may interpret the provisions as they wish. Punishments in these cases may be severe, as is clear from the former case above.

Likewise, 'social order' is undefined, and provisions for the protection of social order are often used as a means to control opposition. Most notoriously, the Tiananmen Square crackdown of 1989 was justified on the basis that the demonstrators were threatening social order. Public expressions of opposition to the regime through television and printed media such as leaflets are also considered to be counter-revolutionary offenses disturbing social order. The same standards are likely to be applied to expressions of dissent on the Internet; the government has established legal justification and precedents to take severe action against any potential threatening expression of opposition, whatever medium is used. Somewhat less clear is the extent to which it is technologically feasible to censor all the information that is available on the Internet.

#### *FIGHTING A MULTI-HEADED DRAGON: TECHNOLOGICAL FEASIBILITY OF CENSORSHIP*

While China's policy of blocking objectionable opinions and materials is the same for the Internet as it is for physical media, the government's ability to do so is significantly different. Officials have attempted physically to block objectionable sites and monitor information and message flows on the Internet. This has been pursued by using filtering programs, which use keywords to search out and block potentially objectionable sites, or by blocking predetermined

sites labeled as 'politically subversive'.<sup>16</sup> Such sites include foreign news sources such as the *New York Times*, CNN, and the *Economist*, as well as domestic sites expressing dissident information. Blocking of sites has been delegated to the ISPs, with the PSB sending out a list of websites to be blocked from users. However, some observers have noted that the actual sites being blocked appear somewhat inconsistent: the *New York Times* is blocked but the *Washington Post* is not, for example.<sup>17</sup> Furthermore, there seems to be somewhat erratic enforcement with some websites available through some servers but not others. Whether this is owing to deliberate or accidental negligence on the part of ISPs or a failure to publish the lists by the PSB is unclear. What can be concluded is that there is no coherent and consistent decision-making process by which content is deemed objectionable, and that enforcement is equally inconsistent.

Enforcement is likely to remain difficult simply because it is impossible to censor the Internet in a comprehensive manner. The quantity of information passing over it is vast - monitoring communication through email, instant messaging, and the other channels that the Internet enables is in itself an enormous and ever-expanding task. Moreover, the rapidity of technological development, combined with the ingenuity of hackers, means that methods of circumventing controls are produced as quickly as officials can devise them. In addition, the Internet has generated and linked together an anti-establishment community internationally which opposes and circumvents attempts by governments or authorities to control it. A service exists which sends blocked pages to those requesting them via email, for example. The founder of this service has stated that numerous requests for western media information have been received from China.<sup>18</sup> Alternatively, using a cellular telephone, it is possible to connect to the Internet through a foreign ISP and completely bypass the Chinese system. Furthermore, dissident and human rights groups outside China are able to help such groups within China to bypass security controls by providing services such as anonymous remailers, which redirect email messages anonymously.

#### *DETERRENCE AND SELF-CENSORSHIP*

The Chinese authorities have recognised the technical limitations on direct controls and the relative ease with which such controls may be circumvented, and consequently have explicitly shifted their strategy from physical blocking towards a policy of deterrence and self-censorship. Deputy Secretary-General Yu of the SCSCNII commented: "if an individual is intent enough on obtaining pornography, that person will find a way to get it".<sup>19</sup> Rather than blocking access, the PSB is able to monitor the account from which objectionable sites were accessed and to trace

and arrest the individual responsible. Indeed, while direct blocking is difficult, the Internet is conducive to detection and monitoring, because of the precise identification protocols used by computers to connect to the network, which leave an electronic trace. Thus it may even be more difficult to escape detection if distributing 'politically subversive' material via email than in a physical medium. The legal requirement for users of the Internet to register their computers means that the PSB has the potential to identify and deal with offenders quickly.

Nevertheless, whether or not the government has the technological capability to block certain areas, or to track down all violators may not be as important as long as the threat of monitoring and punishment exists. Nicholas Negroponte, head of the MIT Media Lab commented, "the use of centralist means to censor the Net is doomed to failure, unless you simply frighten people into silence."<sup>20</sup> This emphasis on deterrence is indicated in the 1997 regulations' increased emphasis on penalties for violators. Fines of up to 5000 RMB for individuals and 15000 for work units may be charged, and network licenses may be suspended or revoked. For offenses such as revealing 'state secrets', punishment could be considerably more severe. Such an approach is consistent with the approach China has followed towards traditional media, in which self-censorship rather than direct censorship by authorities has been practiced. This may also be a reason why the law is so vague on what constitutes subversion or state secrets: if citizens are unsure of what may be deemed illegal, they may opt for the side of caution. However, such a policy presents problems for Internet service providers. Under the regulations they are held responsible for the sites that their users visit, but they are caught between the technological difficulty of monitoring all traffic through their servers and the vagueness of the law on what exactly they should be monitoring.

Further rules regulating domestic online media were issued in 2000 by the Communist Party Propaganda department. These regulations prohibit websites from providing links to outside news sources or posting content from any foreign news sources. Websites are also prohibited from hiring reporters independently; they are restricted to publishing news content provided through the state media. In addition, traditional media, both print and broadcast, were forbidden to use any content sourced from the Internet.<sup>21</sup>

Such restrictions could have an adverse effect on the growth of the Internet in China. Advertising revenues play an important role in the Internet world, and such revenues are closely linked to the quality of the content on a website, which drives the traffic. Without the ability to provide differentiated content, many of China's private websites will lose their business. Following the issue of the regulations, Sina.com, China's largest commercial website, announced that it would be abandoning its news and content business

in favour of e-commerce, and others may be forced to follow. These regulations again seem to coincide with the commercial interests of the government, by "effectively hobbling free-market competition" to the official state media.<sup>22</sup> Such state media are unlikely to run foul of the state secrets provisions, and are guaranteed business as the sole providers of news content. The issue of the regulations came soon after the announcement that the five largest state media websites, including the People's Daily and Xinhua News, would receive funding directly from the central government.

### *HOLDING THE PURSE-STRINGS*

The final strategy in the government's battle to control the Internet is its regulation of the sources of funding for domestic Internet firms. The public equity markets are a vital source of funding for almost all startup Internet companies, and the government is able to maintain control of this channel of funding by requiring approval for all companies seeking to offer shares publicly either domestically or abroad. Approval by the China Securities Regulatory Commission, which usually refers cases to the MII, is required for listing, and such approval usually requires a lengthy wait. The three leading Chinese Websites have all experienced long delays and problems in receiving approval to list on NASDAQ.<sup>23</sup> The MII also announced in March 2000 that Chinese websites wishing to list overseas were required to divest any China-based content assets from the entity to be listed. This provides a further obstacle for firms seeking to go public, as well as decreasing the potential attractiveness of their shares to investors. While regulating stock market listings is not sufficient to control all Internet business, it does provide the government with a stick with which it can threaten companies that attempt to disobey the regulations, since almost all Internet companies require approaching public markets at some stage.

### *CONTROLLING FOREIGN INVESTMENT*

As in other sectors, foreigners have rushed to establish themselves in the Chinese market. Foreign firms have invested heavily, either in domestic startups, or in their own initiatives, eager to take advantage of 2.6 billion eyeballs, and many foreign educated Chinese returned home to start their own businesses. The question of foreign investment in the Internet was ignored by the government until September 1999, as the government welcomed the growth provided by the booming sector. Investors were therefore taken by surprise when Wu Jichuan, Minister of Information Industry announced that Internet businesses would be classed as value-added telecommunications services and would therefore fall under the provisions of the 1993 Regulations governing telecommunications services, the 'PRC Interim Pro-

visions on the Approval and Regulations of Businesses Engaging in Telecommunications Services'. These regulations contain no mention of the Internet; at the time, the Internet was barely known in China. Nevertheless the provisions are clear: foreigners are prohibited from owning, operating or managing telecommunications services in China.

"Foreign individuals and organizations, along with foreign invested or partnered enterprises that have already established in China are forbidden from investing or either solely or cooperatively operating in telecom services in China"

This prohibition is confirmed in later regulation. "Projects that are prohibited from foreign investment" in the 'Catalogue for guidance of Foreign Investment Industries' which forms part of Decree No 5 of the State Planning Commission, SETC and MOFTEC, promulgated in June 1995, specifically prohibits foreign management of postal and telecommunications services. By judging these regulations to be applicable to Internet business, the MII has effectively declared the illegality of all foreign-invested Internet businesses of any kind currently operating in China.

### PROTECTIONISM

Several arguments have been advanced to explain the sudden decision to ban foreign investment. Although many Internet firms have sought to avoid regulatory hurdles by registering as non-Internet businesses, it is improbable that the MII was unaware of the extent of foreign involvement in the sector<sup>24</sup>. Similarly, it is unlikely that the decision was motivated purely by Minister Wu's personal conservatism, although he has a reputation for obstructionism and is an enemy of Zhu Rongji's: he apparently maintained his job only on account of Zhu's humiliation in the WTO talks in April 1999, after opposing Zhu's proposed reform and opening of the telecommunications sector.

A more plausible explanation of the decision is simple mercantilism. Foreign investment was needed and accepted while the Internet was in its infancy, but once the sector had grown to a self-sustaining size, the Chinese government could jettison foreigners in order to keep the benefits of growth to itself. While this argument may contain some essence of truth, as the Chinese government has followed a strategy of protecting and promoting domestic industry by hindering foreign competition, it is lacking in its timing; considerable investment is still required if China is to rival America or Japan's capabilities, and domestic sources of capital remain highly undeveloped. Closing the tap of foreign investment completely would in all likelihood drain the Internet sector of much-needed capital.

The most convincing argument is that the ban on foreign investment is the result of *local* rather than national protec-

tionism. Wu's pronouncements should be viewed from a domestic rather than a foreign perspective as a move to consolidate the MII's control in the bureaucratic competition over the Internet.<sup>25</sup> This view sees the MII as an individual actor within the government, pursuing its own goals of size and prestige. The Internet is potentially an enormous and lucrative sector of the Chinese economy, patronage of which serves to increase the controlling bureau's power and authority. It is therefore highly desirable for the MII to maintain its primacy over it. By declaring that the Internet is a telecommunications service, it is announcing its claim to be the legitimate regulatory agency, to participants in the industry as well as to the other government agencies that also have some claim to it. Aside from the power derived from overseeing a large industry, the MII also benefits commercially from restricting foreign investment, through its involvement with ChinaNet and CCIDnet. By limiting foreign and foreign-funded competition against its sponsored entities, the MII itself stands to gain.

### ENFORCEMENT

Will these threats be enforced? The Chinese government has taken an inconsistent approach to the enforcement of laws in several areas, particularly in terms of foreign investment. Authorities may turn a blind eye to violation of regulations for some time before pursuing sudden crackdowns that make examples out of certain firms, such as the crackdown on the retail distribution sector. Thus far no foreign investors involved in the Internet have been sanctioned, but the case of China Unicom should be borne in mind, especially since it fell under the 1993 Telecoms regulation, the very regulations which the MII claims apply to the Internet. In order to circumvent the prohibition of direct equity ownership and management of telecoms services, various large foreign firms had negotiated a complex series of consulting and leasing contracts with China Unicom, known as China-China-Foreign (CCF) investment. This arrangement had been sanctioned at the highest level, but in 1998 the MII announced suddenly that such investment was in fact illegal, as it was equivalent to equity ownership. Despite vociferous objections from the foreign firms involved, the Ministry ordered China Unicom in July 1999 to break off its agreement with the foreigners. The case illustrates the volatility of Chinese policy-making and the potential for conflict between different parts of the government.

Another case may be somewhat more comforting to foreign investors. In 1998, two brothers were arrested and brought before the courts in Fujian province for providing Internet telephony services without a license. The defendants won the case on appeal, by arguing that the 1993 regulations were inapplicable because computer network ser-

vices did not constitute a telecommunications service. While the verdict in the case might provide some comfort, the lack of doctrine of precedent means that the consistency of the Chinese judiciary should not be counted on to provide protection against sanctions by the MII, especially given that the case involved only domestic players. The decision creates no obligation on future judgements, nor does it place any constraint on bureaucratic agencies.

Foreign investors in the Internet would be well advised to be wary of the risks involved. The government in general and the MII are pragmatic enough to realize that the Internet will play a valuable role in China's economy and growth, and that the development of the sector would be considerably retarded without foreign capital or technology, given the lack of a domestic venture capital market. In addition, the WTO agreement negotiated with the USA provides for liberalization of telecommunications services specifically *including* the Internet, allowing up to 49% foreign ownership on accession, and 50% within two years.<sup>26</sup> Nevertheless, the lesson which foreign Internet investors should learn from the experience of many other industries, is that while the Chinese government is happy to receive foreign money and technology, it wants to do so on its own terms and will make considerable efforts to protect and support domestic firms. The general risks of investing in China and in the Internet are compounded by the security concerns that the Internet has evoked in China, and the competition between different agencies to exert their control. Investors should therefore be well aware of these risks before being blinded by the potential rewards.

Investors are advised to follow the usual precautions of appropriate due diligence before investment, finding trustworthy local partners and staff and maintaining good contacts at all levels. More specifically, foreign investors would be well advised to steer clear of the content and ISP sectors. News and media sites are particularly risky owing to their political sensitivity. There is no definition of 'state secrets' or subversive content in the regulations, and interpretation of these concepts has been broad in past cases. Penalties for publishing what is seen by the government as dissent in any media may be severe. The tight restrictions on independent news and content also effectively protect the state media against private sector competition. ISPs are also potentially an area of political risk. Under the regulations, ISPs bear responsibility for content accessed by their customers.

However they are trapped with the technical difficulty of blocking content from consumers, and the difficulty of knowing exactly which content should be blocked. From the commercial aspect, the domination of the backbone networks by state-owned entities means that private ISPs may find it difficult to operate profitably despite the enormous growth in Internet users. The safest sector to operate

in from a regulatory and political standpoint is e-commerce, although this may in turn be subject to a host of commercial concerns such as low income levels, low numbers of credit cards, and low penetration of computers and technology in companies. Investors are also advised to be particularly careful in their budgeting and funding calculations, given the government's control over public listings. Delays and obstructionism may mean financial difficulties for startups. Investors should also be aware that the requirement for stripping assets in China from overseas listed entities may decrease the appetite for such entities from secondary investors. Finally, foreigners should be prepared for the capriciousness of policy and attitudes as the government attempts to deal with the novelty of the Internet and to keep up with its rapid change.

### CONCLUSIONS

The Internet promises both economic potential and political threat for China. While the government has been keen to welcome the economic benefits, the increasingly draconian regulations that it has announced reflect a desire to maintain tight control over content on the Internet. While this is to some extent driven by the Communist Party's existing policy of suppressing free information (exacerbated by the fear that the Internet will become a tool of dissidents, inspired for example by the Falun Gong's use of email) one of the primary motives for some of the policies seems to be the more economic aim of promoting state-owned Internet businesses at the expense of competitors.

This problem is especially acute because of the overlapping of state regulatory and operating agencies. The top three websites in China are privately owned, but the next seven are all owned by branches of central and local governments. This mercantilist use of legislation to protect the government's own interests will be a large obstacle for private Internet business, both domestic and foreign by creating uneven competition, and an atmosphere of uncertainty. Such national protectionism is further exacerbated by the competition between regulatory agencies to establish their jurisdiction over the sector. The restrictive and uncertain regulatory environment created by these conditions is likely to stunt market development and growth, and disincentivize foreign investors and their much needed capital.

This paper has considered China's attempts to determine the course of the Internet, but in concluding, it is worth speculating briefly on the Internet's likely effect on China. While the government has attempted to maintain strict control over the Internet, the nature of the technology means that it is likely to remain one step behind. In the long-term, the Internet will be one of the factors that contribute to the erosion of the state's political control. To suggest that it will become an instrument of widespread dissent and a tool

for subversion, as the government seems to fear, is unlikely. Change is more likely to come through the increasingly tight links with the outside world that the Internet forges, and through its contribution to economic growth. In the shorter term, the government will be able to maintain its strict control of both online and offline expression, not through regulation but through its ability to use force to scare dissenters

into submission. As Mao remarked, political power grows out of the barrel of a gun. Although the gun is now better concealed, this remains the case in China. Nevertheless, despite the efforts of the government to keep the Internet under control, its ramifications are such that it is likely in the long run to prove longer lasting and more powerful than restrictive government.

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<sup>1</sup> Although 'government' in China in principle includes all entities from the top Communist Party leadership down to village committees, in this paper I use the term to refer to the central government in Beijing.

<sup>2</sup> William A. Niskanen, *Bureaucracy and Representative Government* (Chicago, Aldine, Atherton, 1971).

<sup>3</sup> Tan Zixiang and Will Foster, *Internet Diffusion in P.R. China*, March 1998. <<http://china.syr.edu/chinainternet/chinainternet0398.pdf>>

<sup>4</sup> Ministry of Information Industry website. Cited in Richard Cullen and Pinky D.W. Choy, "The Internet in China," *Columbia Journal of Asian Law*, Spring 1999.

<sup>5</sup> Stephen Anderson, "China's Widening Web," *China Business Review*, Mar-Apr 2000.

<sup>6</sup> Lester J. Gesteland, "China's Internet Regulator Launches Web Site," *ChinaOnline*, 31 March 2000. <<http://www.chinaonline.com>>

<sup>7</sup> "Who's In Charge Here?" *Business China*, 14 February 2000, 5.

<sup>8</sup> "China to Regulate Online Advertising," *ChinaOnline*, 7 April 2000, <<http://www.chinaonline.com/>>.

<sup>9</sup> "Text of New China Online Securities Regulations," *ChinaOnline*, translated from *Zhengquan Shibao (Securities Times)*, 18 April 2000. <[www.chinaonline.com](http://www.chinaonline.com)>

<sup>10</sup> "Circular on the Registration and Riling of Online Businesses" and "Notice on Protecting the Legitimate Rights and Interests of Consumers in Network Economic Activities. Cited in "Lost in cyberspace? Beijing Official Wants to Provide the Map (Through Legislation)," *ChinaOnline*, 27 July 2000 and "Get the Fraud Out of the Baud: Beijing Issues Laws to Regulate E-commerce," *ChinaOnline*, 13 July 2000. <[www.chinaonline.com](http://www.chinaonline.com)>

<sup>11</sup> Zhang Mo, "China Issues New Rules Strengthening Regulatory Structure Over Internet," *East Asian Executive Reports*, 15 November 1997.

<sup>12</sup> Approximately US\$50 at today's exchange rate.

<sup>13</sup> Scott E. Feir, "Regulations Restricting Internet Access: Attempted Repair of China's Great Wall Restraining the Free Exchange of Ideas," *Pacific Rim Law and Policy Journal*, March 1997.

<sup>14</sup> "Stirring the Pot," *Business China*, 14 February 2000.

<sup>15</sup> Stirring the Pot.

<sup>16</sup> Feir, "Regulations Restricting Internet Access."

<sup>17</sup> "New PRC Internet Regulation," *US Embassy Report*, January 1998.

<sup>18</sup> Feir, "Regulations Restricting Internet Access."

<sup>19</sup> "New PRC Internet Regulation."

<sup>20</sup> Simon Fluendy, "Pandora's Box: Asian Regimes Struggle to Keep a Lid on the Net," Far Eastern Economic Review, 26 September 1996.

<sup>21</sup> Gary Chen, "China Internet: Government Tightens Controls, Clamps Down on News," ChinaOnline, 6 March 2000. <www.chinaonline.com>

<sup>22</sup> "Control Freaks," Business China, 14 February 2000.

<sup>23</sup> Gary Chen, "Internet IPO@crossroad.prc," ChinaOnline, 28 February 2000. <www.chinaonline.com>

<sup>24</sup> Anthony Cheng, founder of Renren.com, talk given at Stanford Graduate School of Business, February 2000.

<sup>25</sup> Ken Grant, "The Wu Way: Has China Closed the Net Door?" Virtualchina.com Perspective, 18 October 1999. "Eyes Wide Shut," Business China, 8 November 1999 and Gary Chen, "China's Booming Internet Sector: Open or Close to Foreign Investment?" ChinaOnline, 8 October 1999.

<sup>26</sup> "The Sino-US WTO Agreement: Deal of the Century," Business China, December 1999.



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# The Development of Modern Entrepreneurship in China

Debbie Liao and Philip Sohmen

Entrepreneurship in China used to be an oxymoron. An ideologically Marxist country since Mao Zedong took over in 1949, the Communist regime has actively suppressed and stifled capitalist activities for decades. Yet, was entrepreneurial activity really terminated even in a time when capitalist suspicions could easily mean public humiliation and persecution? In this paper, we will study Chinese entrepreneurs in China and the issues they face in venturing into business independently. Touching briefly on the history since Mao but focussing on the past two decades since Deng took over, we hope to reveal whether entrepreneurship is something that can survive and flourish in China. We will examine prevailing theories regarding Chinese culture and whether it supports capitalist behavior. We will describe the three major waves of entrepreneurial activity, the environment facing and constraining entrepreneurs, and the characteristics and strategies that have evolved. Our research consists primarily of interviews and secondary resources. Because of the difficulty of conducting research in China, our paper is an exploratory study into Chinese entrepreneurship.

So what is entrepreneurship? It has been defined as “the process that takes place...that causes changes in the economic system through innovations brought about by individuals who generate or respond to economic opportunities that create value for both these individuals and society.”<sup>1</sup> However, it is useful to differentiate between *entrepreneurial management*, which may take place in the context of large established organizations, and *entrepreneurship* in terms of starting and running one’s own business, with the higher degree of risk and independence that this implies. For the Chinese, the pertinence of entrepreneurship is particularly relevant in the proverb: “It is better to be a chicken’s head than a phoenix’s tail.” There is a large consensus on the belief that every Chinese person wants to be his own boss. We shall see if this is indeed true.

## *ENTREPRENEURSHIP IN CHINA: 1949-2000*

After the Communists rose to power in 1949, China’s existing market economy was gradually transformed into a socialist economy. Agriculture was collectivized, industry was nationalized, and the private sector was eliminated by

1956. Under the central plan, the state determined the allocation of economic inputs and outputs, and maintained a monopoly over production and distribution. As well as the ‘Iron Rice Bowl’ of lifetime employment, under the *danwei* system, enterprises provided housing and benefits to employees, restricting their ability to live outside of the system. Despite official efforts, however, entrepreneurship was never entirely suppressed and continued to exist on a small scale, particularly in the form of the black market and underground economy. Unfortunately, much of this activity was unproductive rent-seeking taking advantage of the inefficiencies in the economy.<sup>2</sup>

After the Cultural Revolution, with China’s economy in ruins and facing a crisis of legitimacy, Deng launched the ‘Four Modernizations’ reform program in 1978 to stimulate economic growth. The first step was decollectivisation of agriculture. The resulting rural unemployment and disappearance of local-level revenues created the impetus for the rapid development of township and village enterprises (TVEs); by 1990, TVEs accounted for 20 percent of China’s gross output. These enterprises were not state-owned but collectively owned under local governments.<sup>3</sup> While not true entrepreneurs insofar as they were on a contract system, managers of TVEs demonstrated many entrepreneurial characteristics. They chose the product line, found their own funding, labour, raw materials and distribution channels and, most importantly, reacted to prices and costs in pursuit of profits. In one case, the manager decided to switch production from autoclaves to fiber glass and then to fishing rods, achieving sales of \$2 million within two years.<sup>4</sup> This flexibility stands in stark contrast to the constrained and unimaginative behavior of SOE managers. TVEs can, therefore, be seen as the beginnings of modern Chinese entrepreneurship.

In the 1980s, constraints on private enterprise continued to exist, notably a law limiting employment in a private enterprise to seven people and the difficulty of finding funding as income and savings levels were extremely low and the state-owned banking system lent almost exclusively to SOEs. By 1987 however, a change of policy and repeal of the law saw a surge towards the private sector. Especially as income and savings rose, TVEs started facing new problems, and banks sought to improve their loan portfolios.

The number of private enterprises grew 93 percent in 1987 alone. In addition, the central government's recognition of the tremendous waste and inefficiency generated by SOEs helped motivate individuals to move into entrepreneurship. Specifically, SOEs have been forcefully shrunk by the government in the late 80's and 90's. One study claims that "the state-run sector is contracting at a rate of at least three million workers a year"<sup>5</sup> while fifty million join the work force per year. SOEs are also encouraging employees to go back to school to pursue advanced degrees. While this new policy is socially uplifting, a problem exists with employing these students after they graduate. Hence it is quite obvious in the statistics and more so in the daily lives of Chinese people that the iron rice bowl is no longer a reliable method of survival.<sup>6</sup>

### TYPES OF ENTREPRENEURSHIP

It is important to note that entrepreneurship in China took many different forms. Three main varieties can be identified. The first occurred before reform and through the 80's, consisting of very small-scale activities in retail and services such as street vendors, businesses known as *getihu*. Perhaps more accurately referred to as 'self-employed' rather than 'entrepreneurs', those involved were of low social status, often criminals and illegal migrants, and low education. They started out on their own because they were excluded from the state system. Some achieved success beyond their expectations. But for most, business was a means of subsistence.<sup>7</sup> The second group emerged in the late 1980s, with more highly educated individuals, often engineers or SOE managers, operating on a larger scale out of choice rather than necessity. These businesses, known as *siying qiye*, operated in all sectors, ranging from restaurants to transportation to manufacturing, especially the production of inputs for SOEs. The third type is the foreign-educated or trained Chinese returning to China to start businesses. This type of entrepreneurship has been evident recently in the flourishing Internet sector. Each of these types of entrepreneurs operates in a somewhat different environment, under different constraints and has distinctive characteristics. We focus primarily on the second type, which we believe is the most interesting group. After all, for those who have no other choice, starting a business carries no risk, while for others the risk can be tremendous.

### ENVIRONMENTAL BARRIERS

Despite the trends driving the shift to the private sector, Chinese entrepreneurs still face considerable environmental barriers to starting and running successful businesses. The first problem is that of political and legal uncertainty. While the government has begun to promote policies

favouring entrepreneurial activity, Chinese government policy has been notoriously volatile. Property rights are insecure and the rule of law is still in its infancy: businesses remain subject to unpublished (*neibu*) regulations and the caprices of courts.<sup>8</sup> They must deal with local, provincial, and central governments, which often have different and sometimes conflicting agendas and demands.

The second obstacle is one of access to resources, in particular funding, labour and technology. Funding for most entrepreneurs comes from personal savings, family, and friends. Although the increase in non-performing SOE debt has provided some motivation to increase lending to private business, bank loans remain rare.<sup>9</sup> Venture capital is barely two years old in China and is still too small to provide enough funding for most start-ups. Moreover, entrepreneurs in China are not accustomed to the idea of writing business plans and approaching VC's. Confucian principles may also play a role in deterring entrepreneurs from seeking funding from non-kin members. Tight kin relationships—as customary in Confucian cultures—tends to make the average Chinese person hesitant in accepting money and sacrificing equity control to a stranger.

Attracting labour has also posed a problem. Asia is recognized as having a lack of skilled labor. Many foreign companies in Asia have no choice but to hire expensive expatriates because they need a finance manager or an experienced CEO. China is no exception. While unemployment is high, those unemployed are, to a large extent, poorly educated peasants from the countryside. In addition, although university graduates have academic expertise, few have work experience. Even worse, those who have experience tend to be less loyal because they are such highly valued scarcities, moving easily to the highest bidder. In addition, many Chinese workers are risk-averse, unwilling to throw away their iron rice bowls for high-risk jobs in the private sector, even if the pay is higher.<sup>10</sup> This places a constraint on the technological level of enterprises.

The third barrier is that of the low social status attributed to private business in China. Traditionally, merchants have occupied the bottom rung of Chinese society, and this position was reinforced under the Maoist persecution of the bourgeois. Until recently, starting one's own business still carried negative social connotations, and although attitudes are changing rapidly, some preconceptions linger.

The Internet has spurred on radical change. The Chinese government aspires to make China a leader in high-technology<sup>11</sup> as modernization and innovation will be necessary conditions for development. As a result it has been particularly encouraging of high-tech entrepreneurship, establishing many high tech parks throughout the country. Tax incentives, monetary grants, and relaxed laws have engendered a more welcoming environment for growing technology enterprises. "The high tech park in

Zhongguanchun, Beijing, is so successful that it is called 'China's Silicon Valley.' In 1989, there were about 15,000 high tech ventures in China, providing 400,000 jobs and \$700 million in products<sup>12</sup>. As noted, many of these high tech ventures are foreign-funded or are seeking foreign funding because of the lack of capital resources in China. The problem, however, becomes the accessibility of foreign sources. The average Chinese person has never travelled outside of China, let alone accumulated foreign business contacts. The result is that most high tech ventures are started and controlled by foreign-educated Chinese who have spent several years in the West, have the contacts, and have received funding commitments before returning to China. A number of our interviewees named friends who are graduates of American business schools and decided to return to China to start Internet companies. The interviewees themselves are considering similar options.

While funding is perhaps less of a problem for Internet entrepreneurs, access to labour is more of one. The labour issues described previously are also problems Internet entrepreneurs must deal with. However, in addition to those, a 'brain drain' reduces the rapidity in technological advancement. International demand for technical graduates means an inadequate supply in China, especially given the number of technically skilled students who move abroad and never return. Finally, the potential value of stock options, a key incentive of Internet start-ups, is not always understood in China.<sup>13</sup>

While the phenomenon of foreign-educated Chinese returning to their home country to start businesses alleviates the 'brain drain' problem, at the same time, many of these returning Chinese entrepreneurs have "back-up plans."<sup>14</sup> The precariousness and political uncertainty of doing business in China has prompted many of these entrepreneurs to create 'safety nets' independent of the success or failure of their businesses. Examples of such safety nets include dual citizenship, green cards, and even going so far as leaving one's wife and children in North America while spending months away from them to work in China.<sup>15</sup> In such circumstances it is profit rather than pure patriotism which draws them back. If environmental instability were to increase, it is possible China could again see a worsening of the brain drain problem.

An alternative "back-up" plan indigenous Chinese entrepreneurs employ is having each foot on different boats; in a working couple, the wife will continue on at her SOE job while the husband ventures into entrepreneurship. In this way, the family's risk is reduced because they can continue to enjoy state benefits of housing and health plans while they also reap the profits of a private business.

### DOES CULTURE MATTER?

Confronted with a China that had historically produced

many important inventions, and yet had lagged behind the West economically, Weber attributed the difference to Confucianism. This social behavior system condemns pure profit-seeking as well as advocates group orientation, conformity and respect for authority. Following the success of the East Asian countries, however, driven to a large extent by a diaspora of overseas Chinese entrepreneurs, opinion focussed on the Confucian values of persistence, diligence, thrift, and the strong role played by the family as key *supporting* factors for entrepreneurial development. In his seminal research into the role of culture, Hofstede added a fifth cultural dimension, 'Confucian Dynamism,' to take into account East Asian growth.

This raises several issues over the question of entrepreneurship: what role can be ascribed to culture in relation to entrepreneurship in China? Has the political history of Communism suppressed, added to, or changed traditional values? Are the values of Chinese entrepreneurs different from 'standard' Chinese values and similar to those of entrepreneurs elsewhere or are they more Chinese than entrepreneurial?

Kirby and Fan compared a list of sixty traditional Chinese cultural values constructed from research surveys and a list of entrepreneurial attributes as identified by various authors to determine whether Chinese culture is conducive to entrepreneurship.<sup>16</sup> They found considerable overlap between the two sets of values, including perseverance, diligence, resourcefulness, emotional stability, integrity, intelligence, and harmony. But some entrepreneurial attributes – a positive response to change, initiative, profit-orientation, and so on—appeared to be in conflict with Chinese values. Moreover, the most important entrepreneurial values—creativity, innovation, and flexibility—were lacking in the Chinese set of values. This leads to the conclusion that Chinese culture would appear to be only partially conducive to entrepreneurship, while some strong cultural barriers may exist. Such a conclusion seems reflected in the historically low social status of entrepreneurs in China. The role of traditional culture is also influenced and directed by other factors, such as political ideology, and the degree of openness to foreign values. Furthermore, using such lists is not exhaustive. One value not mentioned is the strong Chinese desire to be one's own boss, for example.

David Holt conducted a more analytical study comparing traits of Chinese managers of SOEs, Chinese entrepreneurs, and U.S. entrepreneurs.<sup>17</sup> Based on survey responses taken from managers in Guangdong province he compared the three groups along Hofstede's dimensions. Overall, a sharp contrast existed between Chinese entrepreneurs and Chinese managers regarding individualism, risk, and openness to change. Interestingly, the Chinese entrepreneurs scored higher than their American counterparts on some dimensions, particularly risk tolerance. This perhaps reflects the environmental barriers to entrepreneurship in

China which entrepreneurs must overcome. Holt concludes that the similarity between Chinese and U.S. entrepreneurs, and the difference between Chinese entrepreneurs and managers, provides strong evidence for the convergence of entrepreneurial values universally.<sup>18</sup> However, this still leaves unresolved the question of how and to what extent the dominant *collectivist culture* affects entrepreneurs' personal *individualist values* and inclinations.

Therefore, we can tentatively conclude that the overall Chinese culture is, if not antithetical to entrepreneurship, at least unresponsive of it. On the other hand, a strong subculture of entrepreneurialism with values similar to those of western entrepreneurs does exist. Entrepreneurs are flourishing *despite* the dominant culture, and the additional barriers which this culture erects means that entrepreneurs who emerge must possess especially strong countervailing individual attributes. We must, however, be wary of drawing overly simplistic conclusions which ignore factors such as education, exposure to foreign values, and indeed changing values.

#### CHARACTERISTICS OF ENTREPRENEURS

Our interviews confirmed the conclusion that Chinese entrepreneurs share many characteristics with entrepreneurs worldwide. However, there were some characteristics of management style that were unique to China. Among the universal attributes, comfort with risk and even an enjoyment of risk is most obvious. In China, however, where quitting one's job at an SOE means sacrificing not only a stable income, but also significant fringe benefits such as housing, going into business for oneself is a major undertaking. While successful American entrepreneurs such as Jim Clark and Scott McNealy have been deified in American culture, entrepreneurs in China have only recently become respectable figures. Holt's study suggests perhaps that Chinese entrepreneurs might have to be *more* risk-loving than their American counterparts in order to overcome environmental barriers.

Business acumen is another oft-quoted characteristic universal to successful entrepreneurship. Given the fairly low education levels of many entrepreneurs in China, however, their success has been comparatively more surprising. Whether or not they have more natural 'business instinct' is difficult to establish however. Chinese entrepreneurs work as long and hard as their counterparts in other countries. On the other hand, hard work is not always enough. Luck and fate were also quoted often as "keys" to success. While luck certainly plays a role for entrepreneurs worldwide, Chinese people traditionally place greater belief in fate than many Westerners. Such trust in fate may also partially explain the reliance on opportunism over long-term strategy, which we consider below.

There are a number of characteristics that are more unique

to entrepreneurs in China. The two major ones are political nimbleness and interpersonal harmony. The first is easily understandable considering again the political uncertainty of China as an evolving Communist state. Historically, China has been unpredictable. For example, Deng opened the doors to greater economic freedom, but also ruthlessly cracked down on demonstrators in Tiananmen Square. Marxism is the official state ideology, but any visitor to Shanghai can attest to the burgeoning materialism and capitalism of the city's inhabitants. Even in Shanghai a man can be sentenced to jail for sending email.<sup>19</sup>

Flexibility and liquidity are subsets within the need to be politically nimble. Flexibility is the ability to stand up after being knocked down again and again. Being able to weather setbacks due to unexpected legal restrictions is integral to survival. Likewise, liquidity is a valued intangible asset of Chinese entrepreneurs. Back-up plans, dual citizenship, and low capital-requirement startups all allow for desired liquidity. This is similar to overseas Chinese businessmen's obsession with liquidity. According to Henri-Claude de Bettignies, mobility and quickness are priorities in the "philosophy" of overseas Chinese entrepreneurs. As the most economically powerful ethnic group in countries like Indonesia and Malaysia, the social environment is unstable for these overseas Chinese minorities. Liquidity under those circumstances is indispensable not only for rescuing profits but also in surviving physically unscathed. Therefore, most Chinese entrepreneurs, including those overseas, tend to emphasize short-term profits and opportunism instead of long-term strategy. "There is no long-term strategic planning because you don't know what's going to happen from one day to the next.... You just take it one step at a time," said Fu.<sup>20</sup> Another interviewee mentioned the difficulty from the established business perspective of finding suppliers given the speed with which entrepreneurs move from one business to another: "You don't know if they'll still be around in a year or two. They're very slick."<sup>21</sup>

So far, we have seen that hard work and liquidity are factors Chinese entrepreneurs use to hedge for an unpredictable environment. Additionally, interpersonal harmony and *guanxi*<sup>22</sup> are important factors for further reducing risk. *Guanxi* is decidedly Eastern with roots in Confucianism. While good business contacts are important in the Western business world, merit and innovation alone can also carry a business to success in the U.S. Implicit in *guanxi* are corruption, bribery, and other "under the table" activities to ensure receipt of licenses and speedy governmental approval. These practices are not unknown in China and Wang even goes farther to say that an entrepreneur needs to be thick-skinned for he needs to be able to accept humiliation, drink heavily, sing karaoke, and smoke with his politician "buddies." "You don't just need connections, you need the

*right* kind of connections.”<sup>23</sup> An extremely successful Chinese entrepreneur in the early 90’s, Lei Chen asserts that her success was due in part to the clients she interacted with, her Japanese friend who became an investor, and her contacts in the import and export industry after working with an SOE for five years.<sup>24</sup> Some prospective entrepreneurs may even join SOEs for a few years specifically for the purpose of building up contacts.<sup>25</sup>

In contrast, Fu argues that the degree of importance of *guanxi* is debatable. “It’s a chicken and egg question because you can become successful on your own and the publicity draws people who want to be connected to you. Or on the other hand, you can have the *guanxi* first and then become successful.”<sup>26</sup> He cited a friend and former classmate who had both the business sense and good luck but not the *guanxi* to work his way to success. This man from Shandong worked with an SOE for two years, during which time he bought the SOE’s convenience store and ran it independently. Within five years his store had total revenues of \$100 million RMB.<sup>27</sup>

Regardless of the exact importance *guanxi* plays in the forming of private businesses in China, it is acknowledged that knowing the right people can accelerate growth and even trigger success, especially for fledgling businesses with little history or guarantees. Our Shandong entrepreneur did after all work for the SOE before buying the convenient store from the SOE. It presents the question of whether a similar man could have walked in off the streets and convinced the same SOE to sign a contract to allow him to run the convenient store even though he personally had no affiliation with the SOE.

The management structure of entrepreneurships in China reveals another role of interpersonal relationships in hedging risk. Resembling Chinese overseas, China’s start-ups are controlled by families. The Confucianism-steeped Chinese culture is believed to be the main reason why most private Chinese companies are structured so that the entrepreneur himself is the benevolent patriarch while his kin fan out below him in secondary management roles. In China especially, lack of legal enforcement and unpredictability give rise to concerns about trust. Considering how difficult it already is to start a business in China, the entrepreneur would be most comfortable employing his wife and siblings in helping him build his company. For instance, Wang Zhidong, CEO of Sina.com, ran Stone Rich Sight Information Technology Company (SRS)<sup>28</sup> with his wife and brother. It was not until he began receiving Silicon Valley funding that he re-organized the management team.<sup>29</sup> An added benefit of family is that family tends to be more willing to accept minimal compensation in return for future gains. On the other hand, a fresh university graduate would leave immediately if he were told to wait three months for a paycheck. Both the low availability of funds

in China and the importance of capital in initial stages indicate how important this benefit from kin can be to a growing business.

### GOING FORWARD

As China stands at the brink of a new millennium, entrepreneurship has been recognized as an integral element of economic advancement. Foreign businessmen have also created a new pool of capital resources for Chinese talent that previously had few monetary options beyond their family and friends. The high tech boom has hit China and Internet start-ups are popping up in major Chinese metropolises.

Whether China continues to progress smoothly towards technological modernization and innovation<sup>30</sup> rests largely upon political and social developments. Profit-seeking behavior and private businesses are contradictions in an ideologically Communist state. Whether ideology will clash with reality and social desires remains to be seen. Entry of China into the World Trade Organisation will hasten economic advancement but may also close off many opportunities for indigenous Chinese as wealthy foreign competitors rush into the Chinese market.<sup>31</sup>

Recent events show that there is hope. Multiple high-tech research and development parks have been set up to lure talent back and to keep talent in China. The China Daily reported that “returnees opening ventures...with an investment of less than 1.2 million dollars can enjoy income tax exemption for three years and another three years of reduced taxes as well as two years of free rent for office space.”<sup>32</sup>

Early in the new year of 2000, Zeng Peiyan, minister at the State Development Planning Commission, issued a statement saying the government will actively guide and encourage private investment. Zeng said, “[We will] eliminate all restrictive and discriminatory regulations that are not friendly towards private investment and private economic development in taxes, land use, business start-ups, and import and export. In the area of stock listings, private enterprise should enjoy equal opportunity which was enjoyed by the state-owned enterprises.”<sup>33</sup> This statement virtually created a level playing field for all businesses for the first time since the 1949 Communist revolution.

On a microeconomics level, entrepreneurs will continue to face the issues of finding and retaining skilled workers, lack of infrastructure, and the question of whether potential in China will be realized. As illustrated previously, China is short on skilled labor. Increasing education and greater understanding about entrepreneurship will hopefully alleviate this problem.

Lack of infrastructure may limit areas of future entrepreneurial growth. Technology is a relatively labor-intensive

and capital-unintensive industry. Likewise, service industries typically require little initial capital input. Yet other areas that will require privatization in the future may face obstacles due to the lack of an efficient credit system and lack of necessary infrastructure.

Finally, whether potential can be translated into reality is a question everyone awaits for a country whose 1998 per capita income was \$3600.<sup>34</sup> In the automotive industry, overly optimistic foreign companies scrambled to enter the China market in the 1980's because of reports about a huge, burgeoning market. By the late 1990's Peugeot Citroen left China partially because of poor management but also because potential was not realized.<sup>35</sup>

With accelerating reform and increased exposure to the West, values in China are also changing. Perceptions of entrepreneurs are improving, and people are rushing to 'xiahai'.<sup>36</sup> Successful entrepreneurs are upheld as role models and idols. The Internet is changing the nature of entrepreneurship by introducing stronger foreign involvement through foreign-educated entrepreneurs and foreign funding. It is evident that Chinese entrepreneurs will continue pursuing their dreams and ambitions of becoming the chicken's head. Just as they were undaunted and unsuppressed during Maoist China, their resilience and resourcefulness will continue to elevate them towards success.

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1 G.E. Hills, Market and Entrepreneurship: Research Ideas and Opportunities (Westport, Connecticut: Greenwood Press, 1994).

2 Lu Ding, Entrepreneurship in Suppressed Markets (New York: Garland Publishers, 1994).

3 Jean Oi, Rural China takes off (Berkeley: University of California Press, 1999).

4 John Wong, Ma Rong, and Yang Mu, China's Rural Entrepreneurs (Singapore: Times Academic Press, 1995).

5 John Pomfret, "Private Enterprise Gets a Beijing Endorsement," International Herald Tribune, 5 January 2000.

6 In fact, reality is much graver than these statistics reveal. Lin Wang, an interviewee, related several stories regarding the desperate circumstances many people in China live under. One family of three consisted of two unemployed parents and a daughter. The daughter stole some meat from a store one day and ended up getting caught and beaten. Following the incident, the father poisoned the entire family's food and the three died soon after. "This is a common story throughout China where many people are jobless and/or living below the poverty line," Wang added. (Interview with Lin Wang.)

7 One well-known entrepreneur from Shandong started his own business because he failed the university entrance examination twice. Idolizing Hong Kong entrepreneurs, he started with a small clothes stall and then grew and diversified into restaurants and leisure centers. Cited in Tomisaka S., Heirs of the Dragon (San Francisco: Cadence Books, 1995).

8 Most judges are ex-army officers with no legal training. Enforcement is also extremely weak.

9 According to an interview Nicholas Lardy, only 0.9% of working capital loans went to the private sector in 1999.

10 Edward Gu, "From Permanent Employment to massive layoffs," Economy and Society 28, no. 2 (1999).

11 Evan Feigenbaum, "China Gags the Web and Stifles Its Own High-Tech Ambitions," International Herald Tribune, 5 February 2000.

12 "Beijing to Further Develop Zhongguancun Area," China Daily, 15 June 1999.

13 Julie Schmit, "Internet Revolution Rolls Through Asia," USA Today, 11 February 2000.

14 Interview with Lei Fu.

15 Interview with Lei Fu.

16 David Kirby and Fan Ying, "Chinese Cultural Values and Entrepreneurship: A Preliminary Consideration," Journal of Enterprising Culture 3, no. 3 (1995).

17 David Holt, "A comparative study of values among Chinese and US entrepreneurs: pragmatic convergence between

contrasting cultures," Journal of Business Venturing 12, no. 6 (1997).

18 But Holt also adds caveats about the representativeness of a regional study and the danger that the Chinese entrepreneurs may have responded to *perceived* rather than actual personal values. Cited in Holt, "A comparative study in the values among Chinese and US entrepreneurs."

19 The guilty party had sent 30,000 email addresses to an American electronic publication and was thus sentenced to two-years in jail. Cited in Seth Faison, "Chinese Entrepreneur Sentenced for E-mail," The New York Times, 24 January 1999.

20 Interview with Lei Fu.

21 Interview with Michael Wenderoth.

22 Roughly translated as connections or affiliations.

23 Interview with Lin Wang.

24 Interview with Lei Chen.

25 Interview with Michael Wenderoth.

26 Interview with Lei Fu.

27 Incidentally, this friend is now attempting to start an Internet company and is seeking foreign funding to supplement his own resources.

28 SRS was Wang Zhidong's startup in Beijing before the company merged with Sinanet.com to form today's Sina.com. This information is available at the Sina.com website, <http://www.sina.com>.

29 He re-organized the team due mainly to pressure from investors.

30 Technological innovation assumes the role of privately spurred entrepreneurial activity. Many people including Feigenbaum believe that "innovation cannot be managed by bureaucrats. It is bottom up, not top down.... Three decades into the Silicon Valley miracle, American entrepreneurs and venture capitalists take it for granted that innovation thrives best where government lets markets work unfettered." Cited in Evan Feigenbaum, "China Gags the Web and Stifles Its Own High-Tech Ambitions."

31 Lee Siew Hua, "Beijing Ready for Risks of Net Savvy People," Strait Times, 5 May 2000.

32 "Beijing opens high-tech center to lure back talent from overseas," Agence France Presse, 18 December 1999.

33 James Kynge, "China Plans Support for Private Sector," Financial Times, 5 January 2000.

34 In contrast, Malaysia's per capita GDP \$10,300, Taiwan's \$16,500 and Korea's \$12,600. Cited in CIA World Factbook. The internet version is available at: <<http://www.cia.gov/cia/publications/factbook/index.html>>

35 With regard to the penetration of technology, one study indicates that the percentage of residents with fixed-line phones in China is only about 11 percent, in contrast to the U.S.' 95 percent and Hong Kong's 61 percent. The percentage of Chinese households with personal computers is even more disheartening. Only about 1 percent of Chinese residents owns PCs in contrast to 50 percent of U.S. residents and 29 percent of Hong Kong residents. Cited in Julie Schmit, "Internet Revolution Rolls Through Asia."

36 This phrase literally means go into the sea. Figuratively, it means get rich by working in the private or foreign sectors.



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# China and the Comprehensive Test Ban Treaty Negotiations

William S. W. Chang

Chinese foreign policy in regards to arms control continues to be an area of contention among specialists in the field. Which framework provides the best perspective to understanding the motives and actions within the Chinese foreign policy decision-making community? This study is dedicated to two leading explanations of Chinese foreign policy, realism and international reputation.

The realist school holds that nation states are still the fundamental actors of the global system. Nation states and the leaders of nation states are assumed to be rational actors maneuvering within a Machiavellian anarchy. The goal of any rational actor within this system is to maximize its nation's wealth, security, and power vis-à-vis other nation states. Nation states are expected to do anything necessary to realize these ends including building alliances to balance against stronger powers. Dominant powers or alliances define the global system in such a way that promotes and maintains its interests while emerging powers will attempt to alter the system to meet its own interests.

In the case of China and arms control, the realist theory would predict that Chinese policies should be focused in a manner that best elevates its military capabilities relative to other regional and global powers. According to an analysis done by leading experts on Chinese security, Alastair Johnston and Michael Swaine, "Overall Chinese views and behaviors towards both conventional and unconventional weapons development are motivated primarily by a relatively hard realpolitik, state-centered, balance of power calculus centered on maintaining and increasing China's relative economic, technological, and military power."<sup>1</sup>

Johnston and Swaine also concede that Chinese foreign policy is motivated in part by its desire to promote itself as a peace loving, non-threatening, under-developed, and responsible global power dedicated to the "Five Principles of Peaceful Coexistence."<sup>2</sup> China wants to be known as the *de facto* leader, representative, and protector of all developing nations.

International image matters. This image encompasses everything a nation would like to advertise about itself. Nations build such reputations to justify foreign policies and actions. International image is propaganda aimed at selling a direction and sense as to what common denominator underlies a given set of behaviors exhibited by a nation. In

other words, the concept of image in international relations is an attempt to legitimize and justify actions to one's own constituency and other nations by saying, "Hey, we are the good guys. Our motives are just. We are doing the right thing."

According to political theorist Stuart Harris, a respected international image promotes the legitimacy of the current Chinese regime. Such an image may be a "powerfully motivating factor, a potentially unifying factor, engendering loyalty to the idea of a Chinese nation and maintaining regime legitimacy."<sup>3</sup>

Intuitively, realism appears to be the more compelling theory in understanding Chinese foreign policy. After all, the notions of power, security, and wealth are the foundations of human civilization. China is an emerging great power within a system dictated by its former oppressors. The fact that China would want to shift the system in a way that elevates its own sense of economic, military, and security guarantee vis-à-vis other nations is completely understandable. But the realist argument cannot fully explain Chinese foreign policy, especially in multilateral regimes.

The Comprehensive Test Ban Treaty (CTBT) negotiations revealed a puzzle in Chinese behaviors within multilateral regimes. The decisions and concessions made by the Chinese during CTBT negotiations drastically limited its potential military capabilities relative to the other declared nuclear powers (P5).

This is contrary to what the realist model would predict. This analysis of the CTBT negotiations shows that such concessions were only made when reputation or the international image that the Chinese was trying to promote was at risk. International image is of central importance in Chinese behaviors within multilateral regimes. Realist agendas may be compromised when image costs are placed on the table. Why image is so important to the Chinese and exactly how international image factors into international relations is a separate topic in and of itself.<sup>4</sup> This paper focuses on demonstrating that image concerns superseded realist imperatives during the CTBT negotiations.

Section one lays down the theoretical framework of this argument by defining the independent variables. Exactly what is realpolitik when applied to Chinese behaviors in multilateral arms control regimes? Is it a unique phenomenon? In regards to arms control, exactly what sort of im-

age is the Chinese trying to promote? Section two provides the events and background leading up to the CTBT negotiations in 1996. Section three runs through the four major points of negotiations for the Chinese delegates: unilateral pledges, Peaceful Nuclear Explosions (PNE), verification mechanisms, and the conditions under which the CTBT can Enter Into Force (EIF). Here, I will show that each of these major points of negotiation reflects the previously outlined set of behaviors. That is, Chinese diplomacy centers around:

1. State-centered realpolitik considerations.
2. Elevating image along the lines of the "Five Principles of Peaceful Coexistence."
3. Most importantly, sacrificing realpolitik interests when image costs are at stake.

The last two sections are devoted to analyzing the CTBT negotiations through realist and international image frameworks.

#### *BEHIND CHINESE BEHAVIORS IN THE MULTILATERAL ARMS CONTROL REGIMES REALPOLITIK*

Chinese behaviors in multilateral arms control regimes are not unique to arms control. The same set of behaviors can also be seen in China's participation in a wide range of multilateral fora from human rights to environmental issues.<sup>5</sup> The basis of these behaviors is consistent with a realpolitik consideration aimed at elevating China's military, economic and political status vis-à-vis other nations. Analysis done by Johnston and Swaine reveal the following patterns.<sup>6</sup>

First, China has an affinity for free riding. China actively supports measures that reduces or limits the military capabilities of other nations. Examples of such include the Strategic Arms Limitation Talks (SALT), reducing U.S. and Soviet/Russian nuclear arsenals. China actively opposes measures that reduces or limits its own military capabilities (CTBT).

Second, China is a late comer to the modern arms race. Of the P5, China has the smallest and least advanced weaponry. China's current nuclear forces include 15 ICBM, 1 SSBN with 12 SLBM, 120 antiquated nuclear capable bombers, and 300 nuclear warheads. The U.S. nuclear force includes 701 ICBM, 464 SLBM, 321 advanced bombers, and 10,956 nuclear warheads.<sup>7</sup> China does not want to be locked into a position of strategic inferiority compared to the rest of the P5. As a result, China often opposes or delays agreements, which could circumscribe its military capabilities.

Third, China's modern military capabilities are very lim-

ited in both quantity and quality. The Chinese military complex is deliberately opaque for that reason.<sup>8</sup> The Chinese are most reluctant to engage in intrusive agreements which may disclose the extent of China's military deficiencies. As a result, China actively opposes intrusive comprehensive arms control regime verification mechanisms.

Fourth, fostering an environment that is conducive to Chinese economic reform and growth is the cornerstone of all Chinese foreign policy. Economic growth and reform is the first and primary objective of Deng Xiaoping's Four Modernizations. It remains the top priority of the current Chinese leadership.

In 1978, Deng first opened China up to the world after 39 years of isolation. Since then, China has slowly been drawn into further global integration by domestic and foreign influences. As this occurred, China was also pressured to abide by "international norms" on the moral grounds of peace, prosperity, and fairness. For the Chinese, these norms were defined by former imperialist powers. China was being called to play by rules which benefited their former oppressors. It was only natural that China would want to re-shape aspects of the global structure to serve its interests as well.

China's economic development has long been and still continues to be Beijing's top priority. China needs a peaceful security environment that allows it to devote its resources completely to the modernization of the nation. As a result, military buildup has been a secondary priority for the Chinese leadership.<sup>9</sup>

It is important to note that these behaviors should not be labeled as distinctively Chinese. The common denominator of Chinese foreign policy behaviors is to minimize costs and maximize gains. This is not an unique phenomenon in international relations. Rather, I argue that China's behaviors are quite normal and prevalent in international relations. China is not the only nation that seeks to avoid or delay full implementation of arms control measures that may limit or reduce its military capabilities. Of the five declared nuclear weapon states which have signed the CTBT, the U.S., Russia, United Kingdom, and France, only the UK and France have ratified it.

The U.S. Congress fails to ratify the CTBT on the grounds that it may degrade U.S. nuclear forces below what constitutes a "credible deterrent." The U.S. is therefore "avoiding or delaying full implementation of arms control measures which may limit or reduce its military capabilities."

On October 13, 1999, the chairman of the U.S. Senate Republican Policy Committee released a report called, "In Their Own Words, Administration's Own Statements Help Prove The Comprehensive Test Ban Treaty Should Not Be Ratified." The report concludes that:

The CTBT safeguards package merely outlines a series of policies, most of which the U.S. would

undertake even without a CTBT. So while everyone might agree to the safeguards, they don't change the facts that the CTBT will undermine our nuclear deterrent, cannot be verified, and will jeopardize—rather than enhance—U.S. national security.<sup>10</sup>

The differences between the Chinese and any other foreign policy agenda are not over whether security is desired. Rather, it concerns what constitutes security and how security can be achieved. Global and regional security is not an absolute definition. It is relative to each nation's strategic position. China's realpolitik behavior within multilateral regimes is characteristic of its strategic position. That is, China has the smallest and least advanced nuclear weaponry of the P5. China is not part of any security alliance whereas three of the P5 are part of NATO, the world's most powerful security organization. The other P5, Russia, possesses the world's second largest nuclear arsenal. China is bordered by three nations with which it has gone to war with in the past 40 years. China's security interests are vulnerable to regional instability (Japan, Korea, Vietnam, Cambodia, Tajikistan, and Kazakstan) as well as the intrusive agendas of global powers such as the U.S. In many ways, Chinese behaviors can be reflected in the behaviors of all nations. No nation wants to be locked into a position of strategic inferiority. No nation supports intrusive acts that may violate national security. All nations want to promote their economic interests.<sup>11</sup> All nations want to increase their "power" relative to other nations. No nation will ever make a decision that does not serve some sort of perceived short-term or long-term interest. Given China's strategic position, its system of realpolitik conforms exactly to what the traditional realist model would predict.

### INTERNATIONAL IMAGE

According to Andrew Nathan and Robert Ross, "Perhaps the most consistent in Chinese diplomatic rhetoric is the idea that foreign policy should be based on moral principles."<sup>12</sup> China portrays its foreign policy in two lights. One is the idea of an "independent foreign policy of peace." The other is the "Five Principles of Peaceful Co-existence."<sup>13</sup> This "independent policy" claims that China does not enter into alliances with other major powers. China absolutely upholds the rights and independence of each state to peaceful development and prosperity.

The Five Principles: mutual respect for sovereignty and territorial integrity, mutual non-aggression, noninterference in each other's internal affairs, equality and mutual benefit, and peaceful coexistence, provide a contrast to the U.S.-led new world order. This order is based on international regimes and institutions which often impose U.S. interests and values in areas such as nonproliferation, intellectual property rights, trade, and human rights.<sup>14</sup> Essentially,

Chinese foreign policy divides the world into hegemonies and non-hegemonies. The hegemonies are composed of the U.S., its allies, and in some cases, the Russian Federation. The non-hegemonies are everyone else. Under this moral rhetoric, the global system endorsed by the hegemonies is designed to benefit their political, security, and economic interests at the cost of developing nations. In light of this biased global system, China takes on the "noble" burden of defending the rights of all developing nations.

### PRELUDE TO THE CTBT

Since the 1950s, Canada has led most of the international community in pursuit of a CTBT that would facilitate nuclear disarmament, end the nuclear arms race, and promote nonproliferation.<sup>15</sup> China became a part of this movement in 1963.<sup>16</sup> China successfully tested its first nuclear weapon in October 1964.<sup>17</sup> Since then, China has begun to view test ban measures such as the Partial Test Ban Treaty (PTBT) of 1963, the U.S.-Soviet Union-UK trilateral talks on nuclear test ban in the late 1970s and early 1980s, and the U.S.-Soviet Union-UK Threshold Test Ban Treaty (TTBT) as measures designed by global hegemonies to lock China into a position of nuclear disadvantage while consolidating their own nuclear advantages.<sup>18</sup>

In 1982, China proposed a "three halts and one reduction" plan. Under this plan, the U.S. and the Soviet Union must first reduce their nuclear stockpiles by 50 percent, end nuclear testing, and halt weapons development before other nuclear nations would stop testing and enter into disarmament talks.<sup>19</sup> On October 16, 1980, China's 200 kT-1 MT yield test became the last atmospheric explosion by China or any other country.<sup>20</sup> In 1986, China became a *de facto* member of the PTBT which banned all atmospheric nuclear tests.<sup>21</sup> Even though China has not signed the TTBT (which restricts underground test yields to below 150 kT), it has complied with the treaty since its 660 kT test on May 21, 1992.<sup>22</sup> In 1986 and 1990, China pledged that it would participate in a Conference on Disarmament (CD) on a CTBT if one were created.<sup>23</sup> The Chinese stated that:

China sympathizes with, and understands, the ardent desire of the vast number of Third World countries and other non-nuclear weapon states (NNWS) for the early realization of a complete prohibition of nuclear tests...China will take an active part in the work of the *ad hoc* committee and together with all other delegations work for the early materialization of a nuclear test ban and effective nuclear disarmament.<sup>24</sup>

Despite these gestures encouraging a CTBT, in 1990, the Chinese abstained from a UN resolution calling for the completion of a CTBT.<sup>25</sup> The Chinese were worried by the intensive nuclear weapons developments of "third generation warheads" in the U.S., proposals for a development of

a ballistic missile defense, and the nuclear modernization programs of other nuclear powers.<sup>26</sup> In light of these developments, China continued its rapid nuclear modernization program. From May 26, 1990 until the signing of the CTBT, the Chinese continued with 11 underground nuclear tests.<sup>27</sup>

Regardless of Chinese opposition, the 1990s were characterized by increasing efforts towards a CTBT. The U.S. ended testing in September 1992; the Soviet Union/Russia ended in October 1990; the UK ended in November 1991; and France had a nuclear test moratorium from 1991-1995.<sup>28</sup> In 1995, China opposed the UN General Assembly resolution on disarmament and halting nuclear testing despite mounting international pressure.<sup>29</sup> At this point, China was the sole NWS opposed to test banning. Consequently, China agreed to a UN General Assembly consensus resolution calling for CTBT negotiations to begin in January 1994.<sup>30</sup> For the first time in history, all NWS were engaged in test-ban negotiations.<sup>31</sup> On July 30, 1996, the Chinese signed the CTBT.<sup>32</sup>

### *THE CTBT NEGOTIATIONS*

#### *NO FIRST USE AND NEGATIVE SECURITY ASSURANCES*

The first major issue of negotiation at the CTBT talks was the NFU pledge. According to the Chinese negotiators:

Chinese nuclear strategy is purely defensive in nature. The decision to develop nuclear weapons was a choice China had to make in the face of real nuclear threats. A small arsenal is retained only for the purpose of self-defense. China has unilaterally committed itself to responsibilities not yet taken by other nuclear nations, including the declaration of a no-first-use policy, the commitment not to use or threaten to use nuclear weapons against non-nuclear states and in nuclear free zones (negative security assurances). In short, China's strategy is completely defensive, focused only on deterring the possibility of nuclear blackmail being used against China by other nuclear powers.<sup>33</sup>

The Chinese wanted all nuclear nations to make a NFU pledge as a precondition to any negotiations on the CTBT.<sup>34</sup> The Chinese also insisted that the NFU and NSA be included in the preamble rolling text of the CTBT.<sup>35</sup>

The U.S. led the majority opposition against the NFU and NSA. According to U.S. views, military doctrine could be defensive in nature even within a "first-use" framework.<sup>36</sup> The U.S. has a global network of alliances and interests to protect. The U.S. must protect itself and its troops deployed all over the world from "rogue" nations. The U.S. has alliance commitments to NATO allies, Japan, and South Ko-

rea.

This strategic position is completely different from China's strategic position and therefore demands a completely different nuclear posture. Given the number of threats and alliance commitments the U.S. has, neither the Congress nor the U.S. military would accept a position of NFU or NSA.<sup>37</sup> A U.S. acceptance of NFU could actually contribute to regional instability and proliferation. NFU would be perceived as a decrease in U.S. commitments to NATO, South Korean and Japanese defenses.<sup>38</sup> This may precipitate nuclear proliferation and military buildups.

Implicitly, many nations just did not believe the Chinese NFU and NSA.<sup>39</sup> The NFU and NSA are low cost unilateral pledges with no defined control, enforcement, or penal mechanisms. Without clearly defined and enforceable mechanisms, the NFU and NSA have little significance. Yet, the NFU and NSA did have substantial moral image benefits.

The Chinese negotiators took full advantage of the NFU and NSA moral high ground. The Chinese rallied behind the catch phrases of "anti-nuclear blackmail" and "protector of NNWS." The Chinese negotiators knew from previous arms control negotiations (NPT) that the rest of the NWS would not support the NFU and NSA.<sup>40</sup> The Chinese knew that the NFU and NSA were a dead cause. The proposed text on "NSA to non-nuclear weapon states and mutual NFU of nuclear-weapons among nuclear weapon states" were later withdrawn by the Chinese delegation.<sup>41</sup> The CTBT fora were just another opportunity for the Chinese to blow rhetoric on how it is the only nuclear power state dedicated to "peaceful co-existence."

The CTBT negotiations began in January 1994. The timing of the negotiations had caught China in the middle of its nuclear development program whereas Russia, UK, and the U.S. had already completed several cycles of development.<sup>42</sup> When the CTBT negotiations began in 1994, the U.S. had conducted 1,032 nuclear tests (217 above ground, 815 underground), Russia/Soviet Union had conducted 715 nuclear tests (207 above ground, 508 underground), Britain had conducted 45, France had conducted 191, and China had conducted 39.<sup>43</sup> The Chinese still needed more tests to ensure the safety and reliability of their nuclear arsenal.<sup>44</sup> Negotiations on the NSA and NFU pledges lasted from January 1994 to September 5, 1995. During this time, China continued with four more nuclear tests.<sup>45</sup> The NSA/NFU negotiations delayed CTBT completion in order to give the Chinese more time for nuclear weapons development.<sup>46</sup>

Officially, the Chinese claim that the tests were geared towards designing warheads with safety features, such as Insensitive High Explosives (IHE).<sup>47</sup> Other Chinese sources and intelligence agencies report that those tests were also intended to modernize Chinese nuclear weapons, including Multiple Re-entry Vehicle (MRV) and Multiple Inde-

pendently Targeted Re-entry Vehicle (MIRV) technology, as well as new warheads for China's next-generation solid fuel ICBMs.<sup>48</sup>

### *PEACEFUL NUCLEAR EXPLOSIONS*

In March 1994, the Chinese passed a working paper on the status of PNE.<sup>49</sup> The paper stated that:

No international legal instrument on legal disarmament and nuclear nonproliferation should obstruct or restrain the development and peaceful uses of science and technology, nor impair the legitimate right of States Parties, the mass of developing countries in particular, to make peaceful use of nuclear energy.<sup>50</sup>

The Chinese position held that PNE exploration was far from over. Mankind could benefit from the extensive benefits of a nearly unlimited energy source. As the most populous nation in the world with severely limited energy resources, "China could not abandon forever any promising and potentially useful technology that is suited to its economic needs."<sup>51</sup> On March 9, 1995, the Chinese delegation proposed treaty text on the PNE. The Chinese delegation wanted the rolling text of the CTBT to allow PNE for "purely scientific research or civilian applications."<sup>52</sup> They also wanted the CTBT to include the "inalienable right" of states' parties to nuclear energy for nonmilitary purposes.<sup>53</sup>

The Chinese delegation was the sole supporter of the PNE at the P5 and CD meetings.<sup>54</sup> Most states actively opposed PNE. Japan and Canada led the non-nuclear states in opposition against any mention of "peaceful explosions" within the treaty text.<sup>55</sup> These states wanted all nuclear testing to be comprehensively banned without exception. These objections were based on the dual-use nature of PNE. The results from PNE can be used in military applications. PNE could also be used to hide clandestine nuclear weapons testing program.

In response, the Chinese delegation proposed that PNE would take place under the strictest international regulations and monitoring. In order to prevent proliferation of dual use technology, the PNE would only be conducted by NWS.

The members of the CD still objected to China's revised proposal. The problem was that there was no way to comprehensively monitor a PNE even if international inspectors were on-site.

The yield is the most useful piece of information about a nuclear testing.<sup>56</sup> Seismic detectors measure the yield. There is no way for international inspectors to prevent seismic detection. The yield could then be used in nuclear weapons development.<sup>57</sup>

Despite the unified opposition, China still insisted on the inclusion of the PNE. By June 1996, China's adamant stance was criticized by the rest of the CD as a clear obstacle to

the completion of the CTBT.<sup>58</sup> On June 6, 1996, the Chinese released a statement to the CD:

The Chinese Delegation is now ready to go along with a temporary ban on PNE. Namely, China can agree to a treaty provision that the possibility of permitting the conduct of PNE shall be considered by the review conference of States Parties. If States Parties agree to permit the conduct of PNE by consensus, the Conference of States Parties shall immediately commence its work with a view to agreeing on arrangement for the possible approval and conduct of such nuclear explosions.<sup>59</sup>

Most delegations did not accept this format. Canada proposed an alternative paragraph under Article VIII-Review of the Treaty that made permitting PNE even more difficult. This Article VIII text read:

On the basis of a request by any State Party, the Review Conference shall consider the possibility of permitting the conduct of underground nuclear explosions for peaceful purposes. If the Review Conference decides by consensus that such nuclear explosions may be permitted, it shall commence work without delay, with a view to recommending to States Parties an appropriate amendment to this Treaty that shall preclude any military benefits of such nuclear explosions.<sup>60</sup>

Under this text, PNE would have to pass a review conference and an amendment conference. In return, the treaty text recognized the PNE as an issue that could be raised in the future. This Canada-China compromise became the final Article VIII draft. PNE is consistent with the previously described Chinese behaviors. A successful PNE would allow for a possible nuclear arms development even after the CTBT enters into force.

Furthermore, the PNE issue delayed the completion of the CTBT until 1996. In the period between March 1994 (when China first raised the issue of PNE) and June 6, 1996 (when China compromised its stance on PNE), China conducted four more nuclear tests.<sup>61</sup> China only compromised its position on PNE when the entire CD formally criticized China's behaviors as an obstacle to CTBT completion.

### *VERIFICATION*

Effective implementation of the CTBT rested on an effective verification system. Without such a system, the CTBT would be rendered a meaningless document. The basis of the CTBT verification system was the on-site inspections (OSI). Negotiations over the OSI were over two key issues: what techniques can be employed to trigger the OSI and the Executive Council procedure for confirming an OSI.

Under the CTBT, OSI could only be initiated by a trigger mechanism. Disagreements occurred over what constituted

this trigger mechanism. The U.S.-led coalition wanted a rapid responding trigger mechanism that could initiate an immediate inspection of suspected treaty violation sites. China and Russia wanted a more cautious trigger mechanism. They believed that OSI are highly sensitive security risks. OSI can be abused to violate state security if the proper mechanisms were not in place.<sup>62</sup>

All CD members agreed that the International Monitoring System (IMS) should be used as an informational source for initiating OSI. Western nations also proposed that OSI could be initiated by information obtained through National Technical Means (NTM). NTM encompasses all technical means which “belonged to, and were operated by, a state that provided information on the compliance of treaty partners with a given treaty.”<sup>63</sup> In other words, in addition to the IMS, each nation could also use any means at its disposal to gather “relevant” information on possible CTBT violations.

China, India, Pakistan, and several nonaligned G-21 countries objected to the use of NTM for three reasons.<sup>64</sup> First, NTM includes imaging satellites, signal intelligence, and communication intercepts. The inclusion of NTM in the trigger mechanism would favor those nations with technical advantages such as the U.S. and Russia. Second, NTM could promote the use of information obtained through espionage. Third, NTM can be unilaterally abused to initiate intrusive OSI.<sup>65</sup>

The CD finally came to a compromise on the NTM. Article IV of the CTBT text states:

The on-site inspection request shall be based on information collected by the International Monitoring System, on any relevant technical information obtained by national technical means of verification in a manner consistent with generally recognized principles of international law, or on a combination thereof.<sup>66</sup>

In other words, NTM would be allowed as long as espionage or any other violations of state security were not utilized in obtaining relevant information.

The two sides also disagreed over the decision-making process of the OSI. The U.S. and most of its allies wanted the quickest access to violation sites in order to obtain time-sensitive evidence.<sup>67</sup> They proposed a red-light decision-making process in which the technical secretariat of the CTBT Organization would send out an inspection team to the suspected violation site as soon as the OSI mechanism was triggered either by the IMS or NTM. The technical secretariat would do so unless a majority of the Executive Council voted otherwise.<sup>68</sup>

China, India, Pakistan, Russia, Israel, and a number of G-21 countries wanted a more cautious decision-making process.<sup>69</sup> They were concerned with the potential abuse of the OSI that could lead to infringements on national secu-

urity. They proposed a “green-light process” in which no inspection could take place until two-thirds or three-quarters of the Executive Council authorized the inspection.<sup>70</sup>

The CD eventually agreed on the green-light mechanism but disagreed on the majority required to authorize the OSI. The U.S.-led nations wanted a simple majority. The Chinese on the other hand wanted a two-thirds majority. The two sides finally settled on 31 out of the 51 Executive Council Votes.

### *ENTRY INTO FORCE (EIF)*

The EIF requirements were the last issue of negotiation in the CTBT talks. The U.S. wanted the CTBT to become effective as soon as possible. Therefore, the EIF should only require ratification by the P5 nations. The Chinese position stated that the CTBT should be a universal promotion of nuclear disarmament and nonproliferation. Furthermore, the Chinese emphasized the importance of equality within the CD. According to Ambassador Sha Zukang: China could not accept a kind of political discrimination against the P5 NWS. It could not agree to confining the conditions of the treaty’s EIF to ratification by the P5 only. From the perspective of political equality, it would be inappropriate to single out the P5.<sup>71</sup>

The difficulty of this negotiation was to balance rapid implementation of the CTBT with the universality of the CTBT.<sup>72</sup> The two sides finally compromised. They decided to only require ratification from the P5, the three nuclear threshold states, India, Israel, and Pakistan, and 35 states identified by the International Atomic Energy Agency as nuclear testing capable before the CTBT can enter into force.<sup>73</sup>

### *PATTERNS OF REALISM*

In the beginning of this paper, I outlined a set of consistent realpolitik Chinese behaviors in international regimes. These trends were no different during the CTBT negotiations.

1. China did try to delay and/or obstruct measures that placed limitations on its military capabilities. China supported an EIF requirement which made the CTBT virtually impossible to enter into effect.<sup>74</sup> The Chinese unilaterally obstructed the CTBT negotiations on issues such as the NFU, NSA, and PNE. PNE would allow China to continue nuclear weapons development even after the CTBT was implemented. These obstructions delayed the completion of the CTBT negotiations long enough for the Chinese to conduct four additional nuclear tests.

2. The Chinese negotiation positions represented

a free-riding tendency. On one hand, China wanted an increasing role in the international community as a responsible and cooperative actor dedicated to nuclear disarmament and nonproliferation. On the other hand, China did not want to put limitations on its own nuclear development. China's support for the PNE represented this pattern. China argued from the moral high ground that humanity should not be denied an invaluable energy source. China even offered to have international monitoring of PNE even though such mechanisms cannot prevent any nation with seismic detectors from making use of PNE results.

3. China promoted low-cost/high-image-benefit unilateral pledges. China originally demanded inclusion of the NFU and NSA pledges into the Preamble of the CTBT before further negotiations could continue. They later dropped the requirement only when the CD multilaterally condemned China's unilateral stance as a block to the negotiations.

4. The Chinese actively opposed highly intrusive measures such as NTM and red-light OSI which threatened to disclose their military capabilities.

### *IMAGE IS EVERYTHING*

Historically, China has entered into a number of nuclear non-armament agreements such as the Outer Space Treaty, the Seabed Arms Control Treaty, the Antarctic Treaty, and various Nuclear Weapon Free Zone Agreements.<sup>75</sup> None of these agreements represented a meaningful limit to China's nuclear capabilities. The CTBT was the first time in which China agreed, in a multinational forum, to place significant limitations on its own nuclear capabilities under verifiable conditions. Why?

The PLA and those closely associated with the Chinese military industrial complex argued that strategically, the CTBT does not benefit the PRC. China was not yet "technically ready" to sign the CTBT.<sup>76</sup> Of the nuclear weapon states, China has the smallest as well as the lowest quantity nuclear arsenal. China nuclear forces at the time was extremely small (15 ICBMs, 1SSBN with 12SLBMs, and 120 antiquated nuclear capable bombers) and vulnerable to both enemy detection and conventional and nuclear attack.<sup>77</sup> This arsenal barely constituted a credible limited deterrence. The CTBT would halt China in the middle of its nuclear development program. Nations such as the U.S. and Russia have already completed several cycles of nuclear development. The U.S., Russia, France, and UK all have "Science Based Stockpile Stewardship Programs" (SBSS) which allow them to continue their nuclear programs through subcritical/non-nuclear tests.<sup>78</sup> China did not possess the economic or technological capabilities to engage in SBSS testing. In sum,

the CTBT could potentially lock China into a position of strategic inferiority.

There were also other issues at stake. The January 1994 to August 1996 CTBT negotiations were the result of increasing international pressure towards stopping nuclear proliferation and testing.<sup>79</sup> The other four NWS had already entered into an informal testing moratorium. Russia's last test was in October 1990; the last U.S. test was in September 1992; the last UK test was in November 1991; and France had ceased testing from 1991 to late 1995.<sup>80</sup> In May 1995, the other NWS decided to extend the Nonproliferation Treaty indefinitely.<sup>81</sup> As the only NWS that had not ended testing, China in particular was under enormous multilateral pressure to enter into the CTBT negotiations. Japan suspended its foreign aid grants after China's May 1995 test.<sup>82</sup> In August 1995, the Japanese Diet suspended foreign aid grants to China for the rest of the year and passed a formal protest against Chinese testing. Several Central Asian Republics near China's Lop Nor test site protested Chinese testing. Kazakhstan, Kyrgyzstan, and Uzbekistan declared formal diplomatic protests against the Chinese. Had China not entered into the CTBT negotiations, it would have become the regional as well as the international pariah. Furthermore, China was being called on by the international community to live up to the constant rhetoric of "peaceful co-existence," disarmament, and nonproliferation.<sup>83</sup>

The CTBT had the potential to be the most significant arms reduction treaty ever negotiated. More importantly, it had almost universal support. As the agency responsible for promoting China's foreign interests, the Ministry of Foreign Affairs (MFA) argued that the CTBT must be signed in order to protect China's international image as a responsible and cooperative global actor despite the limitations it would place on China's nuclear deterrent.<sup>84</sup> Ambassador Sha Zukang, China's lead negotiator on the CTBT and chief arms controller in the MFA, argued that "China's international stature and image as a responsible great power were at stake, and that China's political and diplomatic maneuverability and progress demanded a constructive position on the CTBT. Supporting the CTBT would support China's great power image."<sup>85</sup> The MFA also pointed out that signing the CTBT would have substantial benefits.

First, a responsible international image is essential for China's diplomatic maneuverability as it seeks to play a greater role in the international community. Second, FDI and foreign aid programs fuel Chinese economic development. China could not afford to place these sources of foreign finance at risk by becoming a pariah in the international community.<sup>86</sup>

The CTBT would place significant limits on China's military capabilities and programs. The CTBT issues are highly technical in nature. The MFA would be less qualified to argue the technical merits of key points at the negotiations

than the scientists of the Second Artillery would.<sup>87</sup> From a strategic and technical standpoint, the Party leadership should have given the PLA/testing community the lead of the interagency delegation at the CTBT negotiation. Instead, Ambassador Sha Zukang of the MFA led the Chinese delegation while PLA/testing community members assisted in the technical aspects of the negotiations. In essence, the Chinese placed image considerations (MFA) over realpolitik considerations (PLA).

### CONCLUSION

In closing, consider the counterfactual of this argument's theoretical framework. This study argues that the realist model is necessary but not sufficient in fully identifying patterns of Chinese behaviors within multilateral regimes. During the CTBT negotiations, international reputation was more valuable than realpolitik considerations. China significantly compromised its strategic interests in each instance of the CTBT negotiations when it became apparent that the Chinese position had no substantial support from other nations. Such was the case with the PNE, initiation of the CTBT talks, and the unilateral pledges. In all these situations, China finally decided to budge from its realpolitik position only when it became obvious that the Chinese position was the sole obstacle to completing a treaty universally recognized within the international community as essential for a nuclear safe world.

The counterfactual considers the same scenario but without image costs. Would China have made the same degree of strategic sacrifice if its international reputation were not at stake? According to my argument, the counterfactual predicts that China would not.

In the case of the CTBT, we do not have to hypothesize about the counterfactual. The negotiations over the verification mechanisms are the counterfactual to my argument. During those negotiations, China was not the only nation arguing for a more cautious trigger mechanism. China, India, Pakistan, Russia, Israel, and a number of G-21 countries formed a unified block against NTM and red-light decision-making. In this case, image costs were not an issue because China's position had substantial support. As a result, the U.S./Allies had to compromise its strategic position that demanded a rapid responding OSI.

The desire to maximize economic, military, and strategic advantages vis-à-vis rival powers is the common denominator of all international relations. Behaviors within multilateral regimes may vary depending on a given nation's strategic position, but this common denominator remains constant. Labeling Chinese behaviors as "hard realpolitik, centered on maintaining and increasing China's relative economic, technological, and military power"<sup>88</sup> says nothing. Which nation is not?

Saying that China values its international image is an

equally worthless analytical label. Again I ask, which nation is not concerned with promoting its international image? Every nation engages in rhetoric and propaganda: in short, advertisement for its national policies.

Moral concerns and ethical rhetoric have been used since the days of Thucydides. When Corcyra went to Athens to plead for help against Corinth, it used the language of ethics: "First of all, you will not be helping aggressors but people who are the victims of aggression."<sup>89</sup> Substitute Taiwan for Corcyra, China for Corinth, and Athens for the U.S., and the very same words could be applied to modern times.

The U.S. calls itself the leader the free world. The U.S. justifies its invasion of Vietnam under the rhetoric of protecting the free world from communism.

Stalin and Mao sold their national policies under name of socialist ideology. U.S. presidents have lectured the world on "proper" state behaviors every bit as much as Mao, Deng, or Jiang ever have. Every nation, state, leader, or "rational actor" within the system of international relations has been preoccupied with their image because moral arguments can move and constrain people.<sup>90</sup> In this sense, moral image is a powerful reality. This holds true regardless of geography, history, strategic position, or culture.

The Roman Empire conquered the Germanic tribes in order to bring "the civilization of Rome to the barbarian hordes." The Vatican launched the 200 year Crusades in the name of God and righteousness. The British were "promoting global trade" when they decided to push dope on the Chinese. The Opium Wars were "retaliation for unjust treatment from the Chinese" against British drug dealers. Hitler had his Aryan nation image.

The policies may change, the actors may change, the times may change, but as far as image goes, everyone wants to be the "good guy who is doing the right thing (even when the right thing may be genocide or imperialism. Some statesman will always come up with a justification for it)." This is a consistency of international relations. It should not be presented as an unique feature of Chinese foreign policy.

The question should not be whether Chinese foreign policy could be encapsulated within the frameworks of realism or international image.

Rather, the question should seek to identify the relative values Chinese foreign policy places on its strategic concerns versus its image. The CTBT negotiations answer that question. China is willing to sacrifice strategic concerns when image is at stake. *Image carries more weight than strategic interests do when China is engaged in multilateral fora.* This piece of knowledge is useful. It reveals a possible way of successfully negotiating with the Chinese: draw the Chinese into a multilateral forum, isolate the Chinese position, and put China's "peaceful coexistence" reputation on the line.

The next worthwhile question should be why China is

willing to sacrifice strategic concerns when image is at stake. Every rational entity will only engage in an action if the gains of that action are greater than the costs. Exactly what

do the Chinese gain from promoting international image? How does that gain outweigh the strategic costs?

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<sup>1</sup> Michel D. Swaine and Alastair Iain Johnston, "China and Arm Control Institutions," in *China Joins the World*, ed. Elizabeth Economy and Michael Oksenberg (New York: Council on Foreign Relations Press, 1999), 92.

<sup>2</sup> Swaine and Johnston, "China and Arms Control," 99.

<sup>3</sup> Stuart Harris, "The People's Republic's of China's Quest for Great Power Status: A Long and Winding Road," in *China Under Jiang Zemin*, ed. Hung Mao and Yun-han Chu (London: Lynne Rienner Publishers, 2000), 165.

<sup>4</sup> According to Swaine and Johnston, "China's concern with its international image is also arguably part of its overall realpolitik perspective; that is, it could reflect the desire of a weak state facing highly industrialized powers such as the U.S. and Japan to avoid alienating potential political supporters in the international community." Other theories tie China's obsession with international image to historical and cultural factors such as: the traditional role of the Confucian state as a moral standard for other states, China's 150 year humiliation at the hands of imperialist powers/current great powers of the world, and the Communist Party's desire to take its place as leader of the Third World. "Moreover, many internal arguments for participation are put in terms of sui generis status enhancement, not in terms of instrumental reputation." Swaine and Johnston, "China and Arms Control," 134.

<sup>5</sup> Swaine and Johnston, "China and Arms Control," 92.

<sup>6</sup> Swaine and Johnston, "China and Arms Control," 118-9.

<sup>7</sup> Major Jefferson R. Panton, March, 1999 briefing for a member of the National Security Council.

<sup>8</sup> Andrew J. Nathan and Robert S. Ross, *The Great Wall and the Empty Fortress, China's Search for Security* (New York: W.W. Norton, 1997), 22.

<sup>9</sup> "White Paper—China: Arms Control and Disarmament," Information Office of the State Council, November 1995.

<sup>10</sup> This position was articulated in an October 13, 1999 United States Senate Republican Policy Committee paper entitled, "Administration's (Clinton) Own Statements Help Prove the Comprehensive Test Ban Treaty Should Not be Ratified."

<sup>11</sup> The U.S. has also engaged in military action and joined organizations in order to foster a stable environment for economic reasons (NATO, Persian Gulf War). Johnston and Swaine characterize China's reluctance for transparency and on-site inspection measures as a unique behavior. I wonder if they fail to consider how the U.S. would react to an international demand for full disclosure of its military capabilities and on-site inspections of Los Alamos Laboratory?

<sup>12</sup> Nathan and Ross, *Great Wall*, 4.

<sup>13</sup> Nathan and Ross, *Great Wall*, 4.

<sup>14</sup> Nathan and Ross, *Great Wall*, 4.

<sup>15</sup> Tariq Rauf, "Test-Ban Treaty: Asian Concerns." Report of the Center for Nonproliferation Studies at the Monterey Institute of International Studies, August 17, 1996.

<sup>16</sup> Walter C. Clemens Jr., "China," in *the Encyclopedia of Arms Control and Disarmament*, ed. Richard Dean Burns (New York: Maxwell Macmillan International, 1993), 66.

<sup>17</sup> Nathan and Ross, *Great Wall*, 43.

<sup>18</sup> Bates Gill, "'Two Steps Forward, One Step Back': The Dynamics of Chinese Nonproliferation and Arms Control Policy-Making in an Era of Reform," Unpublished Paper, January 1999, 3.

- <sup>19</sup> “China’s Proposal on Essential Measures for an Immediate Halt to the Arms Race and for Disarmament,” submitted at the United Nations Second Special Session on Disarmament, June 21, 1982.
- <sup>20</sup> “China’s Nuclear Tests: Dates, Yields, Types, Methods, and Comments,” data gathered by the Center for Nonproliferation Studies Monterey Institute of International Studies, 1998.
- <sup>21</sup> Gill, “Two Steps,” 4.
- <sup>22</sup> “China’s Nuclear Tests: Dates, Yields, Types, Methods, and Comments,” data gathered by the Center for Nonproliferation Studies Monterey Institute of International Studies, 1998.
- <sup>23</sup> Gill, “Two Steps,” 4.
- <sup>24</sup> “Chinese Plenary Statement to the Conference on Disarmament,” July 17, 1990. Cited in Gill, “Two Steps,” 4.
- <sup>25</sup> “Chinese Plenary Statement to the Conference on Disarmament,” July 17, 1990. Cited in Gill, “Two Steps,” 4.
- <sup>26</sup> “Chinese Plenary Statement to the Conference on Disarmament,” July 17, 1990. Cited in Gill, “Two Steps,” 4.
- <sup>27</sup> “China’s Nuclear Tests: Dates, Yields, Types, Methods, and Comments,” data gathered by the Center for Nonproliferation Studies Monterey Institute of International Studies, 1998.
- <sup>28</sup> Gill, “Two Steps,” 7.
- <sup>29</sup> Michael Littlejohns, “UN Votes Against Nuclear Testing,” *Financial Times*, December 1995, 6.
- <sup>30</sup> Gill, “Two Steps,” 5.
- <sup>31</sup> Zou Yunhua, “China and the CTBT Negotiation,” prepared for the Center for International Security and Cooperation at Stanford University, December 1998, 4.
- <sup>32</sup> Tariq Rauf, “Test-Ban Treaty: Asian Concerns,” Report of the Center for Nonproliferation Studies at the Monterey Institute of International Studies, August 17, 1996.
- <sup>33</sup> An Address at the U.S. Army War College by Lieutenant General Li Jijun, Vice President of the Academy of Military Science, The Chinese People’s Liberation Army, “Letort Paper No. 1,” August 29, 1997, 7.
- <sup>34</sup> Gill, “Two Steps,” 5.
- <sup>35</sup> Zou, “China,” 9.
- <sup>36</sup> East Asian Nonproliferation Studies Conference Report of the Monterey Institute of International Studies, 1998.
- <sup>37</sup> East Asian Nonproliferation Studies Conference Report of the Monterey Institute of International Studies, 1998.
- <sup>38</sup> Both South Korea and Japan face regional threats from North Korea.
- <sup>39</sup> Michel Oksenberg, Director of the Asian Pacific Research Center at Stanford University and former member of the National Security Council, lecturing on Chinese arms control policies.
- <sup>40</sup> Michel Oksenberg, Director of the Asian Pacific Research Center at Stanford University and former member of the National Security Council, lecturing on Chinese arms control policies. The Chinese raised the same issue of NFU and NSA at the NPT as well as other arms control fora. The arguments and results were always the same as they were in the CTBT talks.
- <sup>41</sup> Ambassador Sha Zukang’s statement at the Conference on Disarmament Plenary, September 5, 1995. Cited in Zou, “China,” 8.
- <sup>42</sup> Rebecca Johnson, “A Comprehensive Test Ban Within Reach,” ACRONYM, booklet No. 1, May 1994, 18.

<sup>43</sup> Zou, "China," 4.

<sup>44</sup> Zou, "China," 4.

<sup>45</sup> "China's Nuclear Tests: Dates, Yields, Types, Methods, and Comments," data gathered by the Center for Nonproliferation Studies Monterey Institute of International Studies, 1998.

<sup>46</sup> Robert S. Norris, "French and Chinese Nuclear Weapon Testing," *Security Dialogue*, March 1996, 49.

<sup>47</sup> "China Increases Test Total Before Treaty," *Jane's Defense Weekly*, April 8, 1995, 3.

<sup>48</sup> "China Increases Test Total Before Treaty," *Jane's Defense Weekly*, April 8, 1995, 3.

<sup>49</sup> Zou, "China," 10.

<sup>50</sup> Zou, "China," 10.

<sup>51</sup> Zou, "China," 11.

<sup>52</sup> Statement on the peaceful use of nuclear energy and peaceful nuclear explosion of the Chinese Delegation at the Working Group II of the NTB Ad Hoc Committee, March 9, 1995. Cited in Zou, "China," 11.

<sup>53</sup> Rebecca Johnson, "Comprehensive Test Ban Treaty: Now or Never," *ACRONYM*, No. 8, October 1995, 17.

<sup>54</sup> Patricia M. Lewis, "China and the Nuclear Test Ban," *China Review*, Autumn/Winter, 1996, 11.

<sup>55</sup> Zou, "China," 11.

<sup>56</sup> Lewis, "China Nuclear Test Ban," 12.

<sup>57</sup> Lewis, "China Nuclear Test Ban," 12.

<sup>58</sup> Lewis, "China Nuclear Test Ban," 12.

<sup>59</sup> Sha Zukang's Statement at the CD Plenary, June 6, 1996. Cited in Zou, "China," 12.

<sup>60</sup> "The Comprehensive Nuclear Test-Ban Treaty," Text, Article VIII, Review of the Treaty.

<sup>61</sup> "China's Nuclear Tests: Dates, Yields, Types, Methods, and Comments," data gathered by the Center for Nonproliferation Studies Monterey Institute of International Studies, 1998.

<sup>62</sup> Zou, "China," 18.

<sup>63</sup> Lewis, "China Nuclear Test Ban," 13.

<sup>64</sup> Johnson, "Now or Never," 22.

<sup>65</sup> Indian ambassador Satish Chandra's statement on behalf of the G-21, June 29, 1995. Cited in Lewis, "China," 13.

<sup>66</sup> "CTBT Text," Article IV, Section D, Paragraph 37.

<sup>67</sup> Zou, "China," 19.

<sup>68</sup> Zou, "China," 19.

<sup>69</sup> Gill, "Two Steps," 6.

<sup>70</sup> Zou, "China," 20.

<sup>71</sup> Zou, "China," 21.

<sup>72</sup> Zou, "China," 21.

<sup>73</sup> Dr. Kalpana Chittatanjan of the Institute of Defence Studies and Analysis lecturing on the CTBT Article XIV, "Entry Into Force," clause on June 11, 1999.

<sup>74</sup> It was doubtful that India, Pakistan, or North Korea would ratify the CTBT.

<sup>75</sup> Gill, "Two Steps," 7.

<sup>76</sup> Xiangli Sun, "Implications of a Comprehensive Test Ban for China's Security Policy," prepared for the Center for International Security and Arms Control at Stanford University, June 1997, 8.

<sup>77</sup> Panton, 4.

<sup>78</sup> Jonathan Medalia, "Nuclear Weapons: Comprehensive Test Ban Treaty," Unpublished Paper, April 7, 1998.

<sup>79</sup> Bates Gill and Even S. Mediros, "Domestic and Foreign Influences on Chinese Arms Control Policy," Working Paper for the East Asia Nonproliferation Project at the Center for Nonproliferation Studies in Monterey, California, 1999.

<sup>80</sup> Gill and Mediros, "Domestic."

<sup>81</sup> Gill and Mediros, "Domestic."

<sup>82</sup> Gill and Mediros, "Domestic."

<sup>83</sup> Bates Gill, Silkworms and Summitry: Chinese Arms Exports to Iran and U.S.-China Relations (Washington, D.C.: The Brookings Institution, December 1997).

<sup>84</sup> Statements based on Gills interviews with members of the Chinese CTBT negotiating team. Cited in Gill, "Two Steps," 11.

<sup>85</sup> Gill, "Two Steps," 11.

<sup>86</sup> Gill, "Two Steps," 11.

<sup>87</sup> The Second Artillery is the branch of the PLA responsible for Chinese nuclear weaponry.

<sup>88</sup> Swaine and Johnston, "China and Arms Control," 92.

<sup>89</sup> Thucydides, History of the Peloponnesian war. Translation and Introduction by Rex Warner and notes by M.I. Finley (Baltimore: Penguin Books, 1972), 55.

<sup>90</sup> Joseph S. Nye, Understanding International Conflict: An Introduction to History and Theory (New York: Longman, 2000), 19.



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# Trade Sanctions and the Rule of Law: Lessons from China

Charles Baum

The “Rule of Law” is a phrase which comes loaded with tacit assumptions and unarticulated values. As Americans, we associate the concept with due process, the doctrines of natural rights and natural law, an independent judiciary and the institution of judicial review. When viewing legal developments in China and around the globe, we look through a filter created by a shared intellectual heritage. But however positive a role these beliefs have played in the development of the American state, when applied to other nations our assumptions become deterministic; we tend to assume that given a proper legal environment – an independent judiciary, a government constrained by law, and transparent regulation – that sustainable economic growth and a democratic political system will result. Consciously or not, we use our ideas of what a legal system should be to judge the progress, or lack thereof, in developing nations.

This standard of review has become particularly prevalent in the context of American foreign policy and international trade. Both Warren Christopher and Madeline Albright as Secretary of State have made rule-of-law development “... an integral part of [the] agenda as Sec[retary of] State... and ... a central feature of U.S. foreign policy...[because of its] centrality to... promoting democracy and human rights, building free and fair markets, and fighting international crime and terrorism.”<sup>71</sup> Regarding China’s accession to the World Trade Organization (WTO), President Clinton has argued that China’s accession will “draw China into a system of international rules and thereby encourage the Chinese to choose reform at home and integration with the world.”<sup>72</sup> United States Trade Representative (USTR) Charlene Barshefsky, a vocal proponent of China’s bid to rejoin the WTO, said that “... our [WTO] agreement brings China further away from the legal void of the Maoist era, and closer to the rule of law.”<sup>73</sup> Explicitly linking the absence of an effective legal system to the chaos and destruction of the Chinese Cultural Revolution, Barshefsky cited the effect of U.S.-China intellectual property negotiations in strengthening the rule of law in China: “...[T]o develop intellectual property policy is to draft and publish laws; train lawyers and officials; improve and ensure access to judicial procedures – ultimately, to create a culture of rights, due process, and limits on arbitrary state

power where it did not exist before.”<sup>74</sup>

But is this linkage between WTO membership, trade sanctions, and legal development justified? This paper examines the intensive U.S.-China negotiations over intellectual property (IP) rights in the 1990s and the current WTO negotiations with the purpose of describing the effects of U.S. trade policy on the development of Chinese legal institutions. It concludes that the use of trade sanctions to force IP reform in China during the 1990s not only did not promote the rule of law, but actively hindered its development in several key respects. Similar constraints suggest that WTO membership alone is unlikely to promote the rule of law within China; rather, the process of legal development in the PRC will most likely be the outcome of internal dynamics which are beyond either the moral authority or the capacity of the U.S. Government and international institutions to direct. A de-linking of trade policy and rule-of-law programs and a renewed emphasis on NGO and targeted legal-development programs is thus more likely to promote U.S. goals as stated.

Part II of this paper seeks to unpack the notion of the “rule of law”, and define it and its relationship to political liberalization with a functional approach to legal development. Part II will also briefly evaluate legal development and reform in China using this analysis, and present inferences drawn regarding the future of rule-of-law reform in the post-Deng era. Part III presents an historical overview of IP protection under Chinese law through 1979, and Part IV will then focus upon IP development and the Sino-American negotiations from 1979-1995. Part V examines the emphasis on administrative remedies contained within of the 1995 Memorandum of Understanding, and examines the effect measures mandated therein by the U.S. had upon the development of Chinese legal institutions during the past five years. Part VI examines the potential of an alternative emphasis on private, civil law remedies, and the Conclusion at Part VII offers suggestions and observations regarding future development of the rule of law in the PRC.

## I. *THE RULE OF LAW AND POLITICAL LIBERALIZATION*

### A. Defining the Rule of Law: A Functional Approach

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What elements are necessary to constitute a “legal system”? When applying this analysis to rule-of-law development abroad, it is important to distinguish the functional aspects of a legal system from the broader Western intellectual tradition purportedly derived from a “universal” conception of human nature and divine justice. One cannot cut a limb from one philosophic and religious approach to law, graft it onto a separate intellectual tradition, and expect it to function in a comparable manner. At the same time, however, it is also important not to over-emphasize the legacy of the past; the study of post-Mao China demonstrates the adaptability and pragmatic approach of her people, and their willingness to make dramatic changes in order to advance China’s place in the world order.

A focus on positive law, or the body of law consisting of enacted statutes and regulations, is likewise singly insufficient to describe the complex interaction of law, society, and government. To think of law as commands backed by the coercive authority of the State mistakes obedience for submission; although it may be combined with the threat of harm, the command embodied in law is primarily an appeal to respect for authority. An effective legal system rests upon the legitimacy implied where a police officer lawfully asks you to step out of your car, not when a gunman offers you a choice between your money and your life. In this sense, law can be considered a set of rules which rest upon a perceived and generally accepted *obligation* the citizenry owes to the body politic, and not necessarily an obligation to the rules or the rulers themselves.

It is more useful to think of law in a second sense, as a set of *enabling rules* which facilitate the realization of structured rights and duties within a pre-defined system. This secondary set of rules does not flow directly from State interests; instead, it provides a framework which allows the citizens to organize their affairs in a predictable and consistent manner. Contract laws, for example, do not exist for the direct benefit of the State, but allow the citizen-businessman to conduct his economic affairs with reduced risk. An error in a sales contract between private parties would not be considered an ‘offense’ against the polity, however it may (if sufficiently egregious) deny the citizen-businessman recourse to the legal remedies necessary to enforce it. The State indirectly benefits from the reduced costs of administration (i.e., mediating or otherwise containing disputes which would arise) and also from the role such predictability plays in promoting economic development. Five salient requirements are integral to this system of enabling rules. The first requirement is that enabling rules be *cognizable*, i.e. identifiable as “law” in contrast to existing norms or unwritten rules of obligation. Article X of the General Agreement on Tariffs and Trade (GATT) discusses this requirement in terms of *transparency*, stating the all trade-related “laws, regulations, judicial decisions, and

administrative rulings of general application.... shall be published promptly and in such a manner as to enable governments and traders to become acquainted with them.”<sup>75</sup> Law must be cognizable as separate from the mores and standards which make up society as a whole.

Second, an effective system must include a *judicial mechanism*, or a pre-existing system which allows an authoritative and final evaluation of claims. This system must be able to decide claims with *consistency* and a reasonable level of *efficiency*, lest the unpredictable or uneconomical resolution of claims prevent the legal system from fulfilling its enabling function. Every system of justice is allied with the sovereign, and is influenced by political considerations to a greater or lesser extent. However, where the political considerations come to predominate, the system becomes a mere appendage of policy and consistency is lost in the ebb and flow of political priorities.

Finally, the system must allow for *adaptability within the framework* mentioned above. Rarely do courts render a decision solely in reference to the codes; more often, they frame their judgements as to give the impression that their decisions are the necessary consequence of predetermined rules whose meaning is fixed and clear. In the vast majority of cases that trouble the courts, neither statutes nor precedents in which the rules are allegedly contained allow only one result. In the most important cases, the court is offered a choice. The judge must choose between alternative meanings to be given to the words of a statute or between rival interpretations of precedent. It is only the tradition that judges ‘find’ and do not ‘make’ law that conceals this, and presents their decisions as if they were deductions smoothly made from clear pre-existing rules without intrusion of the judge’s choice. But this final requirement is necessary to ensure the vitality of the system; without it, stagnation would inevitably result.

Enabling rules codify an activity utterly different from performance of duty or submission to coercive control; they represent a system distinct from and superior to one designed to ensure subjugation. Such power-conferring rules are thought of, spoken of, and used by both citizen and state differently from rules which impose duties, and are valued for different reasons. Rules seeking to establish the obligation to obey sovereign commands are ubiquitous; it is the creation of enabling rules and a system to enforce them which constitutes the crucial step from the pre-legal to the legal world.

## B. Law, Development and Legitimacy

The nexus connecting political culture and law is a complex one. A statute is, by itself, meaningless; if it is to be obeyed, it must resonate at some level within the domestic environment it purports to constrain. Laws can be legiti-

mated either by the nature of the regulation (it is not accidental that law and morality frequently overlap) or the process by which they were created.

Why would a sovereign choose to advocate supremacy of the law, rather than supremacy of his own authority? In an insightful study of law and development in Guangdong,<sup>6</sup> Linda Chelan Li argues that Beijing's policy promoting *fazhi guojia* (rule the nation according to law) was well-received in Guangdong Province, historically a place where "heaven was high, and the Emperor far away," in part because of a desire on the part of both central and local governments to establish a rule-based relationship governing tax remittances between the two. During the 1980s, the central-provincial fiscal system consisted of a series of negotiated "contracts," wherein the provincial government was to turn over to Beijing either a fixed amount or a specified percentage of revenue received. While the original intention was to provide a predictable fiscal environment, in the absence of an effective legal system both sides became adept at using loopholes. On top of contractual remittances, for instance, the national government might demand additional payments in the form of new taxes, mandatory purchase of state bonds, or fiscal "loans" which were never repaid.<sup>7</sup> Anticipating this, provincial officials engaged in a wide variety of means to minimize their financial exposure, including diversion of resources into ostensibly separate budgets, generous tax exemptions to key enterprises, and by underreporting income. Both sides came to see themselves as losers in what Ms. Li describes as the "ambiguity game;"<sup>8</sup> Beijing felt that the Guangdong provincial government, which benefited financially from explosive growth in the 1980s and early 1990s, was not shouldering its financial fair share, while the Guangdong government wished to contain Beijing's ability to impose extra-contractual remittances.

As this example illustrates, the power of even an authoritarian sovereign to enforce enacted law is not absolute; decrees can be evaded, subverted, or simply ignored. Indeed, the situation in Guangdong continues to be resolved through the less formal negotiation process and poses a serious impediment not only to the coffers but also to the successful implementation of other policies articulated by the national government. This demonstrates the imperative need for a consistent, rule-based system even in an authoritarian state.

Crafting a legal system which incorporates the disputants and fairly resolves the dispute creates political legitimacy and assures a basic continuity of process. The sovereign, by working within a legal framework, imparts legitimacy to his commands. By expanding the system to include enabling rules as well, the sovereign also integrates disputes normally outside the State sphere within the process, reaps the indirect benefits of dispute-resolution, and promotes a stable environment for economic growth.

### C. *Fazhi Guojia*: Rule of Law, or Rule by Law?

The phrase *fazhi guojia* is generally translated as "rule the nation according to law", but the exact meaning of *fazhi* can imply advocacy of either "rule of law" or "rule by law". The difference is more than mere semantics; the former implies the use of law as a process, potentially in accordance with the view of law as a system of enabling rules, while the latter indicates an instrumental use of law solely as a tool of governance to facilitate social control. This connotation is generally in accordance with traditional Confucian and Communist views of law, and historically has done little to promote law as an enabling system.

#### 1. The Confucian Tradition as Rules of Obligation

Chinese law from the Qin Dynasty (221-206 B.C) through the Qing (1611-1911 A.D.), characterized by commentators as "overwhelmingly penal in emphasis,"<sup>9</sup> serves as a clear example of obligatory law, or rules seeking to establish subjugation to the body politic. What make the Chinese case unique, and has engendered sharp debate amongst commentators, is the utilization of both *li* (moral ritual) and *lu* (positive law) in creating the system of obligatory rules. The Legalist tradition emphasized the use of positive law as an instrument of governance, to insure social control and provide standards for the imposition of punishment. This instrumental utilization of law was placed subordinate to the Confucian tradition, in which a well-ordered society would arise from moral persuasion and the example of virtuous leaders with minimum reliance upon laws as a supplemental tool. As noted China authority Willam Alford writes:

[The] Chinese neither saw public, positive law as the defining focus of social order nor divided it into distinct categories of civil and criminal. Chinese thought arrayed the various instruments which the state might administered and social harmony maintained into a hierarchy ranging downward from heavenly reason (*tianli*), the way (*tao*), morality (*de*) ritual propriety (*li*) customary (*xixu*) community contracts (*xiang ye*) and family rules (*jia cheng*) to formal law (*lu*).<sup>10</sup>

The result was a system which relied extensively upon the regional magistrates and their Confucian moral training; law was reserved as a tool of last resort for those individuals who could not be persuaded to follow the path of moral enlightenment.

As a result, the Tang Legal Codes, which were preserved virtually *in toto* in succeeding dynasties up until 1911, contain little of what Western scholars would think of as civil law. While the Codes dealt with succession and inherit-

ance, marriage, family, and quite thoroughly with criminal law, commercial and economic matters were largely left to the provenance of merchant guilds.<sup>11</sup> Even the inclusion of family law in the Codes was intended to advance State interests; clan members were expected to maintain order within their lineage, and were responsible for the conduct of their members.<sup>12</sup> Thus, whether broader social standards formed an “implicit” framework supplying legal standards where the *lu* was silent, as has been suggested by some scholars,<sup>13</sup> is irrelevant; both were instruments used almost exclusively for purposes of State administration and the maintenance of social harmony.

## 2. Marxism-Leninism and Law

Marxism-Leninism viewed law as a tool of exploitation, a mere mechanism designed to insure the perpetuation of the ruling class. In June 1949, one month after the Communist forces gained effective control of China, the Chinese Communist Party (CCP) issued directives repealing all laws made by the Nationalist Party (KMT).<sup>14</sup> The CCP, true to their ideological heritage, emphasized that the fundamental task of the socialist legal system was to consolidate proletarian dictatorship of the people, and suppress the enemies of the fledgling socialist state.<sup>15</sup> Article 4 of the 1954 Constitution of the PRC imitated the socialist construction of the Soviet Constitution, with the stated objective of “... wip[ing] out gradually the exploiting class... and build[ing] up a socialist country.” From 1954 to 1960, some 148 laws and statutes were enacted, and 731 administrative regulations were promulgated. Only a few non-criminal statutes dealt with private activity, and most of these were concerned with the political needs of socialist transformation and the establishment of socialist public ownership.<sup>16</sup>

Beginning with the Anti-Rightist Campaign in 1957 and continuing into the Great Proletarian Cultural Revolution (1966-1976), the legal system and its functionaries fell under political attack. Lawyers were jailed for defending clients charged with political subversion, and judges were persecuted for “rigidly” placing law above the People’s Revolution, a “reactionary view”. Many were exiled to the countryside, imprisoned, or criticized. In 1958, the Beijing government began to merge public security organs with people’s courts and procurators, into one Ministry of Politics and Law. As part of this process, the number of court personnel was drastically cut; in 1956, there were as many as 41,483 judges, lawyers, and staff, but by the end of 1958 there were 32,068, a reduction of 22.7 percent.<sup>17</sup> Also beginning in 1958, most civil disputes were directly dealt with by the mediation committees of the People’s Communes, and the total number of civil cases filed with the court between 1957 and 1960 decreased by nearly 40 percent.<sup>18</sup>

During the peak years of the Cultural Revolution, the legal system as a distinct entity effectively ceased to exist; in many parts of the country, cases were tried illegally by executive agencies, the leaders of people’s communes, and by various working groups and Revolutionary Councils in violation of the Constitutional provision that specified “judicial power is exercised by the people’s court.”<sup>19</sup> When cases were tried, political slogans and the decisions of individuals – not rule-based standards - prevailed.

## 3. Opening the Door:

### Legal Reform in China after 1978

Examination of the post-Mao legal reforms fully illuminates the dichotomy between law as a system of sovereign-enforced rules of obligation and law as a system of enabling rules. Initially viewed in the aftermath of the Cultural Revolution as a tool to reassert Party control, Deng Xiaoping’s policy of promoting *fazhi guojia* has grown to encompass genuine reform. The purpose of this final section of Part II is to provide an analytical context for understanding developments of intellectual property law by examining the thrust of legal reform after 1978.

In a speech given at the closing ceremony for the Central Working Conference of the Eleventh Party Congress in 1978, Deng Xiaoping announced four slogans to guide Party officials in the promotion of *fazhi guojia*.<sup>20</sup> The four slogans - *youfa keyi* (law for people to follow), *youfa buyi* (laws where people currently do not obey), *zhifa buyan* (laws not strictly enforced) and *weifa buyu* (lawbreakers not caught) outlined Deng’s perception of the failures of the existing legal system, and his emphasis indicated the primary goal of the resurrected legal system was to restore the authority of the Communist Party. Indeed, one source reports that Party leadership originally preferred the expression “strengthening the law and the legal system” to “strengthening the rule of law”, because of concerns regarding the latter’s potential implications for broader political reform.<sup>21</sup> Deng’s “new” policy echoed the traditional instrumentalist conception of law as a tool for facilitating subjugation to the sovereign.

The promotion of *fazhi guojia*, however, also included elements which set the stage for the development of deeper legal reform. Beijing recognized the importance of a legal system capable of supporting economic development; as one official stated, the “market economy is a legal economy”, *i.e.* a healthy market is a regulated one.<sup>22</sup> Growing out of Beijing’s successful experiments with agricultural reforms in the early 1980s, privately run enterprises were allowed under an amendment to the 1988 PRC Constitution. More importantly, however, the State began to construct a system of legal rules to promote economic de-

velopment, technology transfer, and foreign investment. Private economic interests were explicitly (if grudgingly) recognized. While this was done with the goal of promoting national development, the existence of laws protecting private interests and the first hesitant steps toward development of concomitant legal protections and an infrastructure to enforce them, represented a positive step gain for the rule of law.

As the legal reforms progressed, Beijing began to utilize law as an alternative to existing internal Party systems to bring the abuses of lower officials to light. The Administrative Litigation Law (ALL),<sup>23</sup> passed in 1990, allows private citizens to challenge certain types of administrative decisions in court, and the State Compensation Law, passed in 1992, allows recovery by private citizens for damages caused by narrowly defined categories of official misconduct. The Administrative Supervision Law,<sup>24</sup> passed in 1996, limits the power of officials to administer penalties and punishments, and specifically requires officials to adhere to vaguely-defined principles of transparency, legal authority, and due process in making their decision. Since the passage of the Administrative Penalties Law in 1996, some 35,000 cases of corruption and/or mistreatment by state officers were prosecuted under its aegis; in 1999 alone, 51,370 cases were filed.<sup>25</sup> Significantly, two-thirds of the judgements on these cases were decided in favor of the citizen-plaintiff.<sup>26</sup>

It is important to emphasize that these measures are not intended to promote popular, democratic rights vis a vis the government; rather, they represent an attempt to force lower officials to conform with standards articulated in Beijing. The new Legislation Law (Legislation Law), enacted by the National People's Congress (NPC) on March 15, 2000, seeks to clearly establish the NPC (and the Party) as the final arbiter of the law and its application. The Legislation Law formally establishes the legal hierarchy amongst the Constitution, laws, various administrative orders, rules, and regulations at the national and local levels. Articles 71-73 require that all administrative regulations must expressly identify their legal authority, and be published in designated official publications (Article 77). The Legislation Law further lays out required legislative procedures, including timely notification, quasi-public meetings or discussions, and three readings before the legislative committees and the full legislative body. But the Legislation Law also grants the NPC Standing Committee sole authority to interpret laws (Art. 42), subject to an override by the full NPC. Only the NPC and the NPC Standing Committee may declare a law or regulation unconstitutional, or invalid because of conflict with a higher statutory authority. The Supreme People's Court, the State Council, various Ministries, and local agencies are explicitly denied authority to interpret the constitutionality or validity of any stat-

ute (art 90). The evident intent of this statute is to retain sole authority for law and legal reform in the hands of the legislature, and ultimately the Communist Party.

#### D. America, China, and the Rule of Law

Modern Chinese law exists in a transient state; the present legal system is intended to provide enabling rules and rights only so far as they strengthen the rule of the Communist Party. Yet within the system exist nuclei which represent a genuine departure from the traditional utilitarian approach to law. The compromises Beijing has created formally recognize the importance of a private sphere of action in facilitating economic growth, and also recognize (at least conceptually) the importance of a legal system to enforce them. Legal mechanisms to effectively enforce the rights so created, however, are notably absent.

This paper now turns to an examination of the interaction between American trade policy and legal development in China. Part III will begin with a historical overview of intellectual-property protection in China.

## II. *EARLY DEVELOPMENT OF INTELLECTUAL PROPERTY PROTECTION*

### A. Emperors and Intellectual Property

The earliest historical records dealing with intellectual property rights in China indicate the concern of officials with publication and republication of works related to the imperial throne. Han dynasty regulations (circa 200 B.C.), for example, barred the unauthorized reproduction of the Confucian Classics.<sup>27</sup> The Classics and accompanying commentary served as one of the most important ideological bases legitimizing the rule of the Han Emperor, hence the concern of the Court with their ideological orthodoxy.

A proclamation by the T'ang Emperor Wenzong in AD 835 similarly evinced concerns regarding control over works related to Imperial authority. The proclamation, which became part of the T'ang Code and was adopted by later dynasties, prohibited the unauthorized reproduction of calendars, almanacs, and items which could be used in prognostication which were at the time being produced in the southern regions and distributed throughout China.<sup>28</sup> Questions of time and astronomy were central to the Emperor's role as the link between human and heavenly events, and so were tightly controlled by court astronomers. Works of prognostication were also of concern because of their potential use in predicting the dynasty's downfall. Before its

collapse, the emperors of the T'ang dynasty also prohibited the unauthorized copying and distribution of state legal pronouncements, official histories, and the reproduction, distribution, or possession of works related to the "devil works", the competing faiths of Buddhism and Taoism.<sup>29</sup>

The Song Dynasty (960 – 1279 AD) saw a marked increase in the production of printed materials. The invention of moveable type by Bi Sheng around the year 1000 had profound effects on the manufacture of printed materials because of the complexity of the Chinese language.<sup>30</sup> Because of the rapid spread of printed works, the Zhenzhong Emperor ordered private printers to submit works they intended to publish to local officials for prepublication review in order to control heterodox materials.<sup>31</sup> Persons failing to obtain official review prior to printing works that were neither subject to exclusive state control nor banned altogether might suffer one hundred blows with the heavy bamboo cane and destruction of their printing blocks;<sup>32</sup> however, no laws forbade reproduction by any printer of works that had been authorized by Imperial censors.

The law regarding publication and dissemination of works underwent relatively few changes from the Song until the Ming dynasty (1644-1911). The system of imperial censorship appears to have lost vitality during this time; despite the formal legal continuation of the Song censorship system, the Qianlong emperor in 1744 found it necessary to re-issue a decree requiring pre-publication review to "preserve the moral integrity of the State."<sup>33</sup> Thirty-four years later, in 1778 the Qing Emperor again directed the re-institution of a strict system of local prepublication review.<sup>34</sup> The limited effect of the two decrees is likely attributable to the fact that many of the literati either were government officials, or were closely related to them, and were themselves responsible for the existence of the printed materials.

At the close of the Ming there existed no centrally promulgated legal protection for either proprietary symbols or inventions, except for those relating to the imperial family<sup>35</sup> or protection for marks placed on goods made exclusively for imperial use.<sup>36</sup> During the Ming and Qing, however, an informal system of guild registration and protection of marks was instituted, where a manufacturer could register his trade mark with other guilds or occasionally with a local magistrate.<sup>37</sup> In the event of trademark infringement recourse to local officials could occasionally be had by imploring the magistrate to prevent fraud and unfairness; in one case, sericulturalists in Shanghai were able to get the local magistrate to order that infringement of their unique mark be stopped.<sup>38</sup> These remedies, however, were not found in the legal code, and hence were dependent upon the ability of the manufacturer to appeal to local trade guilds and officials.

## B. The End of the Dynasties: IP in the Late Qing and Warlord Period (1911-1927)

Piracy became a major problem with the wide dissemination of Western learning within China. Initially dismissive, intellectuals and government officials began to realize the importance of "barbarian learning" in establishing a modern, militarily capable nation. Many Chinese felt that unhindered translation and reprinting of Western books was justified as necessary.<sup>39</sup>

The same time period evidenced a boom in IP consciousness in the West, as the growth of industrialization made ideas more valuable in the commercial sense. In 1883 the International Union for the Protection of Industrial Property was signed; commonly referred to as the Paris Convention, the organization provided international protection for patents and trademarks. In 1886 the International Union for the Protection of Literary and Artistic Property was formed;<sup>40</sup> the so-called Berne Convention addressed issues of copyright protection amongst the Western nations.

The Chinese were not, however, signatories to either convention. Western rights holders could register marks with Imperial Maritime Customs Service, established in 1854 and controlled by Western powers (primarily the British), but such registration would be effective only inside the treaty ports.<sup>41</sup> Accordingly, in 1903 the U.S. sought to include an agreement protecting intellectual property with a broader trade agreement. The final agreement, the Treaty with China for the Extension of the Commercial Relations (Treaty of 1903),<sup>42</sup> provided that intellectual property protection would be extended on reciprocal basis, after the Chinese had established a patent office and adopted a patent law, but did not set a date for establishing such an agency or providing interim protection.<sup>43</sup> The agreement specifically excluded translations of Western works done by Chinese.<sup>44</sup>

Conflict over the implementing measures prevented the establishment of an IP legal regime. A short-lived copyright law was promulgated in 1910;<sup>45</sup> it was abrogated on the founding of the Republic in 1912, but re-enacted in substantially same form in 1915.<sup>46</sup> The law did not purport to put the Treaty of 1903 into effect, and gave limited copyright protection to Chinese authors only. Because the Treaty of 1903 specified that protection was to be accorded in the "same way and manner and subject to the same conditions"<sup>47</sup> as trademark protections, the Chinese government contended, it was premature to issue a more complete copyright law until the trademark law "goes into force and proves acceptable and effective." The proposed trademark law, in turn, was delayed due to disputes between the Chinese Ministry of Commerce, the Customs Service advisors, and the foreign powers, and was not adopted until almost two decades later.<sup>48</sup>

In the interim, foreign groups commenced negotiations amongst themselves designed to provide reciprocal protection in the treaty ports. The U.S. and France exchanged diplomatic notes agreeing to extend bilateral protections in 1911,<sup>49</sup> and by 1919 the agreements covered all the Western treaty ports. Thus, an American national who registered in Italy would be able to bring action before the Italian Consular Court in China against a person subject to the jurisdiction of that court.<sup>50</sup>

Not surprisingly, relatively few cases of copyright infringement were brought. The G&C Merriam case, brought in the Shanghai Mixed Court in 1923, demonstrates the difficulties faced in securing judicial protection of copyrights in the era. G&C Merriam had spent several years preparing a bilingual version of Webster's Dictionary for sale in the Chinese market. However, before the dictionary could be released, Merriam managers discovered the Commercial Press in Shanghai had already begun to distribute its own virtually identical version. Merriam brought suit in 1923 at the Mixed Court in Shanghai, invoking both the copyright and trademark provisions of the treaty of 1903 between the U.S. and China. The Mixed Court found, however, that the dictionary did not fall within the limited class of American works entitled to copyright protection, but did fine the Commercial Press for using a seal on the cover which was very similar to that used on the Webster's Dictionary; the court accordingly fined the Shanghai printer 1,500 *liang* of silver but did nothing to halt continued publication.<sup>51</sup>

Throughout the late Qing and Republican era, the Chinese government remained focused on control over ideas and the maintenance of order, rather than protection of private economic interests. Registration of newspapers and magazines was required by government edicts issued and re-issued in 1907, 1908, and 1909.<sup>52</sup> Rulers seemed more interested in using the guise of legal development to promote their legitimacy than any genuine desire to see reform; Republic President Yuan Shikai wished to be known as the Hongxian (Great Constitutional) Emperor in the belief that this would demonstrate his self-professed abiding commitment to the rule of law,<sup>53</sup> despite his intention to restore the monarchy and abolish the Republic.

William Alford convincingly argues that much of the motivation behind the development of intellectual property laws during this period stemmed from the promises of Western powers to end the extraterritorial status of the treaty ports, when and if domestic Chinese law had improved enough to maintain order and enforce the rights of foreign traders. The outcome — development of formal legal protection, but little or no improvement in enforcement mechanisms — reflected these ulterior motives behind the formation of the laws. When the Western powers proved reluctant to relinquish control, the Chinese proved similarly un-

willing to develop new intellectual property laws or enforce existing ones.<sup>54</sup>

### C. The Nationalist Period (1927-1949)

The collapse of the Republic and the formation of the Nationalist Party (GMD) ushered in an active period of legal development. Foreign-trained Chinese and German legal advisors were brought in to draft a new Constitution and a modern legal code.

In 1928, a new Copyright Law was passed. Protection under Chinese law was extended to foreign nationals on a reciprocal basis if the copyrighted works were “useful to the Chinese [people],” for a period not to exceed 19 years.<sup>55</sup> Whether the work was “useful” under the law was determined by the Ministry of Internal Affairs. This same Ministry had authority to block registration of foreign and domestic works where the work “obviously goes against the doctrines” of the GMD or where “the release of the work is prohibited by other laws.”<sup>56</sup> These restrictions were amplified in the Publication Law<sup>57</sup> and its implementing regulations: according to Article 19, registered works could not contain anything “intended to... undermine the Guomindang” or violate the Three People's Principles [of Sun Yatsen], “to overthrow the Nationalist Government or to damage the interests of the Republic of China”, to “destroy public order” or to “impair good customs and habits”. A permit was required for all works to be published, regardless of whether a copyright was sought; failure to obtain a permit could result in imprisonment, fines, seizure of publications, and destruction of the type.<sup>58</sup>

Protection for trademarks also required registration with the central government, which had authority under Article 2 of the 1930 Trademark Law to bar marks it deemed prejudicial to public order or marks which utilized the portrait or name of Dr. Sun Yatsen, the plum blossom (symbol of Guomindang), or other signs evocative of the national government or the Guomindang Party.

Under the terms of the Trademark Law, Chinese nationals received 30 years of protection, while foreigners received 10 years. The U.S. objected to the new Trademark Law as conflicting with the provisions of the 1903 Treaty, and the Nationalist government agreed not to apply the 10-year limit to American nationals and to drop the requirement that the copyrighted works be “useful” to the Chinese.<sup>59</sup> The U.S. also concluded the Treaty of Friendship, Commerce and Navigation with Nationalist China on November 4, 1946; article IX provided for a system of mutual obligation with respect to intellectual property laws.<sup>60</sup>

While the internal chaos and problems wrought by civil war with the Communists added to the difficulty of developing the legal infrastructure, the tension between the perceived need for strong State control and the requirements

of an capable, politically independent judiciary proved to be the largest impediment to promotion of the rule of law. Harvard-trained political scientist Qian Duansheng concluded during the last years of the Nanking era that “in draftsmanship the codes are, on the whole, well done. If they have not been duly enforced, it is... because of the inaccessibility of the courts, the incompetence of the judges, and especially, the interference of authorities other than judicial in the administration of justice.”<sup>61</sup> In the words of a generally sympathetic 1945 report by the Subcommittee of the National Foreign Trade Council in New York, “adoption of suitable statutes relating to Patents, Trademarks and Copyrights will not be enough if China is to derive any real benefit.... No matter how sound a law may be, it is of no value if it is not enforced.”<sup>62</sup>

#### D. Intellectual Property in a Socialist Economy (1949-1976)

Reflecting both their Marxist-Leninist and Confucian heritage, the Communist Party did not seek to protect intellectual property when it came to power in 1949. In June of that year, all laws made by the GMD were repealed.

The Communist Party did, however, pass laws designed to smooth the transition between the capitalist and socialist systems. The Provisional Regulations on the Protection of Invention Rights and Patent Rights, adopted on August 11, 1950, provided a 2-track system of incentives and protection for patents. The State could grant the inventor a ‘certificate of invention’ which would allow the inventors in State enterprises recognition and a monetary bonus determined as a percentage of the savings realized by their invention. The State retained formal ownership and control over the dissemination of the invention. Alternatively, the State might issue patents vesting inventors with ownership and fundamental control, thereby entitling them to receive whatever royalties might be negotiated. Inventions which concerned national security or “affected the welfare of the great majority of the people” would automatically fall under the first category.

The legislation also empowered the Central Bureau of Technological Management of the Finance and Economic Committee and the General Administration of Commerce to set terms of protection for patents and certificates of invention for periods of three to fifteen years, and to establish the rates at which holders of certificates were to be rewarded. Further control was exercised through provisions of the regulations that required the working of patents within two years and forbade transfer of patent rights without the Central Bureau’s permission.

Trademarks were to be protected under the 1950 Procedures for Dealing with Trademarks Registered at the Trademark Office of the Former Guomindang Government and the Provisional Trademark Registration. The system al-

lowed trademarks used under the Guomindang to be re-registered. The measure, intended as an appeal to the remaining industrialists, allowed them to seek at least nominal protection for their marks. Few did, and as the economy moved toward socialism the need diminished.<sup>63</sup> Copyright law was severely diminished under the new Communist rules. Building on an intellectual heritage that emphasized the external origins of knowledge and the educational importance of wide dissemination, the Party instituted a system where writers and poets were directly employed by the State. Remuneration was based upon their salary and a small payment based on the number of copies printed at the state-run printing press. Since private presses no longer existed, royalties likewise became an antiquated notion. While the writers nominally had the right to prevent unauthorized alteration of their work, ownership and the right to dissemination rested with their employer, the State.<sup>64</sup>

As the transition to a socialist economy accelerated, IP laws were amended to reduce their stated concern with property rights and their reliance on material incentives. On November 3, 1963, the State Council supplanted the Provisional Regulations on the Protection of Invention and Patent rights with two sets of permanent regulations – the Regulations to Encourage Inventions and the Regulations to Encourage Improvements in Technology.

The new regulations struck patent protection from the law, and specified that new inventions and improvements in technology were to be the exclusive property of the state. Even the awarding of the ‘invention certificates’ was discontinued. Consistent with the notion that “in giving awards, politics should be in command, extensive ideological work carried out, and the principle of combining honorary awards with materials awards maintained”, the material awards provided for by the new regulations called for far lower payments than the precious schedules.<sup>65</sup> The new recognition was to be complemented by a set of honorary awards, ranging from certificates and banners to applications of one’s name to the invention and free trips to worker’s resorts.<sup>66</sup>

The chaos of the Cultural Revolution shifted the focus from observance to law to adherence to political dogma. Regulations and rights were largely ignored in the maelstrom which followed; formal authority was delegated to an uncertain and constantly changing milieu of revolutionary committees and local leaders. During the period from 1966 to 1976, intellectuals were the victims of a series of political campaigns. In the early 1960s, a campaign was waged against those in the party who allegedly sought to protect capitalist legal rights, including copyright.<sup>67</sup> Beginning in 1973, the Gang of Four, with Mao Zedong’s support, asserted that intellectuals were not proletarians and that protection of their work would constitute a protection of “bourgeois” rights. Intense conflict between radicals and

intellectuals continued and did not end until the death of Mao and the arrest of the Gang of Four in August 1976.

#### E. Conclusions

The lack of a clear economic rationale for the protection of intellectual property and the continuous emphasis on the State power to control ideas resulted in a system where intellectual property was inadequately protected. Where Western powers sought to establish legal protections, at times quite literally at gunpoint, the result was an adequate system of positive law which was not enforced. In terms of legal development, the system thus created continued to ensure the subjugation of ideas and commerce to State interests, and lacked the infrastructure necessary to create a true system of enabling rules.

### III. INTELLECTUAL PROPERTY LAW IN THE ERA OF REFORM

#### A. Creating an IPR Regime

At the National Science Conference in 1978, Deng Xiaoping announced the rehabilitation of the intellectuals as part of a sweeping change in the Chinese political landscape. Intellectuals were recast as part of the proletariat, and property was no longer classified as a “bourgeois right.”<sup>68</sup> In December 1978, the State Council re-issued the 1963 Patent regulations, which reinstated monetary and honorific awards for inventors.<sup>69</sup> Drafting of trademark, patent and copyright laws was soon under way.

The passage of a revised Patent Law<sup>70</sup> in 1984 was heralded in the Chinese press as “signaling the dawn of a new era in Chinese economic and legal development.”<sup>71</sup> The new legislation clearly established the validity of the inventor’s economic rights, but again placed them subordinate to the interests of the State. The Patent Law moved away from invention patents in favor of “utility” patents, under which the grantee received protection for a 5 year term, or monetary rewards and no rights. Article 29 allowed foreigners who had filed patent applications abroad a 12 month priority period in which to seek protection in China, but made no such concession to Chinese nationals. Article 14 of the law vested the State Council and provincial governments with the authority to compel state entities to license patents they held, subject only to the requirement that such a step be taken “in accordance with the state plan” and that a fee (determined by the state) be paid. Articles 51 and 52 provided that patents held by foreigners or Sino-foreign joint ventures were also subject to compulsory licensing if the patentee failed within a three-year period to make the patented good, utilize the patented process, or license another person to do so. The Patent Law also did not

offer protection for pharmaceutical products and chemical processes, a shortcoming which would cause considerable conflict with the U.S.

Article 1 of the Trademark Law, passed in 1982, offered protection for trademarks based on their role in “fostering development of socialist market economy.” Article 6 emphasized the role of the Trademark Law in maintaining quality of goods offered in the marketplace, and its importance in preventing consumer deception. Typical of Chinese legislation, the Trademark Law enumerated a fairly comprehensive list of rights, but failed to articulate how these rights were to be enforced. The State Administration of Industry and Commerce (SAIC) was empowered under Article 31 to cancel trademarks, impose fines, and refer violators of the law for more serious punishment, but it did not specify the procedures by which this was to be accomplished, or the standards which should be used.

Copyright was first addressed in General Principles of Civil Law, passed in 1986. Article 94 provided the following vague recognition of copyright:

Citizens and legal persons, shall enjoy rights of authorship (copyright) and shall be entitled to sign their names as authors, issue and publish their works and obtain remuneration in accordance with the law.

At the time, no statutory guidance determining an author’s remuneration existed.

A more complete Copyright Law was passed on September 7, 1990. The law reserved the exercise of copyright rights to the author’s work unit, rather than to the author themselves.<sup>72</sup> Broad fair use provisions allowed state organs the right to make use of materials free of charge in the “execution of official duties,” while acting with restraint sufficient to avoid prejudicing, “without reason,” the rights of owners.<sup>73</sup> “Works prohibited by law to be published and disseminated” were not entitled to copyright protection, and Article 4 further enjoined rights holders from “violat[ing] the Constitution and the law, or infring[ing] upon the public interest” while exercising their copyrights. The State Administration of Press & Publications was placed in charge of administering the copyright system, again with very little explicit statutory direction.

The final phase of the initial legislation was the passage of the Computer Software Regulations<sup>74</sup> in October of 1991. The regulations did not cover programs embedded in silicon chips, and also contained broad “fair use” provisions. Article 31 specifies that similarities between newly developed and preciously existing software will “not constitute infringement of... copyright... if the similarity is necessary for the execution of national policies, laws, regulations and rules... or for the implementation of national technical standards.” Article 31 does not further define these terms, nor does it require compensation for affected soft-

ware developers. Further, software developed by state enterprises within China that is of “great significance to national interests and public interests” shall potentially be subject to government expropriation.<sup>75</sup> Finally, all software published prior to the issuance of the regulations on June 4, 1991 is effectively presumed to have been in the public domain.

## B. IP Protection and U.S. Trade Policy

During the 1980s and 1990s, the shift from manufacturing to intellectual-property based industries in the United States accelerated rapidly; between 1977 and 1996, copyright industries grew at 4.6 percent annually, nearly three times the national average.<sup>76</sup>

This development became imperiled, however, by the electronic medium copyrighted products utilize. The most valuable intellectual property (“IP”) assets – software, music, and movies – have become increasingly easy to illegally duplicate, due to the proliferation of low-cost replication technology.<sup>77</sup>

The United States developed domestic legislation to limit the market access of countries who (by U.S. standards) offer inadequate levels of IP protection. Under Section 301 of the Trade Act of 1974 (Section 301),<sup>78</sup> the United States Trade Representative (USTR) may take action against nations based on “an act, policy or practice” which “denies benefits to the United States under any trade agreement” or simply “restricts United States commerce.”<sup>79</sup> The USTR may designate a nation as a “priority foreign country”, when the perceived violations are particularly egregious, or place the country on the “priority watch list” or the lesser “watch list”, which advise the targeted nation of the USTR findings and require continued monitoring.<sup>80</sup> After a further affirmative determination of infringing trade practices, the USTR may impose countervailing duties, enter into binding agreements, or suspend or withdraw trade benefits to that country.<sup>81</sup>

In order to protect “an increasingly important component of national wealth”<sup>82</sup> and alleviate the economic distortion piracy creates in the world marketplace, the U.S. has also sought to link intellectual property protections with international trade regimes. The United States successfully campaigned for the adoption of the 1994 Agreement on Trade-Related Aspects of Intellectual Property Rights (“TRIPS”)<sup>83</sup> as part of the Uruguay Round revisions to the General Agreement on Tariffs and Trade (“GATT”). TRIPS incorporates previous multilateral intellectual property accords, notably the Berne Convention for the Protection of Literary and Artistic Works<sup>84</sup> (“Berne Convention”) and the Universal Copyright Convention<sup>85</sup> (“UCC”), and expands the scope of protection afforded to intellectual property under the auspices of the World Trade Organization. Al-

though TRIPS is not self-executing (each nation must “determine the appropriate method” of implementation),<sup>86</sup> it will eventually apply to all members of the WTO.

## C. Sino-American Negotiation of IP Protections, 1989-1992

The importance that Washington attached to IP protection was apparent from the outset of renewed economic relations with China. In July 1979, the PRC agreed as part of the Agreement on Trade Relations to offer IP protection for American goods, again on a reciprocal basis.<sup>87</sup> American dissatisfaction with the 1982 Trademark Law and the 1984 Patent Law, and frustration over delays in the passage of a copyright law, led the USTR to consider imposing trade sanctions following the passage of the 1988 U.S. Omnibus Trade Act (Trade Act) with its Section 301 provisions.<sup>88</sup> In May 1989, the U.S. and China concluded a Memorandum of Understanding (MOU) under which the U.S. agreed to delay imposing sanctions so the Chinese could have more time to comply with the provisions of the Trade Act. In 1991, then-USTR Carla Hills identified China as a “Priority Foreign Country,” and examined the imposition of sanctions for China’s failure to protect copyrights and offer patent protection for American pharmaceuticals and other chemicals. American losses to Chinese patent infringement and industrial piracy in the late 1980s and early 1990s was estimated to be approximately US \$400 million.<sup>89</sup> Intensive negotiations resulted in the signing of a second MOU in January 1992, just before U.S. trade sanctions were to go into effect.

The 1992 MOU focused on technical legal improvements to the Chinese IP regime, and the commitments therein were undertaken with great rapidity. China’s required accessions to the Berne Convention and the Geneva Phonograms Convention were accomplished in October 1992 and April 1993 respectively. Also in October 1992, China acceded to the Universal Copyright Convention, an action not required under the 1992 MOU. The NPC also issued regulations in September 1992 designed to implement the conventions and the terms of the MOU. The 1990 Copyright Law was amended, and the computer software was recognized under Chinese law as a literary work under the Berne Convention.<sup>90</sup> Consistent with Articles 1 and 2 of the MOU, China amended its 1984 patent law to extend protection for chemical and pharmaceutical products<sup>91</sup>, and presented instruments of accession to the Patent Cooperation Treaty on September 13, 1993. Consistent with the requirements of Article 4 of the MOU, the Anti-Unfair Competition Law, adopted on September 2, 1993, specified eleven types of actionable unfair competition, including infringement of trade secrets belonging to another party.<sup>92</sup>

By 1993, however, the piracy problem had worsened. While significant legal reform had taken place, enforce-

ment measures remained inadequate. From July 1993 through February 1995, a series of 21 intensive negotiations took place. Following a October 1993 visit to Beijing where then-Deputy United States Trade Representative Charlene Barchefsky characterized Chinese enforcement efforts as “essentially absent,”<sup>93</sup> USTR Mickey Kantor placed China on the 301 Priority Watch List. In its March, 1994 National Trade Estimate Report, the Office of the USTR found piracy in China to be rampant, particularly in the areas of audio-visual materials, publishing, and computer software.<sup>94</sup> The decision of whether to include China as a Priority Foreign Country was postponed sixty days; following the postponement, the USTR found that the Chinese government remained unwilling to take action against major IPR pirates, and on June 30, 1994 designated China a Priority Foreign Country.<sup>95</sup> Following a six-month investigation, the USTR proposed US\$1.08 billion in sanctions, mostly directed at goods originating from Guangdong Province.<sup>96</sup> Beijing retaliated with similar sanctions, but, as in 1991-92, the parties were able to reach a last-minute agreement, the 1995 Memorandum of Understanding.

#### IV. ADMINISTRATIVE ENFORCEMENT OF IP RIGHTS: THE 1995 MOU

The 1995 MOU committed the Chinese to substantial IPR enforcement measures, most of them focused on improved administrative protection of IP rights. The attached “Action Plan,” designed by the State Council Working Conference on Intellectual Property Rights (“IPR Working Conference”), proposed major changes in how IP rights were protected.

First, the IPR Working Conference became a national-level coordinating body for the various administrative agencies charged with IP protection. The self-ascribed purpose of the IPR Working Conference was to “coordinate and organize enforcement activities among provinces”<sup>97</sup> and to “achieve uniform and effective protection and enforcement of intellectual property rights[.]”<sup>98</sup> 22 Intellectual Property Working Conferences were to be created in the provinces and directly administered municipalities, to “organize and instruct the relevant authorities within regions and departments to investigate and substantially reduce infringement of intellectual property rights.”<sup>99</sup> Personnel of the National Copyright Administration (NCA), the State Administration for Industry and Commerce (SAIC), the China Patent Office (CPO), and the Ministry of Public Security (PSB) were directed to coordinate their activities under the regional IPR Working Conference. Significantly, the burden of enforcement was placed on local government; the People’s Governments at each level were called upon to furnish the “necessary guarantees” in terms of personnel, facilities, and operating budgets.<sup>100</sup>

Second, the powers of the administrative enforcement agencies were clarified and, in some cases, greatly expanded. Each enforcement agency was explicitly authorized in cases where “there is reason to believe” that infringement had taken place, to enter and search the premises, review the businesses’ books and records, and seal suspected goods and the implements used to make them.<sup>101</sup> When infringement was found, the enforcement task force had the authority to impose fines, order an end to the production, and seize infringing goods and the materials used in manufacture.<sup>102</sup> Suspected infringers could also be turned over to the People’s Procurate for criminal proceedings. These actions could be taken *ex officio*, on their own initiative, or on receipt of a right holder’s petition. In areas where the problem was “especially serious”, an ad hoc enforcement group was to be set up to take sustained action.<sup>103</sup> A fourth agency was added to the anti-piracy collage: the Chinese Customs service was revamped with American technical support, and granted the power to inspect and detain all infringing goods passing through China’s borders. Rights holders could apply to the Customs service if they suspected infringement, but the service was also expected to take action *ex officio*.<sup>104</sup> “Severe administrative penalties”, both financial and administrative, were to be imposed against infringers.<sup>105</sup> Finally, guidelines for patent, trademark, and copyright protection were to be published by the responsible agencies, and agencies were required to respond in writing to rightholder petitions within specific time frames.

Third, the 1995 MOU called for increased scrutiny of optical media production. Beginning March 1, 1995, all manufacturers were required to print a Source Identification Code, or SID, on all CDs and CD-ROMs produced. Further, every CD factory was to undergo re-registration, and those involved in pirate activity would be “subject to administrative and/or judicial penalties, commensurate with the level of infringement.”<sup>106</sup> The inspection and re-registration process was to be completed by July 1, 1995.<sup>107</sup>

Fourth, a system of intensive training and propaganda was to be established, in order to educate not only industry, but average citizens and government officials as well. Intellectual Property laws were to be incorporated into the State’s “knowledge-of-law” awareness program, “with the aim of providing training on intellectual property rights for over 50 percent of officials at or above the county and departmental ranks in all departments within one to two years.”<sup>108</sup> Additionally, 80 percent of persons in charge of research institutes, large and medium-sized enterprises, and educational institutes were to undergo IP training.<sup>109</sup> IP educational programs were launched at Beijing University, among others, and publicity campaigns were designed to spread information about IP laws and the importance of respecting them.

Finally, IP violations were to be included in the “Strike Hard Against Crime” campaign, a period of heightened criminal enforcement activity. For these periodic campaigns, additional manpower was allocated from the PSB and the People’s Procurate to punish infringers. Punishments and fines were increased for the duration of the campaign, and the State press featured articles about leading trials. In the 1995 MOU, the special enforcement period was to begin March 1, a week after the 1995 agreement was signed, and continue for six months. The campaign was to focus on key geographical regions<sup>110</sup> and specific sectors, such as audio-visual products, computer software, sound recordings, trademarks, patents, and unfair competition.<sup>111</sup> Where infringing activity in a particular region was not significantly reduced by August 31, the term of the special enforcement would be extended beyond the six-month period.<sup>112</sup>

### 1. Enforcement of the 1995 MOU

Under the 1995 MOU, the Chinese made a considerable commitment to reduce IP piracy. However, despite official claims that “China has . . . strictly fulfilled its obligations under [the MOU],”<sup>113</sup> enforcement remained lax, and piracy continued to grow dramatically. Under the 1995 MOU, the Chinese were obliged to close seven infringing plants and investigate and close all other pirate CD plants within three months. By November 1995, however, the USTR found that “[t]o our great dismay, China has instead re-registered . . . all but one of the CD factories.”<sup>114</sup> Production of pirated CDs continued to increase; by February of 1996, most analysts estimated the number of pirate plants at twenty-nine or more.<sup>115</sup> Moreover, production in many CD plants had shifted from music CDs to the higher value-added CD-ROMs, and exports of both CDs and CD-ROMs had not demonstrably declined. Finally, many of the administrative measures either belatedly implemented or entirely ignored. The commitment to require SID codes, for example, was not instituted until January 1996,<sup>116</sup> and even then, the State Press and Publication Administration’s order was only sporadically implemented.

Appearing before the Senate Subcommittee on East Asian and Pacific Affairs, then-Deputy USTR Charlene Barshefsky stated that although piracy at the retail level had been addressed, the Chinese had done little to attack the continued production and export of pirated goods.<sup>117</sup> The U.S. was particularly incensed that 29 known pirate CD factories remained in operation. China was warned that its implementation of the 1995 MOU would lead to another round of sanctions, greater than those previously considered.

China vociferously claimed compliance with the 1995 MOU – Lee Sands, the Assistant USTR for China and Ja-

pan, returned from an information-gathering trip to Beijing with literally scores of official Chinese documents<sup>118</sup> – but the U.S. demanded hard evidence of IP crackdowns.

China once again pledged to crack down on pirate production, this time providing a self-imposed June 1, 1996 deadline.<sup>119</sup> On March 13, China announced it had shut down three pirate factories, and another three were shut down on April 21.<sup>120</sup>

The U.S., however, was not satisfied with these measures; on April 30, 1996, the USTR named China a Priority Foreign Country under Section 301. On May 15, Acting USTR Barshefsky released a list containing US \$3 billion worth of Chinese goods which would be sanctioned if China did not take steps to improve implementation of the 1995 agreement.<sup>121</sup> Chinese officials threatened retaliatory sanctions on a similar scale.<sup>122</sup> As before, the U.S. and China reached a last-minute deal in June 1996 (the “1996 Agreement”).

The Chinese government agreed to more thoroughly implement four key provisions of the 1995 MOU: (1) closure of 15 infringing CD factories; (2) reinstatement of the Special Enforcement Period; (3) strengthened border enforcement, and (4) increased market access.<sup>123</sup> The Chinese government closed the Guangdong factories by revoking their business licenses, seizing materials and machinery used to produce bootleg goods, and prosecuting the persons responsible.<sup>124</sup> Additionally, the Chinese government announced a moratorium on construction of new CD plants, and banned the importation of any new CD presses.<sup>125</sup> Responsibility for enforcement was shifted to the Ministry of Public Security, which added thousands of enforcement officials to the IP enforcement effort.<sup>126</sup> Customs also stepped up enforcement efforts, seizing 20,000 pirated CDs and VCDs at Beijing Airport, and 16,000 CDs at the Hong Kong border.<sup>127</sup> The Chinese government also pledged to procure only legitimate software for use in government and research facilities. Finally, market access was again addressed; quotas on the import of foreign films were to be dropped, and China agreed to allow U.S. companies to co-produce movies, plays, and dramas for domestic audiences.

### 2. The 1995 MOU: Five Years Later

The 1999 “Report on Intellectual Property” recently released by the Chinese State Intellectual Property Office (SIPO) claims that in the five years since the 1995 MOU, some 72,000 suspects have been detained by the MPS and more than 79 plants producing optical-media products have been closed.<sup>128</sup> The National Administration of Press and Publications (NAPP) states that in last 5 years, 6,546 pirate “dealers” have been subjected to jail terms and 12, 179 copyright violators have been fined.<sup>129</sup> The USTR, citing China’s success in reducing export of pirated CDs, has

moved China from the Priority Foreign Country list to the less onerous Watch List.<sup>130</sup>

Detailed examination of the situation reveals that progress has in fact been much more limited. While trade sanctions were successful in promoting legislative revision at the national level, they were unsuccessful in promoting development of the infrastructure necessary to make those changes viable in the long term.

### 1. Export has shifted from optical media to counterfeit goods.

While the export of optical-media goods appears to have rapidly declined, the export of counterfeit goods poses a more serious problem. According to the 1998 Annual Report of the Recording Industry Association of America, active measures undertaken by mainland administrative agencies have led to a dramatic drop in the production and export of counterfeit CDs.<sup>131</sup> All 15 of the optical media facilities referenced in the 1996 Agreement have been shut down or converted to legitimate production, and the provisions for round-the-clock inspection appear to have been implemented. Indeed, many pirate operations have shifted production to Hong Kong and Macao, and the PRC is now a net importer of pirated optical media products.<sup>132</sup> Despite its own active efforts to crack down on piracy, Hong Kong was placed on the Priority Watch List by the USTR in May of 1998 because of a 3.5 percent growth in illegal production.<sup>133</sup> Commentators have suggested that the relative disparity of possible criminal sentences (Hong Kong law allows a maximum of 2 months imprisonment for counterfeiting, as opposed to the 7 years allowed under PRC law)<sup>134</sup> has played a role in this shift. Macao has also become an active supplier of pirated goods to other Pacific Rim nations.<sup>135</sup> These measures have had little effect on end-user piracy, however, as music, audio, and software CDs remain readily available in the mainland market.<sup>136</sup>

At least some export of high-value CD-ROMs appears to be continuing. John Chen, Chief Executive Officer of Sybase, Inc., a California-based maker of database systems, reported continuing problems with pirated software exported from the PRC. "They [the Chinese] not only copied our software, they were exporting it to Southeast Asia. You could see pirated copies in Singapore, Hong Kong and Malaysia."<sup>137</sup>

The mainland has become a major market to and exporter for manufacturers of counterfeit goods. One scholar working with the China Anti-Counterfeiting Coalition assessed the problem as "the most serious counterfeiting problem in the history of the world."<sup>138</sup> In May 2000, agents of Gillette and local officials seized 48,000 knockoff Parker pens, and some 4 million replacement "Gillette" razor blades. Much of the packaging had been rendered into Korean and Rus-

sian for export to those countries.<sup>139</sup> In a similar raid, Chinese officials seized more than 1 million fake Duracell batteries which had been loaded onto container ships bound for Spain and Malaysia.<sup>140</sup>

State-owned enterprises play a major role in the production and export of counterfeit goods. Japanese motorcycle manufacturer Yamaha invested some US \$93 million in three motorbike and engine manufacturing joint ventures in the early 1990s. The booming market for motorbikes has, however, not helped sales; within four months of launching a new model, says Masayuki Hosokawa, chief representative for the Beijing office, "copies of our machines came onto the market, and we lost money on the project." Hosokawa estimates that 88 local manufacturers, some state-owned, are copying Yamaha's popular 125cc scooter and selling it for some US \$1,450 versus the US \$2,300 the real ones fetch. Hosokawa also estimated that some 110,000 counterfeit Yamaha motorcycles were exported to the U.S., Europe, and South America in 1998.<sup>141</sup>

While sustained political action was able to reduce copyright infringement, the failure to the 1995 MOU to institutionalize legal reform within the Chinese system has simply shifted the problem to another sector, i.e. manufacturing and export of counterfeit goods.

### 2. Prevalence of local protectionism.

Standards and commitments articulated in Beijing have not been successfully implemented on the local level. Local protectionism is widespread, and poses the single most significant problem for those seeking enforcement of their rights. The trade in counterfeit goods has become "a vital portion of some local economies, providing employment of otherwise unemployable workers and generating significant revenue for the local economy."<sup>142</sup> In most jurisdictions, officials at the county and municipal level control appointments, dismissals, job transfers, salaries, housing, and other benefits for local enforcement agencies, public security officers, and judges. Higher level units of the enforcement agencies may control policies or reverse erroneous decisions of at the lower level, but are powerless to dismiss or sanction lower level officials for misconduct. Thus, faced with a choice between disobeying or ignoring a directive from a higher-level unit, and displeasing the local mayor who can terminate employment or arrange an undesirable job transfer, many local officials not surprisingly choose the former. When Kroll & Associates raided a factory producing fake Japanese motorcycles in Southern China, they had to bring in provincial-level authorities because the local police refused to cooperate.<sup>143</sup>

### 3. Lack of effective sanctions.

The Chinese press reported that some 400 individuals were convicted of copyright violations under the criminal law in 1996, and that another 300 were convicted in 1997 and 1998.<sup>144</sup> However, criminal convictions based solely on violation of intellectual property laws appear to be quite rare.<sup>145</sup>

Part of the problem is that cases are rarely transferred from administrative authorities to police and prosecutors for criminal prosecution. According to the 1997 SAIC Annual Report,<sup>146</sup> of the 15,321 trademark infringement and counterfeiting cases brought nationwide, only fifty-seven cases were transferred to judicial authorities for prosecution. In 1998, of the 14,736 trademark infringement and counterfeiting actions brought, only thirty-five cases were so transferred.<sup>147</sup> This low rate of transfer may result from an institutional cellularity which prevents effective cooperation between parallel enforcement authorities. It may also be a reluctance to part with the spoils of enforcement; under Chinese law, if a case is transferred from SAIC to the MPS, all seized goods, contraband, fees and fines payable are transferred as well.

Part of the problem is that new evidentiary and legal standards may be difficult to satisfy. New interpretations of Articles 214-217 of the Criminal Law issued by the Supreme People's Court on December 11, 1998 doubled the minimum threshold necessary for the imposition of criminal sanctions. The minimum threshold is now RMB 50,000 (US\$6,250) for individual violations and RMB 200,000 (US\$25,000) for institutional violations.<sup>148</sup> In addition, the courts have interpreted the RMB 50,000 threshold must be met by evidence of actual sales.<sup>149</sup> Thus, a warehouse filled with infringing goods would not allow imposition of criminal sanctions without evidence the merchandise was actually sold.

Fines are also too low to impose sufficient deterrent upon counterfeiters. The 15,321 cases brought by SAIC in 1997 resulted in total fines of RMB 86.34 million, or an average fine of US \$679 per case. Total compensation paid to trademark owners was RMB5.1 million, or an average of US \$40 per case.<sup>150</sup> In 1998, 14,216 actions resulted in total assessed fines of RMB85.5 million, or an average of US\$699 per case, and total compensation was RMB5 million or US\$ 41 per case. Part of the problem is that administrative enforcement agencies, because they rely in part upon fines for operating expenses, have a vested interest in seeing violations continue.<sup>151</sup> The incentive is to impose a relatively low fine that the counterfeiter can economically regard as a cost of doing business.

As with the imposition of criminal sentences, the problem is also one of evidentiary standards. Under Article 43 of the Trademark Law Implementing Rules,<sup>152</sup> for example, SAIC is directed to impose a maximum fine of up to fifty

percent of the illegal turnover or up to five times the profit obtained from the counterfeiting activity. SAIC also has authority to order the counterfeiter to pay compensation based on the infringer's profits or damages suffered by the trademark owner.<sup>153</sup> Because most counterfeiters do not keep detailed business records, it may be difficult for right holders to definitively demonstrate that the fine is inadequate.

#### 4. Corruption

Some local enforcement agencies ask for payment of "case fees," reimbursement of costs, and gifts such as mobile phones from rights holders before they will commence enforcement actions.<sup>154</sup> Case fees reportedly range from RMB 1,000 to RMB 5,000 (US \$120 - \$600), depending on the size of the case, but can be as high as RMB50,000 (US \$6000) for actions conducted by the MPS.<sup>155</sup> In one instance, a local MPS official asked a brand owner for a reward of RMB 50,000 per arrest per suspected counterfeiter.<sup>156</sup> Government agencies also routinely ask companies to reimburse the cost of lodging when required, the cost of hiring trucks to move confiscated goods, and the cost of storing the goods in a private warehouse.<sup>157</sup> According to one observer, "government officials at all levels regard power in their hands as a rare resource, and those who come to them with requests are 'clients' with whom they will strike various deals of 'power versus money.'" <sup>158</sup>

While the use of trade sanctions arguably may have accelerated development of IP legislation, it could not create the institutional infrastructure necessary for civil enforcement of the rights the new laws created. The demands of American negotiators placed tremendous pressure upon nascent Chinese legal institutions, and finding them unable to keep pace, discarded them for expeditious short-term administrative and criminal law remedies. The resulting reliance upon State ministries and police agencies to enforce what are in essence private, economic interests had a deleterious effect upon the rule of law within China as it strengthened the authoritarian hand of the Chinese state while acting as a barrier to further development of private, civil law remedies. The 1995 agreement *obligated* the PRC government to "consolidate [control over] all printing firms,"<sup>159</sup> to step up "state supervision and monitoring of the distribution of publications,"<sup>160</sup> to establish enforcement task forces authorized to "enter and search any premises" and "review books and records..." of private businesses.<sup>161</sup> The 1996 "Strike Hard At Crime" campaign, which included criminal enforcement of IP laws in accordance with U.S. demands, also led to thousands of arrests and 3,500 executions.<sup>162</sup> The measures have succeeded in slowing the growth of certain types of piracy, but unquestionably cast a

dark shadow over the development of law in China during a formative period.

## 5. Development of Civil Law Remedies

The existing IP regime, with its emphasis on administrative and criminal remedies, does not provide an effective remedy for rights holders in China. As the examples above illustrate, enforcement of IP rights is dependent upon the financial ability and political will of local and regional authorities to take action, and as such is vulnerable to corruption and arbitrary enforcement. While trade sanctions were able to achieve a reduction in the production and export of optical media goods, this short-term success was achieved only through the compelled initiative of the national government in Beijing and is not likely to be sustainable. In contrast, development of private civil remedies would take advantage of a decentralized structure driven by individual actors in the legal system.

Pursuant to the 1992 MOU, specialized intellectual property courts (“IPCs”) were set up in more than 20 provinces and municipalities, including Beijing, Shanghai, Guangzhou, Shenzhen, Fuzhou, Puijian, Haikou, Zhuhai and Shantou. Chinese courts of general jurisdiction have the power to issue orders for the preservation of evidence,<sup>163</sup> and award damages in a civil action, including reasonable costs of investigation and legal fees,<sup>164</sup> but the creation of specialized IP courts was intended to address concerns of foreign claimants by providing access to justices with specialized training and knowledge of foreign languages. From 1991 to 1995, the People’s Courts heard 15,543 IP cases, of which 3,080 concerned patents, 2,600 concerned copyright, 907 concerned trademark, and the remaining 8,956 concerned technology contract and other miscellaneous cases.<sup>165</sup> Further development of this system would not rely as greatly on government funding or policy priorities, and would provide more consistent and reliable protection for IP rights than dependence upon Chinese administrative agencies and bureaucrats.

The results of the 1995 MOU evidence the disparity between policy goals advanced in Beijing and the difficult conditions faced by local officials. A potential advantage to private enforcement remedies is that it reduces to a minimum the number of layers between policymakers and implementation;<sup>166</sup> the parties come before the court with a specific dispute which the court resolves by direct reference to the original text of the policy, i.e. law promulgated by the national legislature. To date, recourse to the courts has not been a tool widely employed by rights holders.<sup>167</sup> Administrative enforcement is faster, less expensive, and more reliable. Recent developments in IP legislation and judicial reform, however, indicate the existence of a continued emphasis on promoting development of a modern legal sys-

tem. Working with this consensus among reformers offers the best long-term hopes, for IP protection and ultimately for the rule of law.

### A. Continued Development of IP Legislation

The continued development of legislation governing intellectual property legislation and the judicial system point to the existence of an effective coalition in the national legislature supporting further development of the rule of law. While some of the impetus for reform undoubtedly stems from external considerations, most prominently China’s still-ongoing bid to join the WTO, it is also clear that Deng Xiaoping’s vision of a nation governed by law continues to resonate within the Chinese government.

A new Patent Law was enacted on August 25<sup>th</sup>, 2000 by the Standing Committee of the NPC and Jiang Zemin signed it into law immediately thereafter by Presidential Order No. 36.<sup>168</sup> The new law revised 36 of 69 articles to bring the law into conformity with WTO standards. The revised law imposes a legal duty of confidentiality upon patent agencies who prepare patents for clients,<sup>169</sup> and offers more protections for patent rights holders in the event of compulsory licensing.<sup>170</sup> The legislation also expressly grant the patent right holder the right to seek preliminary injunctive relief, provided certain conditions are met,<sup>171</sup> which is required by Article 50 of the WTO TRIPS standards. The law provides much-needed clarification of non-infringement situations, specifying criteria required for exhaustion of rights, prior-use rights and “innocent infringement” cases.

The new Patent Law also clarifies legislative authority by restating the State Council’s formal authority to implement rules for management of patent agencies, thus clarifying somewhat the existing murky legislative hierarchy. The law also confers additional explicit administrative powers upon SIPO to make public announcements of infringement, legally demand rectification and indemnification, confiscate illegally gains or fine the infringers up to RMB 50,000 where gains “cannot be proven.” Much of the law is a restatement or amplification of existing powers, but the formal delineation of SIPO authority and clarification of non-infringement use constitutes a credible improvement.

Improvements to the Trademark Law and the Copyright Law are also under way. On November 18, 1998 the State Council approved a new draft bill entitled Amendments to the Copyright Law and transmitted it to the NPC for further review and approval.<sup>172</sup> The NPC committees then began an extensive consultative process across the country; the draft apparently generated heated local debates and was returned for revision. A 1999 draft placed before the Standing Committee of the NPC by various ministries was rejected, and returned to the ministries for its failure to comply with TRIPS and equalize protection for foreigners and

Chinese nationals.<sup>173</sup>

## B. Development of the Judiciary

Part of the very weakness plaguing the Chinese judiciary stems from its rapid development; one survey indicates that the number of judicial personnel increased from 58,000 cadres in 1979 to 292,000 in 1995, of whom 156,000 were judges.<sup>174</sup> By 1997, there were 250,000 judges in the PRC.<sup>175</sup> Such expansive growth would strain any legal infrastructure, and is particularly problematic in a nation where fifty years of Marxist-Maoist ideology and the Cultural Revolution have effectively destroyed the legal profession. Partly because of this shortage, many retired officers of the People's Liberation Army (PLA) were appointed to the bench despite a lack of formal legal or academic training.

A draft revision of the Judges Law currently before the NPC attempts to address some of the problems plaguing the system. The law specifies that those individuals appointed as judges and prosecutors must be graduates of law schools who have been practicing law for at least 2 years, or postgraduates who have practiced for at least 1 year. Those who did not major in law must be "confirmed" as having the same level of legal knowledge, through education or examinations. The law also specifies that heads of courts, People's Procurates, and members of judicial supervision committees should be "selected from among those proven to be high-level legal professionals after passing relevant examinations." Courts and procurators are empowered under the revisions to revoke appointments of judges and prosecutors at the lower level institutions for not complying with procedures and requirements as provided for in the laws.<sup>176</sup>

The Supreme People's Court has also made public a five-year plan for reform. Xiao Yang, president of SPC, cautiously stressed that reform "will be conducted on a gradual basis", and that it "should not be rushed beyond the country's reality."<sup>177</sup> The stated goal of the reforms is to "establish a system where the judicial and supervisory authorities are able to exercise their rights in a just an independent way"<sup>178</sup>. As part of this process, courts in Beijing introduced an open trial system in December 1998. Except for cases closed by the operation of law, any citizen over the age of 18 can enter the court and listen to arguments presented there. The SPC has also begun to publish decisions of selected cases, together with commentary, on the court's web site.

A second systemic weakness which IP courts share with courts of general jurisdiction are the strict limitations which circumscribe the scope of judicial authority. The Chinese Constitution grants the Standing Committee of the National People's Congress sole authority to

interpret the Constitution and the statutes of the PRC.<sup>179</sup> Article 83 of the Organic Law of the People's Courts further emphasizes the proscription, stating that the Supreme People's Court power is limited to "... interpretation of any problems of the concrete *application* of laws or regulations in the course of litigation" [emphasis added].<sup>180</sup> The courts are also required to defer to administrative interpretations of law issued by ministries of the central government. These administrative agencies possess authority to issue regulations to implement specific legislation under grants of power by a legislative body, such as the NPC Standing Committee, but can also exercise inherent power which enables them to issue any rule necessary to carry out their functions. The court must even defer to an agency's interpretation of its own jurisdiction.<sup>181</sup> Given the generally poor quality of legislative draftsmanship and the relative inexperience of Chinese lawmakers with IP in particular, this interpretive straightjacket hinders the ability of the courts to refine and develop legislation. The Legislation Law, discussed *supra* at Part II, presents a mixed blessing for this problem. While the law clarifies the legal hierarchy amongst the Constitution, laws, various administrative orders, rules, and regulations at the national and local levels, and requires that legislation expressly identify its authority and be published, it denies the Supreme Court and the People's Courts at all levels the authority necessary to interpret competing regulations and their relative authority. Under the Legislation Law, a conflict between agencies or laws would presumably be referred to the legislature for correction, an inefficient and time-consuming resolution, at best.

Finally, while few commentators doubt a strong desire on the part of the Chinese leadership to foster a greater respect for and observance of law, the Communist Party's intention to maintain absolute control over the judiciary is equally clear. The same clause of the 1982 Constitution which requires all organizations to obey the law also expresses the absolute supremacy of CCP authority. As Stanley Lubman, a noted scholar of Chinese legal development, writes:

the conventional approach in Chinese doctrine today acknowledges CCP supremacy and treats legislation as an expression of CCP policies and as an instrument to implement those policies. Even after policies have been given legislative expression, they are frequently modified in practice by CCP directives, speeches by leaders, and newspaper editorials. Legislation, then, is at all times dependent on

and potentially secondary to CCP formulation of specific policies.<sup>182</sup>

Transmission and observance of Party directives within the judiciary is primarily assured through strict Party control over the appointment and removal of judges. Selection and retention of chief judges at each level in the hierarchy is decided by the People's Congress of the corresponding level. Appointment and removal of judges above the rank of assistant judge is made by the chief judge, and must be approved by the Standing Committee of the People's Congress legislative body at that level.<sup>183</sup> Despite the availability of graduates from reopened law schools, the practice of appointing former military officers as judges to the People's Courts has continued; as Lubman convincingly argues, the retention of PLA personnel probably stems from their perceived loyalty to the Communist Party as a "soldier of the state."<sup>184</sup>

### C. Cases of Note

Despite these admittedly considerable difficulties, recent cases demonstrate the increasingly competent and effective resolution of intellectual property claims in the Chinese courts. The cases also demonstrate the Court's growing familiarity with complex issues of intellectual property rights in the Internet age, and illustrate some of the technical shortcomings which must be overcome if the courts are to provide a truly effective deterrent.

On June 20 of this year, the Beijing Second Intermediate Court handed down judgement over the dispute name "ikea.com.cn". In *InterIKEAS Systems (China) Ltd. v. China International Network Corporation, Ltd. (CiNet)* (hereinafter referred to as IKEA or the IKEA case), the court ordered CiNet's registration of "ikea.com.cn" be terminated immediately because it violated plaintiff's "well-known mark". Plaintiff, the Dutch corporation InterIKEA Systems B.V. had opened home furnishing retail stores in Shanghai and Beijing, but had not previously registered the mark. In its decision, the Court referenced Article 5, Section 2 of the Anti-Unfair Competition Law, Article 6 of the Paris Convention, and a WIPO Final Report on Domain Name Processes in determining what constituted a "well-known mark", explicitly declining to defer to the findings of a SAIC report on the matter. The court's straightforward use of international materials, its willingness to disregard the findings of the SAIC, and the dissemination of its well-reasoned decision demonstrate a considerable degree of legal sophistication.

In *Wang Meng, et al v. Beijing Cenpok Intercom Technology Co., Ltd.* (the Beijing Online case), six renowned writers filed civil suit before Haidan District People's Court in Beijing, charging Beijing Online, one of the largest

Internet access and content providers in China, for unauthorized and illegal distribution of their works via the online service. The authors sought extensive damages, including compensation for economic loss and alleged mental suffering. On September 18, 2000 the district court ruled in favor of the plaintiffs, and awarded Y26,580 (US\$3200) in compensatory damages, but rejected any award for mental distress. The defendant appealed to Beijing First Intermediate People's Court, arguing first that the Copyright Law did not apply to works posted on the Internet. In finding that Internet publication was actionable under the Copyright Law, the court looked to the broad description of author's rights provided by Article 10 and the nonexclusive language of the definition of "exploitation" found in subsection 5 of that article, even if the Internet medium was not explicitly mentioned. The court also rejected arguments that the Internet "posting" should be treated as fair use or permissible statutory license because there was no profit-taking involved, holding that unauthorized reproduction and distribution of copyrighted works over the Internet is likely to cause more damage to the right holder's copyright given the broad scope of transmission possible. The court recognized that neither the facts of the case nor applicable law offered a clear guideline for calculation of damages, and held simply that the lower court's award of compensatory damages was "not unreasonable". While the case again demonstrates solid reasoning and deft statutory interpretation, it also underscores the need for legislative guidance in determining appropriate damages.

The *Microsoft Corporation (China), Ltd. v. Beijing Yadu Science and Technology Group* (the Microsoft case) marks the first time a major software manufacturer went directly after an end user for copyright infringement in China. On November 17, 1998 Microsoft agent China United Intellectual Property Investigation Center (CUIPIC) joined personnel of the SAIC Haidan District Bureau in a raid of the Yadu Building in Beijing, and discovered more than a dozen pirated titles of its software being used on Yadu Group computers. The official investigation report contained certified statements of two engineers of Yadu where they admitted that at least 50 computers in the complex had more than 10 different types of pirated Microsoft software installed. Microsoft sued for RMB 1.5 million in lost profit, investigation and evidence collection costs, litigation and attorney fees, and also asked the court for an injunction barring further use and a public apology as per Article 46 of the Copyright Law and Article 134 of the General Principles of the Civil Law. The defendant was able to dismiss the charges, however, by claiming that it was not the proper party in the lawsuit. The raid was conducted against another company by the same name (Beijing Yadu Science and Technology, Ltd.) which was alleged to be completely independent from Yadu Group, despite the fact that the com-

panies shared office space and retained the same individual as legal representative and Chairman of the Board. It was uncontested that the engineers who admitted to the existence of the pirated software were both employees of Yadu Group. While Microsoft plans to refile against Yadu Ltd., spokesmen expressed concerns that the assets of the subsidiary would disappear. The case demonstrates the necessity for more independent judicial development of case law; in this instance, determining whether to “pierce the corporate veil” decided Microsoft’s rights, and may have a similarly deleterious impact on the ability of Chinese citizens to recover against corporations.<sup>185</sup>

#### D. Conclusion: Development of the Chinese Courts

Clearly, the limited powers and institutional constraints placed upon the Chinese judiciary detrimentally affect its ability to fully protect the rights of claimants before it. It is equally clear that between the priorities of maintaining order and developing the rule of law, the former will have absolute precedence in the minds of the national leadership. Yet the foundation for the development of a system of enabling rules has been laid, and while political independence of the courts cannot be expected, a increasing degree of institutional competence can be expected. A functional approach geared towards improving transparency, consistency, predictability, and the adaptability of the courts is not invalidated by political control at the national level.

The prevalence of local protectionism remains the greatest impediment to the effective adjudication of matters brought before the court. Removing or diminishing the local’s governments direct control over court personnel and finances would reduce this problem, potentially quite significantly. It appears that local protectionism is much less of a problem at courts of the intermediate and higher (provincial) courts, where the corresponding level of government has a much more tenuous connection with local finances.<sup>186</sup>

Except for the new Patent Law, there is no explicit right to preliminary injunctive relief in intellectual property litigation. Article 97 of the Civil Procedure Law, which allows for enforcement prior to judgement provided certain conditions are met, might be interpreted to allow for such measures. More explicit statutory authority would improve the existing regime. Such a measure would offer the plaintiff in copyright and trademark infringement cases the ability to enjoin further violations pending a full hearing; delays in full litigation would benefit the rights holder, and not the infringer. Such a remedy is required under Article 44 of TRIPS.<sup>187</sup>

Finally, the formulation of an effective contempt power is necessary to back up the court’s commands. Article 313 of the 1997 Criminal Law provides that “Whoever refused

to carry out a decision or order made by a people’s court while he is able to carry it out is to be sentenced to not more than three years of fixed-term imprisonment, criminal detention, or be fined if the circumstances are severe.” Currently, orders freezing accounts and assets are flagrantly flouted. Replacing the cumbersome criminal measure with a civil contempt power, enforceable without the necessity of a full-blown criminal trial, would enable to courts to deal more effectively with those who ignore judicial commands. By pursuing targeted, incremental reforms in a less confrontational manner, IP rights holders working in tandem with American policy and reform coalitions in Beijing can bring life to the existing skeletal legal structure.

## VI. CONCLUSIONS

### A. China and the WTO

Since the conclusion of the 1995 MOU, the American political leadership has pursued IP negotiations and rule-of-law reform in the context of China’s bid to rejoin the WTO. A bilateral agreement on China’s accession was concluded on November 15, 1999, and passed through the U.S. Congress only after a heated legislative battle. As part of the agreement, China agreed to implement the TRIPS standards immediately upon accession<sup>188</sup> and to adhere to the transparency standards articulated in GATT Article X(1).<sup>189</sup>

Bilateral agreements were soon concluded between China and the European Union, and final negotiations are currently underway on the integration of the bilateral agreements into a single WTO accession agreement. However, what in the past has been largely a technical exercise has proven to be enormously difficult; in the rush to conclude bilateral agreements (and win domestic constituents) specific measures for the implementation of China’s commitments were glossed over, and disputes over these details have threatened to derail the entire process. Problem areas include licensing procedures, protection of standards and intellectual property, trademarks and copyright, trading rights for foreign companies and China’s state trading companies, and an overall concern about China’s lack of a free, fair and independent judicial system.<sup>190</sup> Beijing’s chief negotiator Long Yongtu argues that the Western nations are trying to renegotiate the bilateral commitments, seeking additional concessions regarding their implementation: “I don’t think WTO-Plus is fair to China. If we accept this, it would set a precedent for other developing counties.”<sup>191</sup>

Examination of China’s efforts to join the WTO and her adherence to previous international accords, however, cast substantial doubt upon whether the agreement will in fact be fully implemented. Indeed, both sides may have unjustified expectations about the impact WTO membership will have.

Zhu Rongji, the architect of China's recent economic reforms, was initially reluctant to seek WTO membership; certainly he seemed less interested than Jiang Zemin and Vice Premier Li Lanqing, apparently because of concerns regarding China's ability to implement free-market standards so rapidly. But as his plans to reform the SOE economy ground to a near-halt, Zhu came to see international influence as an external pressure useful to promoting reforms.<sup>192</sup> Faced with declining foreign investment for the first time in 15 years, China's leaders also hope that WTO admission would boost exports and shore up foreign investment.

Expectations in the West that WTO integration will promote rule-of-law development similarly exaggerate the institutional capacity of the WTO. The WTO dispute resolution procedures, while strengthened by the reforms of the Uruguay Round, still depend in large measure upon the willingness of its members to implement decisions; the ongoing conflict over European Union policies regarding imports of bananas from Latin America demonstrate the importance of voluntary adherence to standards to the success of the trade regime.

China's record of adherence to such international agreements, even outside the context of the IP agreements discussed above, is not positive. In the Market Access Agreement, concluded in 1992, China agreed to eliminate import-substitution policies. For some years, economic planners in China had utilized restrictions on import licenses to spur domestic manufacture of automobile components, pharmaceuticals, power-generating equipment, consumer electronics, and other items. As part of the agreement, China agreed to phase out import licenses and not raise new barriers. Shortly after abolishing import licenses, however, new import registration requirements were initiated for many of the products previously covered by licenses.<sup>193</sup>

China's adherence to the international Multi-Fiber Agreement (MFA) has also been problematic. Under the framework of the MFA, the U.S. and China negotiated a series of bilateral agreements which imposed a quota on textile imports. During the early 1990s, the USTR determined that China repeatedly violated the agreement by transshipment of goods via Hong Kong and Macao. The U.S. Customs estimates the value of the transshipped goods at US \$2 billion annually.<sup>194</sup> In 1997, China and the U.S. reached a four-year textile agreement that strengthened penalties and reduced quotas in 14 apparel and fabric categories where there had been repeated instance of transshipment. But less than one year later, in May 1998, the USTR and U.S. Customs brought an action against China under the agreement, imposing a penalty of US \$5 million for the continued transshipment of textile goods.<sup>195</sup>

Whether a lack of political will or weaknesses in institu-

tional capacities are to blame, the poor implementation of the 1992 Market Access Agreement and the Multi-Fiber Agreement suggest that China's achievement of WTO standards may be a long and circuitous path, largely dependent upon the outcome of internal political and economic dynamics.

## B. Trade Sanctions

The use of high-profile trade sanctions removes what should be technical and legal trade issues to the arena of political debate; as William Alford has observed, the resulting "secular morality plays" dangerously oversimplify the diversity of the actors and interests involved and the complexity of issues they confront.<sup>196</sup> Despite voluminous scholarship exploring the complexities of central-local government relationships in China, for example, American negotiators continued to insist that Beijing's ability to ensure local compliance was simply "a matter of political will." The very real difficulties facing the government in Beijing became lost in a rhetoric charged with righteousness and nationalism, and the appearance of rapid progress became more important than potential long-term effects.

The negotiation and implementation of the IP agreements in the 1990s also evidences the impact such strategies may have on domestic coalitions. Pressures introduced by foreign negotiators become part of the domestic policy environment in Beijing as different coalitions embrace or reject the implications of the sought-for reforms.

As one study notes, the "losers" in this ongoing bureaucratic process are unlikely to abide by policy position issued by the "winners," and will use the dislocations caused by the changes as ammunition against the "winning" coalition.<sup>197</sup> The demands of foreign negotiators, glaringly exposed in a public forum, can force a domestic coalition genuinely interested in reform to choose between the Scylla of foreign demands and a Charybdis of their concomitant domestic implications. The public disclosure of the concessions allegedly offered by Zhu Rongji during his April 1999 visit to the U.S. very nearly wrecked the negotiating process and almost cost Zhu his position; he was mercilessly abused in the state-run Chinese press, with some commentators even referring to the concessions as "Washington's New 21 Demands" in reference to Japan's infamous 1915 attempt to reduce China to colonial status.<sup>198</sup> Indeed, one of the arguments pressed upon the American Congress was that WTO admission would "help the reformers" within the Chinese leadership, conveniently forgetting the Clinton administration's disastrous record in "helping" reformers in Russia.

Finally, the use of high-pressure tactics discredit the message of respect for rights and the legal processes by which

they are protected. The exercise of raw economic power via trade sanctions resurrects the ghosts of imperialism, memories which are very much alive in present-day China. The imposition of additional administrative channels to protect intellectual property jars dissonantly with loudly articulated concerns with human rights and the rule of law, and undermines the legitimacy of legal institutions in the minds of many Chinese.

### C. American Policy and the Rule of Law

While the use of trade sanctions arguably promoted rapid development of positive rules protecting intellectual property, they could not and did not promote genuine rule of law reform. As the Nationalist period demonstrates, the existence of rules alone is meaningless without a system capable of realizing their effective implementation. Nesting a system of enabling rules within the domestic polity is a complex process necessarily unique to local conditions. "Political culture comprises enduring values and practices

central to a nation's identity, which foreigners perforce should not too readily assume they have either the moral authority or capacity meaningfully to influence."<sup>199</sup>

That is not to say, however, that there is no role for the U.S. government and Americans to play. The United States has a surfeit of legal experience and knowledge, knowledge which would be well-used to help develop the basic components of legal infrastructure in China. Clinical education programs, exchange programs, and the involvement of NGOs and private actors within the Chinese sphere can aid in the drafting, development, and further study of statutes, and enrich the experience of Chinese law students and lawyers. The involvement of corporations doing business within China can also be a positive element, helping to develop domestic constituencies and breathe life into the formal legal system. Finally, low-profile and targeted use of trading rights can help promote the development of a rule-based market economy. But all parties need to recognize the necessity of a long-term approach, and eschew the high-profile, contentious atmosphere of the secular morality play.

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# Long March, Bitter Fruit: The Public Health Impact of Rural-to-Urban Migration in the People's Republic of China

Peter Hansen

Few cases in the comparative study of internal migration systems have drawn as much attention or elicited as much controversy as the People's Republic of China. Over its first decade of rule, the Chinese Communist Party crafted a two-tiered social, economic, and political system that bifurcated society along a rural-urban axis. Policies adopted during this period favored the growth of urban industry at the expense of rural welfare, with peasants receiving little in exchange for mandatory grain sales that helped subsidize an extensive social security system for the urban labor force.<sup>1</sup> Buffered from the chronic malnutrition, high infant mortality and low life expectancy that characterized life in the countryside, the urban public health environment became the envy of the developing world. A household registration and grain rationing system that functioned as a "de facto internal passport mechanism" effectively restricted migration between these polar worlds.<sup>2</sup>

The dismantling of the grain rationing system and return of a cash economy and petty capitalism in the early 1980s partially broke down the 'invisible walls' encircling Chinese cities by weakening many of the Mao-era migration control measures.<sup>3</sup> Although still registering all households as urban or rural, the state acquiesced by the mid-1980s to allow peasant migrants to make a temporary home in the cities.<sup>4</sup> By filing the appropriate paperwork and paying a fee, a peasant can now engage in temporary work in a city, but cannot participate in the urban welfare system without a formal urban *hukou*, or household registration. It is estimated that at any given time 40-100 million peasants are away from their formal places of residence and working or seeking work in urban areas.<sup>5</sup> A few stay permanently in cities, where they live as aliens outside of the system, while the majority engages in short-term or seasonal work before returning to the countryside. Most neglect to notify urban officials of their arrival, because of the low benefit and variable costs involved.<sup>6</sup>

Peasant migrants have become a nameless but not faceless presence in Chinese cities. They are a highly visible subpopulation, identifiable by their physiques, skin tone, clothing, and dialects. They comprise more than 20 percent of the population of Shanghai, 25 percent of Beijing, 33 percent of Guangzhou, and 37.8 percent of Hangzhou.<sup>7</sup> Dorothy Solinger and others have argued that the social

status of these migrants parallels the status of illegal aliens living in foreign countries.<sup>8</sup>

Numerous studies have analyzed internal migration in China—its causes and effects on agriculture and urban economies have drawn much attention and spawned ongoing debate. Few studies, however, have looked directly at the health impact of rural-to-urban migration in China. Most analysts view non-*hukou* migration—that is, migration without the formal transfer of *hukou* from rural to urban locale—as an act that entails considerable hardship yet leads to a substantial increase in earning power. These factors clearly have a bearing on health, but the overall impact of migration on public health has not been well delineated. Does the hardship endured by peasant migrants lead to a corrosion of health? Or do higher wages and a more 'developed' urban environment bring about an improvement of health? Do migrants place a strain on the urban infrastructure and contribute to a deterioration of the broader urban public health environment or do they provide benefits to urban host communities? Can the wages remitted home by migrants alleviate rural poverty—or is disease more likely brought home than the means to improve the local standard of living? This paper intends to pursue answers to these questions by examining the positive and negative health effects of non-*hukou* rural-to-urban migration on three distinct groups—the migrants themselves, receiving area communities, and sending area communities.<sup>9</sup>

## POSITIVE EFFECTS ON THE HEALTH OF MIGRATING INDIVIDUALS

### Income Gain

Since the decision to seek work in an urban area is predominantly motivated by a desire to enhance individual or household earning power,<sup>10</sup> income gain is the logical starting point for this analysis. Although the relationship between income and health is anything but clear, it is assumed that poverty and ill health are strongly associated. Poverty in the Chinese countryside is much more than a lack of pocket money—it is a major cause of infirmity. More rural Chinese die as a result of diseases associated with poverty than the non-communicable diseases responsible for most

urban mortality.<sup>11</sup>

Although rising incomes have been associated with the adoption of less healthy diets and lifestyles in other contexts, the money earned by migrant workers in China is more likely to allow them to gain ground against poverty than accumulate wealth. The high ratio of persons to acres of arable land, the rising price of inputs such as fertilizer and pesticides, and intense competition have kept agricultural incomes low throughout much of China. Without supplementing household income through non-agricultural labor, many rural families have great difficulty making ends meet. Working in cities allows migrants to make three or four times as much as they would in the countryside,<sup>12</sup> even though most make considerably less than workers with formal urban residency. A minority of migrants, such as those involved in scrap collection, earns more than most locals,<sup>13</sup> but the majority earns considerably less. Although it is difficult to generalize, the money earned by migrants more often than not represents a much-needed supplement to regular household income.

#### **Access to better food and water**

The quality of migrant diets varies considerably, but a significant number of migrants have access to better food and water than their rural compatriots. Although rural diets have improved considerably since the initiation of reforms in the late 1970s, urban diets remain significantly better.<sup>14</sup> Whether rural migrants realize an improvement in their diets when they move to urban areas depends on what types of jobs they hold. Nannies tend to live and eat with the families for whom they work and therefore improve their diet considerably.<sup>15</sup> Others, such as those working in the food services, take their meals onsite and tend to eat a sufficiently balanced diet. As addressed in the following section, however, migrants working in many other sectors have inadequate diets.

Water quality, while highly variable even within one region, tends to be higher in urban areas. According to World Bank statistics, 87 percent of urbanites and 68 percent of rural residents have access to clean drinking water.<sup>16</sup> Other statistics reflect a similar rural-urban discrepancy. One study states that levels of contamination with animal and human excreta often exceed permissible levels by as much as 86 percent in rural areas and 28 percent in urban areas.<sup>17</sup>

In recent years, new sources of contamination have compounded water pollution problems in the countryside. The use of chemical pesticides and fertilizers doubled between the mid 1980s and mid 1990s and these products have found their way into drinking supplies in high concentrations.<sup>18</sup> The World Resources Institute (WRI) has identified the rapid development of Township and Village Enterprises and the

absence of regulation of their environmental impact as another major source of pollution in the countryside.<sup>19</sup> Wu et al have found high levels of organic matter, acids, alkalis, nitrogen, phosphate, phenols, cyanide, lead, cadmium, mercury, and bichromate in rural water supplies, with mercury concentrations 45 to 700 percent and lead concentrations 3600 to 5216 percent higher than standard.<sup>20</sup>

Unclean drinking water has exacted a heavy toll on the health of both rural and urban populations. High rates of diarrhea, hepatitis, ascariis, hookworm infection, trachoma, and dracunculiasis have all been linked to water pollution,<sup>21</sup> and flourosis is a major problem in the rural North.<sup>22</sup> The two leading infectious diseases in China over the last two decades—diarrheal diseases and viral hepatitis—are associated with fecal pollution of drinking water.<sup>23</sup> Polluted water is also a prime suspect in the etiology of liver and stomach cancer, two leading causes of death in rural China.<sup>24</sup> Liver cancer deaths have doubled in the last twenty years and are now the highest in the world.<sup>25</sup>

It is likely that some migrants consume cleaner water in urban areas than in their rural homes and may enjoy a resulting improvement of health. As noted in a following section, however, many migrants have little access to clean water even in areas where formal urban residents drink relatively clean water. Moving to an area with cleaner water benefits only those migrants who have access to the treated water supplies enjoyed by local residents, especially boiled water.

#### **Access to superior health services**

The health service infrastructure in urban areas is far superior to that of rural areas. The per capita number of doctors, nurses, clinics, and hospital beds is significantly greater, while medical staffs tend to be better trained and health equipment more technologically advanced.<sup>26</sup> A few migrants, especially those working in coveted state sector jobs or certain joint venture factories, do enjoy a minimum level of health coverage.<sup>27</sup> The great majority, however, can access health services only on a fee-for-service basis. The rapidly rising cost of health services has priced most migrants out of the market. Moving to an area with higher quality health services thus offers little benefit to most migrants, who are in fact less likely to make use of the expensive health services in urban areas than near their rural homes.<sup>28</sup>

#### **Cultural and social experience**

While the subjective advantages of experiencing life in the city are difficult to quantify, some migrants—especially women—report a sense of satisfaction that results from a

perceived improvement in their cultural life and social status.<sup>29</sup> Many nannies and female factory workers claim a newfound sense of power, self-esteem, and autonomy.<sup>30</sup> This derives in part from having their own income and also from their personal encounter with an urban conception of male-female relations that is more egalitarian than found in much of the countryside. Nannies, who spend months or years living with urban families, return to the countryside with new conceptions of love, companionate marriage, home comforts, and smaller families.<sup>31</sup> These changes, while largely positive, can in some cases lead to frustration when the female migrant becomes reacquainted with the entrenched social system at home. At the very least, though, women tend to retain a new measure of control over household resources—a few even exercise a new ability to buy their way out of unhappy marriages.<sup>32</sup>

Christopher Smith suggests that the power that comes with the ability to contribute to the household budget may help curtail the deterioration of rural women's health that has resulted from the dismantling of the collective health care system.<sup>33</sup>

### *NEGATIVE EFFECTS*

#### *ON THE HEALTH OF MIGRATING INDIVIDUALS*

##### **Risks and costs inherent in traveling to, and getting established in, urban centers**

Migrants face a great number of risks between the time they leave their rural homes and settle into jobs and living arrangements in the cities. The expense and perceived danger involved in transportation deter many from engaging in migration.<sup>34</sup> The substantial cost of transportation is a major reason that it is generally not the poorest of the poor who migrate, but those with at least a minimal amount of capital.<sup>35</sup> Migrants commonly fall victim to crime while en route. Moreover, the transportation infrastructure is poor and automobile accidents represent a significant and rising cause of morbidity and mortality.

Although many migrants have prearranged jobs and coordinate their move through networks of friends and relatives, many have no job lined up when they arrive and stay on the streets until they can find a job and a place to live.<sup>36</sup> Many take just enough money for transportation and find themselves isolated in a foreign city without the means to return home after failing to find a satisfactory job.<sup>37</sup> This group is particularly vulnerable to exploitation. Women in particular are often bullied, raped, or dragged into prostitution.<sup>38</sup>

In order to secure a job in an urban enterprise, migrants often have to pay a substantial fee or buy into a "loan."<sup>39</sup> Job contractors take money in advance and often provide misleading information or disappear without rendering

promised services.<sup>40</sup> Thus, peasant migrants often assume risks and invest precious capital without realizing any return.<sup>41</sup>

##### **Vulnerability and lack of legal protection once settled**

Even those who find jobs and an adequate place to live lack legal protection and remain vulnerable to exploitation. Paychecks are often withheld from migrant workers and promises broken with impunity.<sup>42</sup> Once owed back pay, migrants are often unwilling to give up the chance of regaining their back wages by cutting their losses and walking away and thus continue to subject themselves to unjust treatment. Contractors, managers, and bosses know that migrant workers are often desperate for work—regardless of low pay and poor treatment—and have few means of defending themselves in disputes. Migrant workers, especially those who have not filed the appropriate paper work, are highly unlikely to seek the aid of police or other state security officials for fear of detainment or deportation. Migrants have enough trouble with the local authorities without actively seeking them out.

In addition to arresting migrants for minor offenses, police often target them as suspects and detain them without evidence.<sup>43</sup> Municipal officials and the urban public alike associate peasant migrants with rising crime and social disorder. A recent political campaign against crime culminated in the rapid arrest and execution of several migrants who did not have the benefit of a fair trial.<sup>44</sup>

Officials in Beijing and other cities tidied up for events marking the celebration of the return of Macao and the 50<sup>th</sup> anniversary of the founding of the People's Republic by clearing peasant migrants and other unattractive elements off the streets. Security forces ejected or detained illegal migrants and threatened action against any hotel, boarding house, or hostel that gave them shelter.<sup>45</sup> Human Rights in China reported that conditions in migrant detention centers are exceptionally grim, with detained peasants lacking access to sanitation facilities, suffering beatings, and not being allowed to leave until paying a fee.<sup>46</sup>

##### **Occupational disadvantages**

Migrants tend to take the dirty, dangerous, and low-paying jobs spurned by local residents. Rates of work-related illness and injury are very high. One-fifth of the migrant workers in the Pearl River Delta foreign-invested factories sustained work-related medical difficulties.<sup>47</sup> These workers exhibited especially high rates of anemia and white blood cell abnormalities, suggesting they suffer from a poor diet or exposure to lead or mercury poisoning.

Industrial accidents are also very common. Accidents

on construction sites, for instance, have claimed numerous lives.<sup>48</sup> Fires also represent a significant cause of death. A fire in a raincoat factory whose doors and windows were locked killed 60 workers in Dongguan in 1991,<sup>49</sup> and a fire in a Shenzhen factory claimed 80 more workers two years later.<sup>50</sup>

Despite the above-mentioned improvement in diet enjoyed by nannies and some food service workers, migrants in many other occupational sectors have rather meager diets. One study states that members of Beijing construction teams eat a diet that consists of porridge in the morning and three steamed rolls and boiled white cabbage for both lunch and dinner.<sup>51</sup> A survey found that this poor diet was one of the primary sources of dissatisfaction among migrant construction workers.<sup>52</sup> It is assumed that engaging in intense physical labor while subsisting on nutritionally deficient fare is a significant cause of ill health.

### Housing and sanitation

Poor housing is a common problem shared by peasant migrants in many different contexts, but in Chinese cities housing problems are especially severe. The majority of urban residents receives housing from their employers or the government at a subsidized rate. The small but growing free market for housing serves primarily the foreign community and the new indigenous entrepreneurial elite. With no access to subsidized housing and no means of affording expensive free-market housing, rural migrants have few reasonable housing options available.

One common strategy involves several migrants pooling their resources and renting a room from an urban resident, but several municipal governments have largely negated this option by making it illegal for urban residents to rent space to migrants.<sup>53</sup> The police levy heavy fines on urban residents caught violating this law.<sup>54</sup> When migrants do find rooms, they tend to crowd into them to lower the per person cost. A typical room may house four to five adults, an equal number of sewing machines, one or more infants, and only two or three beds—all within ten square meters.<sup>55</sup> Many never succeed in finding shelter in a permanent structure. A minority sleeps outdoors or under bridges, while many use cardboard, bamboo, cloth, or a number of other available materials to construct their own makeshift housing.<sup>56</sup> Such shelters naturally lack electricity, water, and often furniture. Scrap collectors tend to live near the trash heaps on which they make their living, often sleeping inside makeshift structures crafted from materials collected from the trash heap itself.<sup>57</sup> Migrant construction teams tend to sleep on site in crowded tents or other temporary shelters.<sup>58</sup>

Some build their own brick or cement structures within new migrant enclaves, such as Beijing's Zhejiang Village.

This enclave consists almost exclusively of migrants from two counties in Zhejiang Province. Running a sophisticated network of textile production lines, members of this enclave have created a mini-society within the center of Beijing, replete with self-run school, clinics, and businesses. In 1997, however, municipal security agencies destroyed the majority of structures in this community in a massive bulldozing effort.<sup>59</sup> This community has since been rebuilt, but migrant enclave communities face an uncertain future in Chinese cities.

The migrant housing problem is intimately tied with the growing sanitation problem in Chinese cities. A significant portion of migrants lives without access to adequate sewage facilities. One survey indicated that only 11 percent of peasant migrants in Shanghai had regular access to toilets.<sup>60</sup> Where toilets do exist they often drain to open sewers that line roads running through densely populated areas. Some areas have only pits for defecation along the side of the street. Many migrants also lack convenient access to washing and showering facilities. Public faucets and even decorative fountains often provide migrants with their best source of water for cleaning.<sup>61</sup>

Excluding peasant migrants from decent housing and failing to address the sanitation needs of the dense migrant population have created conditions that promote the spread of disease. Diarrhea, hepatitis, and measles have become increasingly serious problems among migrant populations.<sup>62</sup> Even diseases that had hitherto been eradicated from Chinese cities, such as malaria and polio, have reemerged in migrant slums.<sup>63</sup> One study has identified a high incidence rate of tuberculosis among peasant migrants in Beijing.<sup>64</sup>

### Lack of access to health and social services

As alien members of urban societies, peasant migrants have no entitlement to the urban welfare system. As stated above, fee-for-service health care exists, but its high cost renders migrants likely to seek care only as a last resort if at all. Preventive programs are almost non-existent. Even vaccination programs—long viewed as a strong point of the Chinese system—fail to include migrant children, for whom the need is greatest.

One study demonstrated that overall coverage of BCG, OPV, DPT, and MV was under 35 percent in children of migrating families.<sup>65</sup> This figure is far below the level of coverage enjoyed by both urban children and non-migrating rural children, for whom vaccination rates are reported to be well over 90 percent.<sup>66</sup>

The proliferation of advertisements for private STD clinics around migrant enclaves is a strong indication of the high prevalence of STDs among migrant workers.<sup>67</sup> Young rural women who move to the cities to work voluntarily or involuntarily as commercial sex workers and the young

peasant laborers who frequent them have fueled China's growing HIV/AIDS epidemic.<sup>68</sup> *AIDS Weekly Plus* reports that 96 percent of migrant workers are sexually active, but only 10 percent know how to prevent the transmission of HIV.<sup>69</sup> The failure to educate peasant migrants on the modes of HIV transmission and to promote feasible preventive measures has laid the groundwork for an epidemic that will not only impact the health of migrant populations, but likely spread throughout the nation.<sup>70</sup>

The lack of access to general education represents another major problem. One study states that only 40 percent of migrant children in Beijing are enrolled in school.<sup>71</sup> Another states that only 10 percent of migrant children nationwide are attending school.<sup>72</sup> Schools have often refused to accept migrant children. In 1996 the government granted children permission to enroll in urban schools, but only if they paid an exorbitant fee. The lack of resources to pay this fee has effectively prevented migrant children from attending school.<sup>73</sup>

A number of migrant communities have established their own schools with no governmental assistance, but the government has forcibly closed many of them and passed a law banning them.<sup>74</sup> Many have reopened their doors, only to be shut down by the government multiple times.

As a result of these exclusionary policies, two to three million children nationwide receive no formal schooling.<sup>75</sup> The government's active exclusion of migrant children from both government and private schools has exacerbated the gross inequalities that have reemerged in cities and further buttressed the two-tiered nature of Chinese society.

### Psychological costs

Although many migrants, particularly women, report a sense of personal satisfaction associated with their migration experience, several studies have found that migration often exacts a significant psychological cost. One study found that 90 percent of migrant workers reported finding urban life unfamiliar and difficult to adapt to.<sup>76</sup>

Migrants exchange the familiar for a less secure social context in which they are often degraded and marginalized. They occupy the lowest socioeconomic rung in urban society and suffer neglect, scorn, and abuse at the hands of local residents. Children in particular face ostracism and ridicule,<sup>77</sup> while rates of hate crimes committed by urban residents against migrants have risen steadily.<sup>78</sup>

One study found that migrant workers in Shenzhen exhibit poor mental health, with especially high levels of obsession, phobia, and interpersonal hypersensitivity.<sup>79</sup> Another study found that migrant children and those born in cities to migrant parents are likely to engage in anti-social behavior and suffer high levels of depression and low self-esteem.<sup>80</sup>

### Positive effects on sending areas

One of the most salient themes of rural-to-urban migration in China is the continuing connectivity between the migrant and the sending area. Migrants not only remit a significant portion of their income back to their rural homes, but most also return home to work in the fields during the most labor-intensive periods of the agricultural cycle and also return to celebrate major holidays. It is because of this high degree of connectivity that an examination of the public health impact of rural-to-urban migration must take into account the consequences of migration on sending areas.

### Accumulation of capital

The *raison d'être* of circular migration is bringing income back into the home area. Sending remittances home is a near universal feature of rural-to-urban migration in China—usually in the amount of 50 to 60 percent of a migrant's total wages.<sup>81</sup> The nationwide remittance total is estimated at 180 billion RMB per year, which is roughly equal to 15 percent of the GDP of China's agricultural sector and up to 25 percent of that of provinces with high levels of migration, such as Anhui.<sup>82</sup>

The household tends to serve as the locus of decision-making about the utilization of labor and is also the unit that receives remitted wages. The money gained through remittances is vital to household welfare.<sup>83</sup> As stated earlier, low levels of arable land per person and expensive inputs reduce the profitability of farming and make household budgets difficult to balance. Kam Wing Chan estimates that one-third of the total rural agricultural labor force is redundant.<sup>84</sup> This labor power is a vital resource for rural families. Shifting one worker from farm to migratory work raises family income by an average of 49.1 percent.<sup>85</sup> Although sometimes spent on nonessential or luxury items, remittances are best seen as a vital supplement to family incomes that are generally low—and in some cases perilously low. Remittances are vital in improving household diets,<sup>86</sup> and represent an important source of income diversification.<sup>87</sup>

Remittances are also used in sending areas for house construction, wedding finance, and local investment.<sup>88</sup> One author states that a casual observer can determine which families have sent daughters to work as maids in urban homes by walking down village roads and comparing the quality of family homes.<sup>89</sup>

Some migrants invest in village projects, such as the construction of roads, bridges, community halls, drainage pipes, and schools.<sup>90</sup> Overall levels of investment in community infrastructure, however, appear relatively low<sup>91</sup>—but that is not to say that benefits accrue only to those households directly receiving remittances. The capital accumulated through migratory work has been invested in local enter-

prises that employ village compatriots locally. In Sichuan Province over 300,000 returning migrants have started their own businesses in their home regions.<sup>92</sup>

Local governments also stand to benefit from the exportation of rural labor. Some migrants, such as officially organized rural construction teams, pay taxes to rural home governments.<sup>93</sup> Government officials in rural areas, such as in Sichuan Province<sup>94</sup> and Miyun County near Beijing,<sup>95</sup> have officially encouraged locals to engage in short-term work in cities because of all of the above-mentioned benefits.

#### **Flow of intangible benefits**

In addition to absorbing an influx of money from urban areas, rural sending areas also receive a number of intangible benefits. Returning migrants bring with them "continuous flows of information, skills, capital, innovation, and life-style influences."<sup>96</sup> Whether these skills impart a large benefit on local rural economies is debatable, but some level of contribution to social change is likely.

One of the key areas in which returning migrants initiate social change is in gender relations. As stated above, female migrants gain a new sense of autonomy with the ability to contribute to household income. Some of this carries over to their home communities. Returning migrants are more likely to have a say in household affairs than those who have never left.<sup>97</sup> Moreover, although urbanites have tagged peasant migrants with the pejorative term "excess-birth guerrillas," most evidence indicates that migration tends to have a delaying effect on the reproductive life of women.<sup>98</sup> Peasant migrants tend to have more children than urbanites, but fewer than their rural compatriots who never engage in migration.

### *NEGATIVE EFFECTS ON SENDING AREAS*

#### **Increase of intra-community inequality**

Because migration requires start-up costs in the form of transportation fees and the money required for subsistence until a job is found, it is not the poorest of the poor that comprise the migrant ranks. As the middle and upper tiers of rural society improve their standards of living through the accumulation of money earned through migratory labor, intra-community inequalities are exacerbated.<sup>99</sup> Rising inequality has numerous deleterious effects on health in rural China. Those with expendable resources can afford to utilize health services, but others are increasingly shut out as the system moves toward a fee-for-service pay structure.<sup>100</sup> Even some who realize a nominal amount of growth in their income have difficulty drawing themselves out of poverty because of rising prices of provisions and

agricultural inputs.<sup>101</sup>

#### **Negative impact on agriculture**

Many within and outside of China have raised the concern that high rates of migration in the countryside have led to a "brain and muscle drain," a depression of agricultural production, and an over-reliance of village economies on remittances. Individuals shifted away from agricultural production tend to be of prime working age. In some areas, families who survive on remittances alone tend to farm their land half-heartedly or in some cases not at all.<sup>102</sup> In certain cases, however, land is leased to others who assume responsibility for production. Moreover, the fact that migrants maintain strong connections to their rural homes and tend to engage in short-term or seasonal work rather than making permanent homes elsewhere mitigates some of the negative effects migration might otherwise have on agricultural production.

As for the question of over-reliance on remittances, the benefits of income diversification likely outweigh the potential drawbacks. The great majority of households receiving remittances not only continue to engage in agricultural production, but still have more labor power invested in agriculture than is necessary for maximum efficiency.

#### **Introduction of infectious disease**

Circulatory migration naturally facilitates the spread of disease from one area to another. Poor living conditions and a propensity to engage in risky behavior render migrants highly susceptible to infection while residing in urban areas and those who contract infections often introduce disease to their home areas when they return. Some peasant migrants in China replicate the pattern of spouse-to-spouse transmission of HIV often accompanying labor migration in Sub-Saharan Africa.

#### **Positive effects on receiving areas**

Early in the reform period key government officials, including Deng Xiaoping, reached the conclusion that a) economic development requires labor mobility, b) the problem of the huge surplus labor force in the countryside could not be solved without allowing for geographical mobility for workers, c) urbanization is an essential part of modernization and development, and d) private enterprise can help absorb unemployed or underemployed workers.<sup>103</sup>

Although certain government officials, including municipal managers and security forces, oppose the influx of peasant migrants, allowing peasant migrants to live and work in cities represents an important component of a national development strategy. One of the most widely accepted points in the literature on internal migration is that cheap migrant

labor has rendered a remarkable contribution to the robust growth of eastern Chinese cities over the last two decades. It is the seemingly endless supply of cheap migrant labor that has driven China's construction boom, export-processing zones, and surging factories. Migrants do the dirty and dangerous work that registered urban citizens do not want to do, and they do it cheaply. This contribution to national economic growth goals is the primary reason the government tolerates the influx of legal, quasi-legal, and illegal migrants from the countryside.

Municipal governments fear infrastructure strain and loss of stability but do earn revenue through the collection of fees from migrant laborers. The fee for exchange of rural *hukou* to urban *hukou* is 50,000 RMB per person in Beijing. Although only a tiny percentage of migrants can afford to complete this transaction, the Beijing municipal government has collected 200-300 million RMB in exchange fees, and has largely invested this money in urban infrastructure.<sup>104</sup> Other fees are collected as well, including multiple types of short-term registration fees. Though sometimes deposited in municipal coffers, these fees often find their way into the pockets of corrupt officials.<sup>105</sup>

Urban residents do collect some money, as well. Sun Changmin reports that roughly 2 million migrants rent rooms from local residents in Shanghai, where authorities have not cracked down on the practice.<sup>106</sup> With an average annual rent of 500 RMB per person, Sun estimates that local residents collect approximately 1 billion RMB per year from migrants.

Measured in terms of contribution to economic growth, migration has brought clear benefits to urban receiving areas. It is much less clear, however, how migration has affected the *health* of these receiving areas. It is not taken for granted that growth is necessarily good for health. Unlike the economic benefits enjoyed by sending communities, where remittances often contribute to the alleviation of poverty, it is difficult to suggest that urban growth has rendered a significant contribution to the alleviation of poverty. Urban poverty rates were far lower to begin with than rural rates and urban mortality results largely from chronic disease rather than diseases associated with poverty.

Growth in Chinese cities has been highly inequitable over the last two decades. Wealth tends to amass in the hands of the political and entrepreneurial elite (sometimes one and the same), rather than disseminating broadly across society. Overall, it is not clear that the benefits of growth—rising income for some, government investment in infrastructure improvement—outweigh the drawbacks, which will be explored in the following section. Migration renders no obvious contribution to receiving areas that is specifically health-related.

## NEGATIVE EFFECTS ON RECEIVING AREAS

### Employment competition

One problem posed by migration is the increased competition migrants bring to urban labor markets. Some urban residents have complained that their prospects for finding jobs suffer because of the large number of migrant workers willing to work for a very low wage.<sup>107</sup> This problem is exacerbated by the reform of Mao-era state-owned enterprises (SOEs), a process that has required the laying off of millions of workers. The government has hoped that continued growth of the private sector will absorb these workers, and it has to a degree, but private companies looking for low-cost and low skilled labor often hire migrants rather than local residents.<sup>108</sup>

In order to stem this trend and protect local workers, the Beijing municipal government has raised the number of occupations off-limits to migrant laborers from 15 in 1996, to 35 in 1997, to 103 in 2000.<sup>109</sup> China's accession to the World Trade Organization will likely exacerbate this problem in the short term by increasing unemployment in the state sector and rendering more rural labor redundant by increasing the market share of imported food products at the expense of nationally grown products.<sup>110</sup>

Urban unemployment is a problem that merits consideration in a health-oriented analysis. Those laid off from SOEs are legally entitled to a pension and a small subsidy for health care, but in reality many receive but a fraction of the entitled amount. These individuals are less likely to eat a sufficiently balanced diet and less likely to utilize health services.

### Strain on urban infrastructure

Chinese media often suggest that the waves of migrant workers (*mingong chao*) who have entered cities place a great strain on urban infrastructure, including transportation, water, sewage, housing, garbage, and health and social services. While this charge may contain some truth,<sup>111</sup> the strain is likely not nearly as large as reported in sensational media accounts.<sup>112</sup> As stated earlier, migrants do not compete for the same housing as registered urban residents. Similarly, migrants rarely access health and social services—if at all, they do so on a fee-for-service basis.

The claim that migrants strain city garbage services holds little credibility in light of the fact that migrant workers constitute the lion's share of many cities' formal and informal garbage collection force. These workers make a large contribution to garbage collection and provide cities with free recycling services.<sup>113</sup>

Migrants do, however, place a strain on the transportation system, especially during the holidays when the great

majority of peasants return home shortly before the beginning of the Spring Festival. Popular media have called the holiday rush home the largest simultaneous migration in human history. Migrants also contribute to the crowding of city buses throughout the year. Nonetheless, migrants pay full fares and thus can be viewed as subsidizing the transportation of legal urban residents, who often receive discounted fares. Moreover, many migrants stay on or near their work sites and therefore do not participate in the daily commute.

Water may be the one area in which migrants do strain the urban infrastructure in a manner that deteriorates urban health. Clean water is an increasingly scarce resource in China. Most cities have a limited capacity to supply clean water. Shanghai, for instance, supplies roughly 300,000 tons of unclean water a day to residents because demand exceeds the city's capacity to supply treated water.<sup>114</sup> Migrants may be responsible for placing some of this excess demand on the water supply, but not all, since most lack consistent access to clean water and therefore consume little compared to registered urban residents.<sup>115</sup>

Overall, claims that migrants strain the urban infrastructure have some credibility but not to the degree claimed by the Chinese media. Peasant migrants are largely excluded from what Solinger labels the "urban public goods regime."<sup>116</sup> The urban welfare system and urban infrastructure are largely beyond the reach of migrants, who tend to fend for themselves and find their own solutions to their daily needs.<sup>117</sup>

#### Rising crime and crumbling social cohesion

The Chinese media and municipal security agencies similarly cast peasant migrants as a major cause behind the nation's rapidly rising crime rates. Since the mid-1980s, crime has risen 6 percent annually, with "serious" crimes rising 18 percent per year.<sup>118</sup> The official Xinhua news agency states that migrants are responsible for 54.8 percent of all crimes in Beijing and that migrants have "disrupted the city's social stability and security."<sup>119</sup> Another source claims that the percentage of crimes committed by migrants in Shanghai's Pudong District rose from 33 percent in 1988 to 70 percent in 1993 and that migrant gangs rather than individuals are now responsible for the majority of crimes.<sup>120</sup>

Davin makes an important point in stating that these claims tell us as much about urban biases than actual crime patterns,<sup>121</sup> but a number of factors support the claim that migrants do in fact account for a significant percentage of urban crime. The economic, social, and political marginalization of peasant migrants points toward the likelihood of high rates of criminal behavior in this demographic group. Moreover, the majority of migrants are young males in the age range most prone to criminal activity. Migrants

comprise a very large percentage of the total urban male population in this high-risk age group. It is highly likely that migrants therefore do commit a significant percentage of total urban crimes.

#### Spread of disease and return of urban blight

Although formal urban residents still have low rates of infant mortality and relatively high life expectancy, the urban blight so common in other developing countries has returned to Chinese cities after a long absence. Shantytowns have risen as new features of the urban landscape. As stated in an earlier section, several diseases that had been controlled with considerable success in Chinese cities have re-emerged. Malaria and polio, for instance, have returned after being nearly eradicated.<sup>122</sup>

Migrant workers contract these diseases with greater frequency, but residents with urban *hukou* naturally are not immune. Migrants and permanent residents interact on a regular basis and migrants often handle food supplies. Through direct human-to-human transmission of disease and contamination of food and water supplies, the health of migrants and permanent residents alike is threatened.

#### DISCUSSION

If little else, the above sections have demonstrated the difficulty of making absolute judgments about the overall effects of migration. In the words of Christopher Smith, most conclusions about the impact of migration are "articles of faith—unsupported and perhaps unsupportable by hard data."<sup>123</sup> Those who view migration as an effective means of alleviating poverty and those who view migration as a menace to public health can each summon ample evidence to support their claims. Migration creates problems as it solves problems and contributes to both an improvement and a deterioration of health.

Nonetheless, it is possible to make some constructive evaluations about the net public health impact of migration in China. Most evidence indicates that the migration experience is fraught with hazards, especially for children who are excluded from schools and health services. Migrating individuals expose themselves to hardship and disease. Most migrants sacrifice—or at least risk sacrificing—their well being in order to earn a higher wage. Only those among this group—and they may be numerous—who utilize their earnings as a means of making headway against poverty can realistically expect to realize a long-term improvement of health. The manner in which wages are invested is of vital importance.

A key factor in determining the quality of the migration experience is gender. Although in some ways more vulnerable to exploitation than men because traditional gender power structures are superimposed on other uneven power

relationships in the urban workplace, women tend to realize an increase in autonomy that few men report experiencing. Women tend to gain more from the migration experience than men.

The prospects for sending area communities are inextricably tied with those of the migrating individuals. If migrants return home with their health intact and savings in their pockets, their households and broader communities will also benefit. Again, the most significant way in which migration can lead to a lasting improvement of health is if the capital, skills, and ideas brought back from the cities are applied in a manner that leads to a long-term reduction of poverty.

The primary benefit for receiving areas is also economic. However, since the economic gains in cities are rarely applied to poverty reduction, but lead instead to highly inequitable growth in which benefits accrue largely to the economic and political elite, it is difficult to argue that the influx of rural peasants exerts a positive health impact on Chinese cities. It is rather the negative effects of in-migration—such as the deterioration of the sanitation environment, the reemergence of shantytowns, the rising prevalence of communicable diseases, and mounting crime problems—that make a deeper impression on the urban public health environment.

Although several of the problems facing the three groups analyzed in this paper are common to migration in other developing countries, many are exacerbated by specific government policies—both remnant socialist institutions such as the household registration system and protectionist policies municipal governments have implemented in the past decade. The government is teetering between two competing policy goals—achieving rapid industrial and economic growth, on the one hand, and maintaining the social and political status quo on the other. In order to achieve the former, the government strives to tap into the massive reserve of cheap rural labor, while achieving the latter re-

quires the government to protect urban workers, minimize social disorder, and maintain a degree of control over population mobility.

Many of these protectionist policies do not deter migration, but simply make the migration experience more difficult and create numerous public health problems. Migrants are rendered aliens within their own country and deprived of a fair wage, adequate housing, health and social services, and equal protection under the law, while exploited for their labor. Migrant laborers are of course victims, but they are also agents. They leave the countryside for their own reasons, though most often to contribute to household income. They are overworked and undercared for, but the money they remit home represents an important source of diversification of household income and often keeps peasant families from teetering off the edge of the abyss.

The solution to the migration problem is not reimposing draconian mobility controls that would once again subject peasants to “internal colonization.”<sup>124</sup> Nor does the answer lie in immediately doing away with the household registration system, because an abrupt influx of large numbers of peasants would likely overwhelm the urban infrastructure.

Rather, what is needed to create a healthier and more just society is a reorientation toward long-term policies that address the fundamental inequalities that polarize China along an urban-rural axis. The household registration system and its auxiliary protectionist policies should be phased out over the course of several years in conjunction with the rise of new policies that promote the welfare of rural citizens. Long-term investment in rural education and infrastructure should become major policy goals, while low-interest loans are provided for equitable local development. The state should not only educate and vaccinate migrant children, improve environmental sanitation, and safeguard migrants’ rights, but also strive to close the divide between urban and rural areas and free the peasantry from a legacy of exploitation.

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# Japanese Entrepreneurship: Changing Incentives in the Context of Developing a New Economic Model

Kenji Kushida

The Japanese economy has transformed itself radically over the past 150 years. Stages of the Japanese economy range from the late Tokugawa feudal economy to a national integrated economy during the early Meiji period, to rapid industrialization and central control before World War II, to rapid post-war growth. Many elements of the economic system created during the post-war rapid growth era persisted even after rapid growth slowed in the 1970s, contributing to the bubble economy of the late 1980s. After the bursting of Japan's speculative bubble, it has become increasingly clear that the Japanese economy must transform itself once again to remain internationally competitive and to sustain Japan's high level of prosperity. The economic model gaining widest attention in Japan is the Silicon Valley model, which successfully brought the United States out of the recession of the late 1980s and early 1990s, allowing the United States to reassert its position as the dominant leader of the global economy in the late 1990s.

This paper is an analysis of the Silicon Valley economic model and Japan's potential for adapting to a similar one. Specifically, I am taking main actors in the Silicon Valley model – entrepreneurs, employees, and investors – and examining the incentives they face in Silicon Valley, and then I am contrasting them to incentives faced by similar actors in Japan. In my analysis, I break down economic systems into legal factors, societal factors, and entrenched business practices (also referred to hereon as economic *structure*). In the United States, these three main factors that determine the incentives of the principle economic actors are aligned to maximize the potential economic function of start-up enterprises. The post-war Japanese economic system offers a sharp contrast, where these three factors combine to act as disincentives for Silicon Valley model actors to function efficiently. However, the Japanese economic system is currently in the midst of another transformation, and changes in these factors have begun aligning incentives of actors more toward the Silicon Valley model. Yet, due to extremely entrenched characteristics from the rapid growth economic system and the country's demographic trajectory, Japan's evolution into an economic system in-

corporating Silicon Valley model incentives is bound to gain Japanese characteristics.

In sum, this paper illustrates the legal, societal, and economic structural factors of Silicon Valley that create incentives for the main actors, contrasting them to rapid-growth era Japan's factors and recent changes to those factors. It identifies causes for persisting disincentives, suggesting improvements and examining potential economic developments in Japan that signal a different evolutionary trajectory from Silicon Valley-led U.S. development.

## *POTENTIAL ENTREPRENEURS:*

### *WHO ARE THE ENTREPRENEURS AND WHAT ARE THEIR INCENTIVES?*

#### **The United States**

In the United States, notable entrepreneurs are usually students from top universities, professors and researchers from academic institutions, and technical professionals or researchers from large companies and labs.

Within society, interest in entrepreneurship is high in universities, and American society generally accepts a wide variety of career paths. Also, widespread ideas hold that working for small enterprises is more rewarding than working for large firms because they move faster, and individual contribution to the business is easily judged. The U.S. economic system has developed in such a way that industry-academia ties are close. University professors benefit from a lack of legal impediments, and depending on the university, professors can sit on the board of directors of a venture business, devoting one day or so of the week to it, and sometimes even taking sabbatical leave to assist founding or operating companies.<sup>1</sup> Business schools provide a direct link of human resources between industry and academia, and a general business orientation in scientific research allows research outside pure science, focusing on practical applications, to be accepted.<sup>2</sup> U.S. business practices have also evolved to create a fluid labor market for technical professionals, where highly skilled researchers working for large corporations or research labs often have

few qualms about leaving their posts to start a company. Perhaps most importantly, legal, societal, and economic structural factors combine to create an accepting atmosphere for failed entrepreneurial attempts. Favorable bankruptcy laws, combined with a fluid labor market and societal acceptance of failure, allow entrepreneurs to attempt founding a business without risking personal bankruptcy.

### Japan

In Japan, however, this same group of top university students, professors, and technical professionals face a very different set of incentives, rendering entrepreneurship much less attractive. In Japan's rapid growth era economic system, societal, legal, and structural factors created strong disincentives for entrepreneurship. However, many of these factors have been changing rapidly since the 1990s.

#### Rapid-Growth Era Japan

In Japanese post-war society, a clear and entrenched mainstream prestige track let students with academic potential enter high-level junior and senior high schools and take entrance examinations for top universities. From there, the elite path took students to large corporations, medical schools, or elite government bureaucracies. In a society where relative income equality rather than instant wealth was stressed, with almost 90 percent of citizens identifying themselves as middle class, societal prestige was attained by identifying oneself as an employee of a large corporation or a powerful bureaucracy. Identifying oneself with a middle or small-sized businesses was a social indicator of failure to make it to top universities, which in turn displayed a lack of ability or motivation to study hard and attain success.

Regulations and the social structure of Japanese academia were not conducive to professors becoming involved in entrepreneurship. Prestigious national universities attract the best human resources, but regulations prevented national university faculty and staff to serve on boards of venture firms or become active in entrepreneurship until 1998.<sup>3</sup> Since discord in academia during the 1960s, orientation of university research has tended toward pure science rather than practical applications,<sup>4</sup> decreasing the number of potential marketable research outcomes. The entrenched business practices of long-term employment entailed most employees being directly hired from the undergraduate level and taught firm-specific skills, preventing development of business schools to fuse industry and academia.

Entrenched business practices from the rapid growth era also created disincentives for professionals to become entrepreneurs. As a result of long-term employment by large firms, possible largely because of keiretsu organizations,

engineers and workers had virtually no contact outside their own company. Thus, there was little or no chance for professionals to network and share ideas with others possessing similar skills working for different companies. Furthermore, because employment was long-term and workers usually experienced multiple job rotations during their careers, few people started and continued their entire careers as researchers or engineers. Accumulated knowledge by individuals was therefore relatively firm-specific rather than technically advanced. Long-term employment also led to few mid-career hiring opportunities, which created rigid labor markets.

Finally, entrepreneurial failure has traditionally been punished both personally and professionally. Bankruptcy laws, to be expanded on later, have severely punished bankrupt firms and individuals, and society attaches a stigma to those whose businesses have failed, making reentry into the top level labor market almost impossible.

#### Cutting Edge Changes in the Japanese Economic System

Changes occurring in society, regulations, and entrenched business practices since the 1990s have removed many disincentives from the rapid-growth era economic system. However, changes have yet to permeate the whole economy. Within society, university students' interest in Japanese venture businesses has increased dramatically over the past decade. Although the number of students who actually become entrepreneurs straight out of college is still low<sup>5</sup> compared to the United States, many major universities host lecture series and seminars about entrepreneurship.<sup>6</sup> Venture businesses are gaining ground in terms of societal acceptance as influential newspapers, such as the *Nihon Keizai Shinbun*, publish articles related to entrepreneurship with increasing frequency and as books written by or about successful entrepreneurs - such as the founders of Softbank, Oracle Japan, and Rakuten - have become best-sellers. Most people have heard of Shibuya's bit valley in the media, which is portrayed as a destination for talented youth attempting to break free of old corporate culture and exert creativity.

At the same time, large Japanese companies have suffered a general decline in popularity among top university students. Increasing numbers of students want to work for foreign firms in Japan, and competition for positions in bureaucracies has decreased.<sup>7</sup> The trend - although still in its early stages - away from large companies is largely due to changes in entrenched business practices. With the prolonged recession and progressive deregulation, strict keiretsu organizations have started to break down, and implicit lifetime employment is increasingly becoming abandoned. Large companies have engaged in layoffs, and an

increasing number of companies are adopting yearly wage contracts. Furthermore, the labor market for large firms is becoming more flexible, with mid-career hiring increasing.<sup>8</sup> Thus, incentives toward large firms due to guaranteed job security and in-house training are becoming weaker.

Deregulations since 1998 allow national university professors to receive income from private industry while retaining employment at national universities. Furthermore, laws such as the 1998 "University Technology Transfer Assistance Law"<sup>9</sup> have allowed major institutions such as Tokyo University to set up Technology Licensing Offices to excavate technology from research labs and apply for patents. Such institutions can be expected to strengthen societal ties between industry and academia, and combined with deregulations, increasing numbers of professors can be expected to become active in entrepreneurship.

#### **Remaining Barriers and Potential for Independent Japanese Evolution of Entrepreneurs**

Although the Japanese economic system is steadily aligning incentives for potential entrepreneurs, failure of an enterprise still constitutes one of the strongest disincentives. Bankruptcy laws, originally formulated in 1922, have only been reformed once, in 1952. However, with highly skilled labor markets becoming more liquid with the breakdown of lifetime employment, difficulty in finding employment after failure is becoming less of a disincentive. Furthermore, most people who have studied or are involved with the Japanese entrepreneurial scene recognize that since venture businesses are high-risk, high-return enterprises, extreme personal damage resulting from failure is possibly the largest disincentive faced by potential entrepreneurs. It is possible that the end of social ostracism of failed entrepreneurs may be close in sight. With business practices and societal values pressing for acceptance of failure, pressure for deregulation can be mounted, hopefully resulting in changes in bankruptcy laws.

So far this analysis has examined incentives in Japan faced by the same group of people who become entrepreneurs in the United States. It may be argued that Japanese entrepreneurs need not come from the same group of people. While this may be true to some extent, in the long run it seems likely that the best and brightest people in society, hence the same group as seen in the United States, will become the best human resource pool of entrepreneurs as venture businesses enter the mainstream economy. In the short run, though, those Japanese outside the prestigious track defined during the rapid-growth era probably face less difficulty engaging in entrepreneurship, as they have no need to break free from established norms. Employment for middle and small-sized firms has not been long-term, and skilled labor markets for such firms have been comparatively liquid.

Thus many currently successful entrepreneurs either were not part of, or decided not to take part in the mainstream social prestige track.<sup>10</sup> The effect these non-mainstream prestige elite may have on the Japanese entrepreneurial culture, such as the potential for full utilization of female labor, may become increasingly clear as the culture develops.

Thus the potential incentives Japanese entrepreneurs face are somewhere between the rapid-growth era disincentives and the most recent changes in the Japanese economic system. Large companies and the bureaucracy still attract most of the best and brightest people, long-term employment has not yet died out altogether, the labor market for large companies is still relatively rigid, and failure is punished severely. At the same time, many contemporary entrepreneurs are not from the mainstream prestige track, opening the door to a systemic evolution with characteristics diverging from the Silicon Valley model.

#### **Employees of Venture Businesses Attracting People to Venture firms – why they are attractive/unattractive.**

Successful venture firms require talented employees and partners in addition to driven entrepreneurs. Legal, societal, and business practice differences result in vast differences in incentives faced by employees of venture firms in the United States and Japan.

In Silicon Valley-style start-ups, financial incentives for employees are attractive. Stock options provide the potential for rapid wealth, a stake in the welfare of the company, and a sense of partnership in running the firm. The heavier work-loads faced at venture firms in comparison to large corporations, resulting in more responsibility per worker, also signify each employee's ability to feel the consequences of their efforts more directly, making long hours more rewarding. In terms of job security, there is little trade-off between working for a start-up and a large corporation because large corporations shed workers easily, and fluid skilled labor markets allow relatively easy job placement even if a venture firm fails. U.S. workers therefore face a societal, legal, and economic environment that creates incentives to work hard for a venture firm.

In Japan, however, legal barriers in effect until very recently posed serious hurdles in attracting good employees to venture businesses. Although those barriers have for the most part been removed, potential employees still face many rapid growth era disincentives.

Due to legal restrictions, non-salary financial incentives for employees were almost impossible until very recently. Until 1997, the number of firms allowed to issue stock options was severely limited, and until 1998 stock options could be taxed as capital gains even if they were not exer-

cised.<sup>11</sup> Thus most venture firm employees are on orthodox salary structures without the potential for rapidly amassing massive wealth through options.<sup>12</sup> With orthodox pay scales, even if employees feel their individual effect on the firm they do not feel the sense of partnership or sharing that Silicon Valley employees can feel. Thus for people who could be working at large firms, the comparatively long and strenuous work hours, yet orthodox wage scales, do not balance out against the socially inferior “feel” of a normal medium or small firm, only with a higher risk of failure. However, with the recent changes business practices should start to evolve, and firms utilizing stock options, simultaneously cultivating a sense of sharing and “feeling” of a new type of venture firm, should add incentives for working at a venture firm.

Lack of job security is another disincentive that will decrease as long-term employment fades. While labor markets for small- and medium-sized firms has been liquid even during the rapid growth era, people in those labor markets were usually not top-level, highly skilled workers. People who had a choice mostly chose the job security of large firms, but as labor markets for the highly skilled become more liquid and accepting of workers from failed firms, top-level employees will have more incentive to join venture firms.

## *HUMAN RESOURCES*

### **Human Resource Pool Differences between United States and Japan**

The United States and Japan face significant differences in the human resource pool of potential for entrepreneurship, suggesting the need for serious changes to Japan’s legal, societal, and economic structural factors for Japan to best utilize its human resources.

In the United States, favorable immigration laws allow immigrants and newly naturalized citizens from places such as India and Asia to play a large role in the high tech industry which is central to U.S. entrepreneurship. Immigration and the U.S. economic system have also created a polarity in level of skills for workers, with a large proportion of highly skilled labor and a large proportion of unskilled labor. Venture firms make use of this large pool of highly skilled workers.<sup>13</sup> In U.S. society, a predominant proportion of college educated women have their own careers, whether married or not, with liquid labor markets allowing interruptions for childbirth and infant rearing. In Japan, however, the demography combined with societal values and entrenched business practices from the rapid-growth era will continue to result in a serious underutilization of potential human resources unless changes occur.

Japan faces a seriously aging and shrinking population.

The birth rate has been declining rapidly and is now under 1.4 children per family, while the elderly are living longer than ever before. Complex and forbidding immigration laws severely restrict immigration, depriving Japan of the benefit of highly skilled labor and youth pouring in from abroad.

As an outgrowth of the rapid post-war era practices, Japan also seriously underutilizes women in the labor force. A growing number of young women have been pursuing careers after higher education, but a large proportion drop out of the labor force following marriage. With this behavior as a societal norm and expectation, job markets for young women are seriously limited, and re-entry is almost impossible. Women drop out of the labor force largely because of their socially designated responsibility to be actively involved in their children’s education. Young women have increasingly been trying to prolong their working years in careers, creating a destructive cycle where the average marriage age has been pushed higher and higher, decreasing potential for Japanese population growth. Thus, women who pursued careers but are unable to reenter the skilled job market, combined with women who never pursued careers due to early marriages or because they grew up when women didn’t pursue careers, constitute an extremely large, underutilized labor force.

In terms of skills of workers, largely due to the educational system and lack of immigration, Japanese society is not as polarized as that of the United States. Instead, Japan faces a larger proportion of skilled workers in-between highly skilled and unskilled labor.

Thus the evolving Japanese economic system with entrepreneurship as a major factor must utilize a large population of people over 65, a small population of youth, a large underutilized population of women (especially married women), and a predominant pool of skilled (but not highly skilled) workers. Legal changes can extend working legal retirement ages and provide tax incentives for senior citizen labor, but social values and entrenched business practices from the rapid-growth era need to evolve to maximize utilization of Japan’s current and future demography.

## *INCENTIVES OF ENTREPRENEURS ALONG THE LIFE OF A VENTURE BUSINESS*

### **Starting Up - Incorporating**

The first step for entrepreneurs after gathering a core of people to start a company is incorporation. Due to legal factors stemming from societal factors and entrenched business practices, incorporation is extremely easy in the United States while in Japan, significant effort is required by the entrepreneur.

In the United States, once seven or eight people are as-

sembled becoming a company is as easy as filing documents.<sup>14</sup> Furthermore, legal and accounting firms provide future networking opportunities, as legal firms often provide powerful connections and possible networking to venture capitalists and others supporting actors.<sup>15</sup>

Incorporation in Japan, on the other hand, requires an initial minimum capitalization of 10 million yen. The idea behind regulations requiring initial capitalization stems from social and economic structural factors. Since a company's credibility is a large factor in determining its status, large companies with high capitalization have more credibility than firms with low capitalization.<sup>16</sup> Following this logic, incorporated companies are expected to have a certain level of credibility to protect investors, shown by the minimum initial capitalization.<sup>17</sup> Therefore, an entrepreneur must somehow gather at least 10 million yen through friends, family, and / or mortgages and high interest loans. Initial capitalization requirements act as deterrents to potential entrepreneurs because failure will incur personal costs if loans cannot be repaid. Deregulation removing initial capitalization requirements would solve this incentive problem, but social and entrenched business ideas behind the regulations need to change first.

#### **Starting up - Funding**

Collateral-free funding is usually necessary to operate venture businesses in their early stages of development. With legal, social, and structural incentives aligned in Silicon Valley, obtaining funding through venture capitalists or angel investors is not difficult. In Japan, with increasing recognition of the importance of venture firms, funding has become easier to find. The main incentive differences facing entrepreneurs is the potential networking capabilities of venture capitalists and angels.

Due to Japanese rapid-growth era practices of long-term employment, few people are well connected horizontally across many firms or across industries. The few well connected people that exist are usually attached to their own company and cannot act as independent angel investors or come together with others and form venture capital partnerships. While U.S. venture capitalists play large roles in a venture firm's networking with business partners, other investors, and provide support for entrepreneurs, most Japanese venture capital firms provide only money. Thus although both U.S. and Japanese entrepreneurs have little choice for non-collateral funding besides venture capitalists and angel investors, the evolution of these investors, to be discussed later, allow U.S. entrepreneurs to benefit much more than their Japanese counterparts.

#### **Going Public**

The financial incentive of equity holders of start-ups is their realization of value upon the start-ups' going public. Until very recently, Japan lagged far behind the United States in the ease and effectiveness of going public, due to regulations and the rapid-growth era economic structure. However, opportunities are increasing as the Japanese economic structure is adapting U.S. elements.

U.S. companies can value their stock at a fraction of a cent when distributed to founders, employees, venture capitalists, law firms, accounting firms, etc., and NASDAQ provides an active, liquid market supported by a developed over-the-counter market for start-up stocks to be traded. In Japan, on the other hand, until the advent of Mothers and NASDAQ Japan and recent developments in over-the-counter markets, Japanese venture firms had only a slight chance to become a traded company. In major stock markets, the minimum stock price for Japanese firms going public was 50,000 yen. Thus, prospects of massive capital gains were slim, and founders and employees had no advantage over first round investors.<sup>18</sup> Mothers and NASDAQ Japan are still in their embryonic stages, but an IPO-driven value realization incentive structure is now realistic, bringing incentives for all actors involved in venture firms in closer line to the United States.

#### **Failure**

Venture businesses are high-risk, high-return enterprises. It is said that in Silicon Valley, almost seven out of 10 start-ups go under within their first five years. Cushioning from punishment is needed for potential entrepreneurs to decide to engage in such high risk enterprises. While in Silicon Valley, legal, social, and economic structural factors no longer make failure a serious disincentive for potential entrepreneurs, those same factors form the most significant deterrent for potential Japanese entrepreneurs.

U.S. bankruptcy laws afford such extensive protection to the firm that there is even an incentive to misuse them.<sup>19</sup> The U.S. Chapter 11 bankruptcy law protects the firm from creditors as it re-organizes itself to become competitive,<sup>20</sup> and the incumbent management is not forcibly replaced.<sup>21</sup> In terms of societal and business practices, in Silicon Valley it is often said that entrepreneurs who have failed on their first, or even first few, attempts have gained valuable experience.<sup>22</sup> Liquid skilled labor markets allow them to easily find employment elsewhere, and they do not risk personal bankruptcy from a firm's failure. Thus potential entrepreneurs in Silicon Valley have little to lose in taking the final step to embark on a venture business.

In Japan, on the other hand, under the Corporate Reorganization Law, specific guidelines need to be met for a firm to declare bankruptcy.<sup>23</sup> Creditors have more rights than the firm and are allowed to attempt to collect their debts

while the incumbent management is forcibly replaced.<sup>24</sup> Thus, financially ravaged and with experienced management replaced, small or medium firms declaring bankruptcy often face liquidation.<sup>25</sup> Due to factors from the rapid-growth era economic system, entrepreneurs whose venture firms fail can face personal bankruptcy as well. For the initial capitalization to incorporate or for very early stage funding, founders often have to take out loans with personal guarantees and collateral. If the business cannot repay debt, the founder is personally held accountable, easily leading to personal bankruptcy. Compared to the United States, social convention in the Japanese business world seems to attribute success or failure of a firm to entrepreneurs themselves.<sup>26</sup> The community ostracizes those who fail, and their careers are permanently tainted. With relatively inflexible skilled labor markets, finding reemployment at a high-level firm is nearly impossible, and since many VCs are branches of large firms, many of their views on failure are in line with the mainstream, making future funding difficult to secure.<sup>27</sup> Thus, failure is probably the most serious disincentive for potential Japanese entrepreneurs.

Revision of the bankruptcy laws is probably the easiest and most effective government action to remove the overriding disincentive of potential entrepreneurs. Minimum initial capitalization regulations could be eased, and bankruptcy laws could be changed to be more firm-friendly instead of their current investor-friendly nature. Since entrenched economic structural factors such as inflexible skilled labor markets are beginning to change, the burden on founders can be eased significantly, especially as the investing structure develops, allowing more collateral-free investment in early stages. The societal tendency of the business world to focus on the entrepreneur for success or failure also needs to change, and fortunately, people who have studied the Silicon Valley model seem to understand this need.<sup>28</sup>

#### Attaining Success

The potential for attaining success, meaning the relative openness of the economy in allowing new venture firms to become significant players, varies greatly between the United States and Japan due to entrenched business practices. The Japanese rapid-growth era business relationships and values such as “credibility,” along with the continuing dominance of large firms, pose barriers to entry for Japanese venture firms. Such barriers are becoming less severe as the Japanese economic system evolves, but Silicon Valley start-ups seem to have an easier time attaining success if their idea is good and their implementation into business plan effective.

In the United States, merger and acquisition markets are well developed, and large existing firms often acquire or

enter into partnerships with start-ups. Silicon Valley does not have a culture of long-term business relationships, and large companies know that engineers and personnel in start-ups are highly skilled and talented workers. In acquiring start-ups, the main challenge for large firms is keeping the people from leaving once they become acquired.<sup>29</sup> There are also visible success stories of start-ups attaining tremendous stature, for example AOL’s buyout of Time Warner. Thus in the Silicon Valley business structure, it seems unlikely that factors beyond product quality affect a firm’s choice between products made by a large firm and a start-up, as long as the start-up looks healthy. For entrepreneurs in Silicon Valley, there is incentive to compete against large firms if they think they can make a better product. Competition aside, entrepreneurs know that as long as their product is high quality and is marketed and supported well, and if they have sufficient networking capabilities, they are on an even playing field with existing firms. Thus, combined with previously mentioned factors, they have little to lose in starting an enterprise if they see a business chance.

In Japan, merger and acquisition markets are not well established, and one of the largest hurdles for venture businesses is to get their product or service accepted by large firms. Due to the rapid-growth era economic system, large firms dominate most high value-added business, and business structure comes from a background of long-term relationships through keiretsu organizations of reciprocal shareholding, and the main bank system. In doing business with a large firm, credibility is the key issue. Large, established companies have clear track records and existing long-term relationships that become the basis for judging credibility. Credibility of medium- and small-sized companies are judged by with what large companies they hold, and have held, business relationships. Thus start-ups with no track record, even if offering a superior product or service, are not chosen by large companies if other established, more credible companies offer something similar.

Thus many Japanese venture firms often aim not to compete with larger firms but to add value to operations or products and services of large firms.<sup>30</sup> Many venture firms also target low-tech sectors such as goods transportation services. With a long and difficult road to business with large firms, and the road to success still largely determined by relationships to large firms, entrenched business practices cause Japanese entrepreneurs to encounter much more difficulty than Silicon Valley entrepreneurs in getting their products accepted.

#### Investors

In the Silicon Valley entrepreneurial funding structure, laws, society, and business practices align incentives for investors to maximize and monitor the start-up’s progress.

In Japan, however, although recent changes in laws have helped align incentives somewhat, evolution of investing from the rapid growth era has not aligned incentives for investors to maximize the venture business' progress.

### Angel Investors

In Silicon Valley, angel investing is an attractive option for very early funding. Due to a supportive legal structure, U.S. angel investors receive tax exemptions on long-term personal investing in small companies, with deferrals on capital gains. Furthermore, capital losses can reduce taxable income and can be applied toward the future.<sup>31</sup>

Recently, Japanese angel investing has become more attractive due to regulatory changes in 1997, but incentives of angels are still not as strong as in the United States. For angel tax laws to apply, the company must apply for and be categorized as a "venture." Tax-applicable capital gains provisions apply only if the company goes public, and tax deduction on losses can only be deducted from the same category of investments - in this case, "ventures."<sup>32</sup> Therefore, although the legal structure has been improved somewhat, angel investing laws cannot be taken advantage of effectively unless angels invest on a large scale with investments in many ventures.

### INCENTIVES OF VENTURE CAPITALISTS/VENTURE CAPITAL FIRMS

The most important type of investing for enterprises in both countries is undoubtedly venture capital - loans with no collateral except equity. Mainly due to evolution of the investing structure from the rapid-growth era Japanese economic system, the predominant structure of Japanese venture capital firms prevents them from facing Silicon Valley style incentives to maximize start-up performance.

In Silicon Valley, the majority of venture capital firms are partnerships or limited partnership investment funds. Aside from managing funds, partners running the firm are investors with their own money, having a personal stake in the fortunes of start-ups they fund.<sup>33</sup> Therefore, monitoring of start-ups is close and intensive, with VCs often offering or demanding major changes, such as appointing a new CEO to the company.<sup>34</sup> Thus VCs provide money - but more importantly - networks to other start-ups, partners, and law firms, and they add credibility to the start-up.<sup>35</sup>

Competition for promising start-ups among VCs is intense, and start-ups with multiple offers can get information from "gatekeeper" consultant firms that monitor and publicize information about VC performance.<sup>36</sup> Thus the partners of Silicon Valley venture firms have large personal stakes in the welfare of firms they invest in, which gives

them incentive to monitor and nurture these companies, while at the same time they are under pressure to make good investments because they are being monitored themselves.

Japanese venture capital firms are predominantly branches of financial sector firms, trading companies and other large companies. Since they are branches, many VC firms are not financially independent, and their employees are salaried company employees who do not gain directly from good venture business performance. Furthermore, there are no monitors for VC performance. Without as much at stake as a firm or as individuals, and without performance being monitored, Japanese VC investments tend to be risk averse, looking for stability rather than intensive selection and monitoring to realize potentially high returns.<sup>37</sup>

Japanese venture capital is evolving from branches of large companies largely due to human resources issues mentioned earlier due to the evolution of Japanese corporate structure.<sup>38</sup> Large companies have a greater ability to connect start-ups to networks and provide support compared to Silicon Valley-style independent VCs in Japan. Since people connected horizontally across multiple firms are extremely scarce, it is difficult for groups of talented, well connected people to leave large corporations and form venture firms.

Changes are occurring, however, and newly formed venture capital firms independent of large corporations, which live off of venture fund management - with employees having individual stakes in venture businesses - have been increasing. However, such venture capital firms are still small in size and few in number.<sup>39</sup> Furthermore, they lack the expertise to make investment decisions based on business plans, relying instead on how well the venture firm is already established and its prospects for immediate growth.<sup>40</sup> In other words, independent venture capital funding comes at a later stage than in Silicon Valley - after the venture firm already seems to be destined for success,<sup>41</sup> making them "piggyback investments."<sup>42</sup>

VCs that are branches of companies engaged in lines of business outside finance, such as software - for instance, Softbank - usually invest strategically in their own field of expertise, with future acquisitions or benefits in mind.

Since legal barriers do not seem to be significant in forming independent VC firms, if social prestige and attracting and keeping talent in large firms keeps declining, if the economic structure keeps changing in the direction to allow more horizontally connected people to float in a more liquid labor market, and if existing VC firms become more independent with the advent of VC performance monitoring, then investor incentives will be more aligned to maximize enterprise performance. In sum, social and business structural factors already seem to be evolving in the right direction, although there is still a ways to go.

### Networking - Possibly the most major issue for evolution

Networking is a crucial factor in Silicon Valley in connecting entrepreneurs with investors, business partners, and sources of advice. Legal, social, and economic structural factors in the United States create an environment enabling dense networking, while the Japanese economic system needs to evolve significantly before a similar level of networking can be attained.

In Silicon Valley, due to the human resource issues mentioned earlier, well-connected people exist in a variety of places. The networking role of venture capitalists has already been mentioned, and in addition, law firms, accounting firms, and investment banks - all of which are firms providing services that start-ups need to rely on - all interact in a dense network of information. Law firms can contact venture capitalists that may be interested, accounting firms may introduce firms to potential partners, and venture capitalists can enter the start-up and use their extensive knowledge and connections to the start-up's advantage. Consulting firms specializing in aiding start-ups also provide networking and advice. Furthermore, outpatient incubators, such as garage.com, are businesses whose main purpose is to facilitate networking and provide support.

The rapid-growth era Japanese economic system has not facilitated the development of large law firms, and accounting firms are divided into tax firms and accounting oversight firms, making them weak in terms of networking capability. Because of human resource issues mentioned earlier, venture capital firms and other large firms are also not

well equipped to set up extensive communication networks. The future role of consulting firms as well as outpatient incubator style firms seems crucial in the evolution of networking in Japan if they can capitalize on changes in the Japanese economic system and attract talented, well-connected human resources.

Evolving from a different economic system, Japan's networking channels are likely to diverge from the Silicon Valley model to some extent. Yet networking is critical, and support organizations such as the Kansai Silicon Valley Venture Forum are actively trying to create networking channels.

### CONCLUSION

In this paper, we have seen that social factors, legal factors, and entrenched business practices from Japan's high-growth era act as impediments to the development of a Silicon Valley style economic model based on entrepreneurship. Incentives faced by Japanese potential entrepreneurs and investors are not conducive to maximizing the potential of entrepreneurship. However, we have also seen that changes in the Japanese economic system have been steadily aligning the incentives of these actors, and although serious gaps still exist, changes are moving in the right direction. Convergence is unlikely to occur, though, because of the Japanese economic system's evolution from the rapid-growth system. The manner in which Japan's demography and human resources are utilized and the type of networking relationships that develop will determine the character of Japan's new economic system.

<sup>1</sup> Imai, Ken'ichi, Akiyama Yoshihisa, et al, *Ventures' Infra – the Infrastructure of Venture Companies* (Tokyo: NTT shuppan, 1998), 225

<sup>2</sup> Imai, *Ventures*, 225

<sup>3</sup> "Teaching Note: Venture Business in Japan." Graduate School of Business, Stanford University. 1/99. 14

<sup>4</sup> Imai, *Ventures*, 228-229

<sup>5</sup> Horiba, Masao. Chairman, Horiba Seisakusho Ltd. Lecture, Kyoto University, 6/6/2000.

<sup>6</sup> Examples of lecture series include "Venture firm theory" at Kyoto University and similar classes at Osaka University, Doshisha University, etc.

<sup>7</sup> "At the height of ... high growth, as many as forty-three individuals competed for every one who was successful [in attaining a senior civil service position]. By the early 1990s, this was down to fewer than fifteen candidates for each opening." (Pempel, T.J. *Regime Shift – Comparative Dynamics of the Japanese Political Economy* (Ithaca, NY.: Columbia Press, 1998), 160)

<sup>8</sup> Sanyo Electric AV Systems, for example, now hires external professionals on yearly contracts and welcomes mid-career employees (Komamiya Takeo, President and CEO, SANYO Electric AV Systems Co., Ltd. Round Table Talk, KDD Osaka, 5/19/2000).

<sup>9</sup> Imai, Ventures, 229

<sup>10</sup> Nihon Dentsu's CEO, Mr. Nagamori, never intended to work for a large business, even since he was young. Softbank's Son Masayoshi is of Korean descent and went to an American university. Ed-contrive's founder, Mr. Kawai, was a "chimpira," and Igaku seibutsukagu kenkyuujo (Medical Biology Lab)'s founder was a female secretary of a doctor (Tsunoda, Ryutaro. Professor, Ritsumeikan University Economics Department. Lecture, Kyoto University. 5/9/2000.).

<sup>11</sup> Stanford 8

<sup>12</sup> Oota, Hajime. "Hataraku ba to shitenno venture kigyo." (Venture firms as a place to work) Chuo Koron, March 2000, 174

<sup>13</sup> Imai, Ken'ichi. Director, Stanford Japan Center. Personal conversation, May 2000.

<sup>14</sup> Yang

<sup>15</sup> Kawasaki, Guy. CEO, Garage.com. Lecture, Stanford University, May 2000.

<sup>16</sup> It is not uncommon for companies to increase their capitalization amounts to increase their credibility (Kawabe, Yoji. CEO, Futures Venture Capital Ltd. Lecture, Kyoto University, 6/27/2000).

<sup>17</sup> Nagano

<sup>18</sup> Stanford 7

<sup>19</sup> Imai, Ventures, 305

<sup>20</sup> Stanford 8

<sup>21</sup> Imai, Ventures, 304

<sup>22</sup> Fong, Kevin. CEO Mayfield Fund. Lecture, Stanford University, May 2000.

<sup>23</sup> Imai, Ventures, 304

<sup>24</sup> Stanford 8

<sup>25</sup> Stanford 8

<sup>26</sup> Kawabe, Yoji. CEO, Futures Venture Capital Ltd. Lecture, Kyoto University, 6/27/2000.

<sup>27</sup> Kawabe

<sup>28</sup> As mentioned earlier, almost everybody involved with the Japanese entrepreneurial scene points out that acceptance of failure is a large key to success of the economic model.

<sup>29</sup> Andresson, Mark. Founder, Netscape Communications. Lecture, Stanford, April 2000.

<sup>30</sup> "Tsuyoi venture no omowanu sugao," Nihon Keizai Shinbun June 11, 2000.

<sup>31</sup> Stanford 10

<sup>32</sup> Stanford 10

<sup>33</sup> Ventures 14

<sup>34</sup> Fong

<sup>35</sup> Kawasaki

<sup>36</sup> Imai, Ventures, 25

<sup>37</sup> Kawabe

<sup>38</sup> Imai, Ventures, 44-45

<sup>39</sup> Kawabe

<sup>40</sup> Kawabe

<sup>41</sup> Terauchi, Isshu. CEO, Nissho corporation. Round Table Talk, KDD Osaka. 5/19/2000.

<sup>42</sup> Other problems of Japanese venture capital firms, whether independent or branches of firms, mainly stem from inexperience and lack of expertise. Listed here are several opinions of major problems. First, many Japanese VCs lack strategic understanding, investing little by little until the venture firm gets media attention, after which the firm is flooded with funding. The venture firm, lacking management experience, uses up most of the money, causing investors to retreat rapidly, leading to the demise of the business (Imai, Ken'ichi, Akiyama Yoshihisa, et al, Ventures' Infra – the Infrastructure of Venture Companies (Tokyo: NTT shuppan, 1998), 74). Second, Japanese VCs rely mostly on technical specialists for evaluation, causing venture firms to be evaluated on the basis of technology rather than business models, marketing, or implementation (Imai, Ken'ichi, Akiyama Yoshihisa, et al, Ventures' Infra – the Infrastructure of Venture Companies (Tokyo: NTT shuppan, 1998), 74). Third, many venture businesses end up receiving more money than they know what to do with. Combined with the strange high tech market phenomenon that if companies like amazon.com actually invest in real infrastructure such as warehouses, rather than new business models or web pages, their stock goes down (Andresson), venture firms that end up with capital end up becoming VCs themselves, engaging in overseas as well as domestic investments themselves, losing their entrepreneurial spirit (Nagano).



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# The Philosophy of As-Is: The Ethics of Watsuji Tetsuro

Jeffrey Wu

In prewar and wartime Japan, the orthodoxy of imperial subjecthood served to affirm existing political reality. Through the apotheosis of the imperial house as the highest locus of value and the definition of the nation as a seamless community, *tennosei* ideology effectively denied the legitimacy of critique and contestation — in short, politics — in the public sphere. By definition, loyal imperial subjects cannot dispute the will of the august sovereign. Since all state policies were also, by definition, expressions of imperial will, resistance to the state was drained of all legitimacy.<sup>1</sup> In Japan, in the words of Andrew Barshay, “a powerful optimism flowed from what Maruyama called a ‘continuative mode of thought’ in which value and reality, norm and nature, were seen in terms of mutual confirmation.”<sup>2</sup> Japan’s defeat in World War II, however, broke the hold of imperial mythology on public discourse. Naturally, the value orientation of prewar ideology immediately became a target of public criticism.

To Maruyama Masao, the preeminent spokesman of post-war modernist thought, it was precisely the lack of value autonomy in Japanese ultra-nationalism that accounted for its particularly egregious character, which led Japan down the path to nearly total disaster.<sup>3</sup> What accords Japanese nationalism its “ultra” or “extreme” character, according to Maruyama, is the “exteriorization of morality” that resulted from the state’s monopoly over the right to determine values and the identification of ethical value with state power. In Europe, “questions of thought, belief and morality were deemed to be subjective matters and, as such, were guaranteed their subjective internal quality; meanwhile, state power was steadily absorbed into an ‘external’ legal system, which was of a technical nature.”<sup>4</sup> In this case, political power and sovereignty is strictly formal, while the issue of values is left to individual conscience. In contrast, “Japanese morality never underwent the process of internalization that we have seen in the West, and accordingly it always had the impulse to transform itself into power. Morality is not summoned from the depths of the individual; on the contrary, it has its roots outside the individual and does not hesitate to assert itself in the form of energetic outward movement.”<sup>5</sup> The identification of power and morality amounted to the conflation of *sein* and *sollen*, of what is

with what *ought* to be; the nation is equated with value, not subject to any moral code that supercedes itself.

Furthermore, even though morality is identified with power, the power-holders themselves are not responsible moral subjects. Since the highest locus of value is the throne, the assessment of worth for a given social position is determined according to its proximity to it. Power holders themselves, who owed their positions to their proximity to the emperor, acted not according to their subjective values but to an exteriorized norm. Because even the emperor himself owes his position not to his subjective selfhood but to a line of imperial ancestors “coeval with heaven and earth,” there was not a single moral subject in the entire edifice of Japanese nationalism. The result was power without responsibility, accounting for the aggression and brutality that was the hallmark of Japanese militarism.

Though rich in insight, Maruyama’s critique of Japanese nationalism must be situated in its postwar context, for its polemical intensity was necessitated by the urgent need to rethink the course of Japan’s modern history. Maruyama’s critique aimed to describe not an overt doctrine — “ultra-nationalism in Japan has no solid conceptual structure” — but a pervasive psychological condition shared by leaders and masses alike. Yoshimoto Taka’aki has taken Maruyama to task for his alleged status bias and “poverty of life history,” charging that Maruyama’s analysis stemmed from the elite intellectual’s distance from the masses. Indeed, “Maruyama’s analysis of fascism excludes any consideration of social and political role played by the mobilized intelligentsia in late imperial Japan.”<sup>6</sup>

Nevertheless, Maruyama’s insight into the relation of values and politics brings up important questions that one can raise with regard to explicit ideas and doctrines. Was Japanese academic philosophy in the first half of this century to some degree also characterized by the externalization of values that Maruyama spoke of? Did Japanese philosophy offer theoretical vantage points from which the state could be transcended or resisted?

Of course, one can not speak of “Japanese philosophy” in such general terms. As a starting point of inquiry, this paper examines the ethical philosophy of Watsuji Tetsuro, whose *Rinrigaku* has been hailed as “the definitive study

of Japanese ethics,” “ a study of Japanese ethical thought and practice that is still unequaled.”<sup>7</sup> The bulk of Watsuji’s ethical thought was composed during the Fifteen Year’s War: *Ethics as the Study of Man (Ningen no gaku to shite no rinrigaku)* appeared in 1934, and his *magnum opus*, *Rinrigaku*, was published in three volumes in 1937, 1942, and 1949. *Fudo*, which dates back in manuscript form to 1929, was published in 1935. Watsuji supported the war, even if he might have been critical of the way it was handled by the army. Crucial here is the historical context of Watsuji’s ethical system. Was there anything in Watsuji’s ethical philosophy that would have sanctioned resistance against a state that was committing aggression and murder in the name of emperor and nation? To answer this question, the early part of Watsuji’s career will be discussed, followed by an exposition of his ethical philosophy.

### INDIVIDUAL AND COMMUNITY

Watsuji was born in 1889 and educated at Japan’s premier educational institutions, First Higher School and Tokyo Imperial University. Like many other members of his generation, the question of individualism dominated his youthful intellectual life. As Robert Bellah described,

Cut off culturally from most of his countrymen by a through-going exposure to Western culture, and cut off from his family and hometown background by his life as a student in Tokyo, it is natural that Watsuji, like so many others in similar circumstances, should become concerned with the problems of individualism and self-realization.<sup>8</sup>

Watsuji published his first two books on a pair of individualist philosophers, Nietzsche and Kierkegaard. In 1918, however, Watsuji published *The Resurrection of the Idols (Guzo Saiko)*, which Bellah saw as an indication of intellectual reorientation (*tenko*) away from individualism and a “return to the warm *gemeinschaft* community of Japanese life.”<sup>9</sup>

Apparently, the death of Natsume Soseki in 1916, whose lectures Watsuji had attended at First Higher School, helped to inspire the change of course. Indeed, Watsuji’s reminiscence of the novelist in *Guzo Saiko* testified to Soseki’s influence in the “Taisho-period transition from Western individualism and cosmopolitanism to inner cultivation and a repossessed Japanese cultural self-consciousness.”<sup>10</sup> Late in his career, Soseki had turned away from his earlier individualism to embrace a position of *sokuten kyoshi* (follow heaven and abandon the self). His last novels, which seem to have made a great impression on Watsuji, grimly demonstrated the bankruptcy of individualism, for “love and sincerity can only live when *watakushi* and *shi* (egocen-

trism) are radically eliminated.”<sup>11</sup> Watsuji, too, had become disappointed with Nietzsche and Kierkegaard, for individualism only “led him to an abyss of emptiness.” Indeed, “Watsuji’s reminiscence stresses the fact that Soseki loved *ningen*, that is truly human, but repudiated immorality, insincerity, and impurity with all his creative strength. He thus rejected egoism in all its modern bourgeois forms.”<sup>12</sup> Therefore, by 1918 Watsuji had disavowed the individual as a legitimate basis of ethical action. Given the high esteem generally accorded to ideas of *kyodotai* (community) in public discourses of the period, it is not surprising that Watsuji turned toward the community as the true subject of benevolence, compassion, and morality.

Watsuji’s privileging of the community over the individual persisted throughout the remainder of his mature career. He believed that community assumed a culturally specific form in each nation and in the 1920’s composed a number of appreciations of ancient Japanese and Asian culture. Meanwhile, he continued to draw from developments in European philosophy, especially the growing phenomenological movement. Pioneered by Husserl as a non-empirical, intuitive method of knowledge, phenomenology made a great impact on Watsuji. In 1929, the intersection of communalism, cultural particularism, and European philosophy produced *Fudo*, one of Watsuji’s most influential works. This classic study of climate and culture is a useful starting point for our inquiry into Watsuji’s ethical philosophy.

*Fudo* was written in direct and critical response to Heidegger’s *Being and Time*. Sojourning in Berlin in 1927, Watsuji was among the first readers of Heidegger’s epoch-making treatise. To Watsuji, Heidegger’s *Dasein* analysis was tainted by its characteristically Western obsession with individuality and temporality, but its method of hermeneutic phenomenology can be used to re-situate *Dasein* in the concrete spatio-historicity of cultural existence. Through the study of climate, Watsuji would restore space and community to the phenomenological study of man.

By the term “climate,” Watsuji referred not to an objective natural environment, but to climate as the self-expression of man’s subjective existence. Central to Watsuji’s analysis is the phenomenological concept of intentionality, which maintains that “no one is ever aware of anything that is not in consciousness, and therefore, all objectivity is objectivity for some consciousness.”<sup>13</sup> In the opening, theoretical chapter of *Fudo*, Watsuji illustrates this point with the example of the sensation of coldness. When one feels cold, it is not that coldness presses against one from the outside, but rather that one discovers oneself in the cold. The instance that the cold is discovered, we are already outside in the cold. Therefore, the basic essence of what is ‘present outside’ is not a thing or object as cold, but we

ourselves. 'Ex-sistere' is the fundamental principle of the structure our selves, and it is on this principle that intentionality depends. That we feel the cold is an intentional experience, in which we discover our selves in the state of 'ex-sistere', or our selves already outside in the cold.<sup>14</sup> Moreover, intentional experience is not individual, but always mediated by others:

The structure of which "ex-sistere" is the fundamental principle is this "we," not the mere "I." Accordingly, "ex-sistere" is "to be out among other 'I's'" rather than "to be out in a thing such as the cold." This is not an intentional relation but a "mutual relationship" of existence. Thus it is primarily "we" in this "mutual relationship" that we discover ourselves in the cold."<sup>15</sup>

Climate, then, is that in which man subjectively comprehends himself via mediation by others, in a form of Being-in-the-World that does not neglect man's relation to specific climactic-cultural spaces and communities.

As shown in *Fudo*, Watsuji's earlier embrace of the cultural community as the basis of love and sincerity was by now fully integrated into a sophisticated philosophical system. Watsuji was critical of Heidegger's neglect of the spatial dimension of human existence, but he employed a similar mode of phenomenological inquiry to expound his concern with community and culture. With the concept of *fudo*, Watsuji was able to "uncover" the fundamentally social and intersubjective nature of human existence, and the resulting definition of man as inextricably both individual and social would become the pillar of his ethical thought. Bellah has interpreted Watsuji's work as symptomatic of a larger pattern of Japanese particularism; Dilworth, in contrast, cites Watsuji's grounding in German philosophy to argue that the ethicist's views were philosophical rather than ideological. But, however one defines and distinguishes philosophy and ideology, Watsuji's case indicates that academic philosophy is not free from political concerns. In fact, Watsuji seems to have reproduced a tendency, already prevalent in Japanese discourse of the time, to conflate *sein* and *sollen* and thereby accord ultimate value to the social totality rather than to a specific group of ideas.

### ETHICS

To Watsuji, the problem of ethics is not the problem of individual consciousness, but of human relations and reciprocities in the context of practical everyday activities. Therefore, any ethical inquiry can succeed only by subjectively grasping the historical realities of human existence through an understanding of its expressions. In short, what is required to answer the above question is a hermeneutic, or interpretive, method.<sup>16</sup> Irrational historical reality can

not be grasped by logic; rather, a hermeneutic that aims at the understanding historical reality through the interpretation of human expressions constitutes the proper path of ethical inquiry. In Heideggerian phenomenology, truth is the unconcealedness of Being that is disclosed through *logos*, or language. So it was with Watsuji, who opened *Rinrigaku* with an etymological analysis of four key terms in which the truth of human existence would reveal itself.

The first term is, not surprisingly, *rinri* (ethics), which consists of two characters: *rin* and *ri*. *Rin* means *nakama*, which "signifies a body or a system of relations, which a definite group of persons have with respect to each other, and at the same time signifies individual persons as determined by this system."<sup>17</sup> *Ri*, on the other hand, means reason or order. *Rinri*, therefore, "consists of the laws of social existence."

But if *rinri* denotes the pattern of human interaction, "human" must first be defined. Watsuji differentiates the Japanese "*ningen*" from the Western "man" or "*Mensch*"; while *ningen* can be used like its Western counterparts to denote the individual, it originally signified the betweenness of human beings, or the public. Hence, "we Japanese have produced a distinctive conception of human being. According to it, *ningen* is the public and, at the same time, the individual human beings living in it."<sup>18</sup> *Ningen*, denoting both individual and society, is in itself a "unity of contradictions."

"Public" (*seken* or *yoonaka*) also has a specific and original meaning for Watsuji. The character *yo* is equivalent to "generation," thereby giving the term "public" a historical dimension. *Ken* (or *aida*), which is also the second character of *ningen*, implies "living and dynamic betweenness, as a subjective interconnection of acts."<sup>19</sup> In sum, *seken* designates "community as subject," which involves "the historical, climatic, and social structure of human existence." As a result the community, conceived as the public, is identified with the nation.<sup>20</sup>

Finally, *sonzai* (existence) is introduced. Again Watsuji contrasts the Japanese term against its European counterparts. Unlike "is" or *sein*, *sonzai* cannot be used as a copula. The character *son* designates preservation, or maintenance against loss over time, while *zai* originally designated the subject's staying-in-place against departure. Since the subject always stays in a place in the context of human relationships, on a deeper level *zai* "means that she who acts subjectively, while coming and going in human relations in one way or another, nevertheless, remains within these relationships."<sup>21</sup> Taken together, *sonzai* is "the self-sustenance of the self as betweenness," or "the interconnection of the acts of *ningen*."

Ethics, then, is the manner of being for *ningen* as its activities unfold in the practical interconnections of everyday being. For Watsuji, ethics is inextricably a manner of social being, and he goes to great lengths to critique the illu-

sion of individual consciousness so prevalent in Western philosophy. Even theorists of *cogito* necessarily think through language; and language, of course, is communally shared. The very use of language reflects the essential communality of *ningen sonzai*. “In combination with language, common sense, and those scientific theories prevalent in an age, all play a role, providing a number of prism facets that affect the contents of individual consciousness.”<sup>22</sup> The notion of individual consciousness is no more than an abstraction in the face of the practical everydayness of *ningen’s* activities.

Hence, Watsuji’s hermeneutic does not assume a vantage point outside of the historical and practical reality of *ningen sonzai*. The individual does not suffice as a category of analysis because of its one-sidedness with respect to *ningen’s* intersubjective reality. The science of ethics, as the investigation of *ningen sonzai* itself, must be distinguished from and claims basic status over the study of being, on the one hand, and the study of moral ought (*sollen*), on the other. “Through the basic clarification of *ningen’s sonzai*, the problem of how objective things arise or of how consciousness of the ought to be arises in each age can be resolved.”<sup>23</sup> *Sollen* is to be sought from within the historical horizon of *ningen’s* practical, subjective, and dynamic existence. In short, the justification of the ought is to be found in what historically is. Watsuji’s methodological premises thus already hint at the priority of what is over what ought to be.

Taking *ningen’s* condition of intersubjective betweenness as the point of departure, the laws of ethics are to be located in the double structure of human existence as both individual and totality. This structure is essentially a movement of negation that unfolds through the dialectic between individual and totality, the movement of absolute negativity returning to itself in the form of the nonduality of self and other. In Watsuji’s words,

There are three moments that are dynamically unified as the movement of negation: fundamental emptiness, then individual existence, and social existence as its negative development. These three are interactive with one another in practical reality and cannot be separated.<sup>24</sup>

Watsuji defines the individual as the negation of the community; the individual comes into being only by revolting against the totality. “Hence, individuality itself does not have an independent existence. Its essence is negation, that is emptiness.”<sup>25</sup> Naoki Sakai argues that Watsuji’s negative definition of the individual results in the construction of the totality as both immanent in and anterior to individual consciousness.<sup>26</sup> It follows that Watsuji’s dialectic was really no dialectic at all, but the tyranny of the community over the individual. Sakai’s criticism is valid, as we

will see later. But it is also important to explicate Watsuji’s own emphasis on the doubly negative quality of both the individual and totality. Totality, too, is established through negation, specifically the negation of the individual. In other words,

The ultimate feature of every kind of wholeness in human beings is “emptiness” and, hence, that the whole does not subsist in itself but appears only in the form of the restriction or the negation of the individual. To speak candidly, something whole that precedes individuals and prescribes them as such . . . does not really exist.<sup>27</sup>

The dual negation of both individual and the whole cannot in any way be temporally or spatially divided, and neither aspect is prior to another. The two terms of the dialectic “empties each other” in absolute negativity; in the Buddhist terms of William LaFleur, priority is an “illusion,” and the true meaning of emptiness lies in “co-dependent origination.”<sup>28</sup> Totality perishes without self-aware individuals who can be negated, and individuals cannot subsist independently of a totality also to be negated. How, then, does one distinguish between the ethically good and the bad?

Although the dialectic between individual and totality constitute one single inseparable movement, some moments of the totality are privileged over the others. It was an unequal dialectic in which value is disproportionately distributed among different moments. For Watsuji, authenticity is identified solely with the moment of totality in the dialectic. Morality consists of a return to authenticity; the self arises by negating the whole in inauthentic revolt, but authenticity is again realized with the abandonment of the self, culminating in the nonduality of self and other. Watsuji wrote in direct opposition to Heidegger’s idea of authenticity, which he believed to be negligent of the moral dimension of intersubjective existence. Heidegger had defined authenticity as *Dasein’s* preparedness towards death, and identified inauthenticity with the loss of the self to the public (*das Man*). To Watsuji, Heidegger’s “up-side down version of authenticity,” hindered the development of the proper understanding of death.

The original countenance that makes its appearance in Heidegger’s “preparedness for death” is concerned through and through with “an individual” but not with *ningen*. Only in the relationship between self and other [does] the “preparedness for death” give full play to its genuine significance. As a spontaneous abandonment of the self, it paves the way for the nondual relation between the self and other and terminates in the activity of benevolence.<sup>29</sup>

In short, in Watsuji’s dialectic, moral goodness lies with the negation of the individual in selfless return to wholeness. As Robert Carter puts it, “the ethics of benevolence

is the development of the capacity to embrace others as oneself...(it is) a matter of compassion, spontaneous caring, concern for the whole."<sup>30</sup>

Watsuji's ethics are above all concerned with the embrace of the whole by the individual, and the individual in itself is not endowed with any intrinsic ethical value. The negation of the whole, through which the individual is born, "is goodness when it is pierced by the movement of coming back (to authenticity) but is badness in and by itself."<sup>31</sup> Morally worthless in and of itself, the individual functions as a formal category whose value is derived solely from its own negation. In this sense, value is externalized; the locus of value lies outside of the individual, who must relinquish the self to embrace what is outside of oneself. Watsuji's individual, then, clearly lacks the value autonomy that Maruyama so cherishes. Morality compels the individual to embrace the whole, yet the latter is not bound by a similar ethical imperative.

This can be illustrated further through Watsuji's analysis of trust and truth. Thus far, Watsuji's analysis has been highly abstract. In terms of practical and concrete everyday activities, however, "the structure of existence (*sonzai*) appropriate to human beings (*ningen*) expects and depends on *trust* and *truth* in human relationships."<sup>32</sup> Watsuji argues that trust is not a pre-condition of human relationships. Rather, it is the law of human existence that "renders trust capable of existing." "Human relationships are those of trust; and at a place where human relationships prevail, trust is also established."<sup>33</sup> For instance, the fact that one may ask strangers for directions indicates the inherent existence of trust in the mutuality of *ningen*. In a state where trust does not exist, such human interaction is impossible; as long as *ningen* exists, so does trust.

Watsuji defines truth (*makoto*), on the other hand, as the reality of *ningen sonzai*, whose double structure entails a dialectical negative movement that returns to authentic homeground in unity. Watsuji here refers not to truth as the correspondence of word and deed, but to the truthfulness of human relations that are grounded in trust. "Truthfulness is decided in and through the human relation that consists in a relationship of trust. To speak truth expresses this relationship."<sup>34</sup> Since truthfulness refers to the reality of human trust, truthfulness necessarily occurs as human relationships unfold in the returning movement of *ningen sonzai* to its authentic countenance. "Insofar as *ningen sonzai* is *ningen sonzai*, this movement cannot come to a halt. In other words, there is no state of affairs in which truthfulness does not occur."<sup>35</sup> Falsehood and betrayal of trust, then, constitute halting moments in the dialectic in which the inauthentic opposition between self and other results in the negation of unity and the betrayal of trust. However, given that falsehood does not have its own subsistence, the halting moments in the dialectic are necessar-

ily overcome in the return movement toward authenticity. Betrayal and falsehood, by halting *ningen sonzai*'s movement toward authenticity, constitute badness, but they are good insofar as the movement continues and they are negated. Once again, the dispersion of *ningen sonzai* into individuals and the corresponding oppositions between self and other seem to be no more than formal categories devoid of ethical value. Of course, the individual is absolutely essential to Watsuji's system; if individuals were completely submerged in the totality like cells in an organism, society and culture would lose their disciplinary function and henceforth perish.<sup>36</sup> Moreover, trust and truth would be meaningless without the possibility of falsehood and betrayal. But, just as the above examples show, the individual is devoid of any intrinsic ethical value, and it functions only as a negative category that is necessary for the realization of the social whole. Since Watsuji's idea of morality demands self-sacrifice, selves must exist, even if only to be sacrificed. Thus value is externalized beyond the individual and concentrated in the social whole, a whole without its own ethical imperative to follow.

The emptiness of the individual in Watsuji's system also denies the possibility of actually negating and therefore transcending the whole. Even though truthfulness and trust are already inherent in *ningen sonzai*, given the possibility of falsehood and betrayal in the halting moments of the dialectic, the reality of *ningen sonzai* is also transformed into an ethical *ought*. "Because a human being's truthfulness has the possibility of not taking place while always and already taking place, it turns out to be something that should take place."<sup>37</sup> Given the structure of *ningen sonzai*, human beings are necessarily and inextricably implicated in mutual and reciprocal relationships of trust, the betrayal of which constitutes a moral wrong.

However, human social totalities differ greatly, from nomadic tribes to modern nation-states. According to Watsuji's prescription, the existing trust relationships of a given social totality also constitute a moral *ought* to be followed. Therefore, one is denied the possibility of morally transcending one's particular social totality, if moral good is identified with trust in the totality regardless of its actions. As Gino Piovesana points out, Watsuji's social relationism "lacked a scheme of values which could transcend the social aspects of society."<sup>38</sup> Watsuji even "seems to justify the primitive custom of giving the wife to the guest as being a sign of communitarian spirit." *Sein* is conflated with *sollen*, and one is left without a vantage point with which to challenge the existing reality of the community.

In hindsight, given the historical context of war in the 1930's and 1940's, Watsuji's was an ethical philosophy that unfortunately failed to provide a conceptual vocabulary with which one could resist a state that breached morality in the name of emperor and nation. In Japanese discourses of the

time, the externalization of value and its identification with the nation, rather than with a set of abstract ideas, probably contributed to the silencing of resistance to the state.<sup>39</sup>

“The humane and gracious figure of Watsuji Tetsuro would not be problematic for modern Japan were it not for the fact that partly behind the cloak of just such thinking as his, a profoundly pathological social movement brought Japan to total near disaster,” wrote Robert Bellah.<sup>40</sup>

In Naoki Sakai’s dramatic terms, Watsuji’s ethics sanctioned a “blind leap into the destiny of the community,”

through which his ethics of *nakayoshi* (being on good terms with others) was transformed into one of *ichioku gyokusai* (the total suicide of 100 million).<sup>41</sup>

In the end, Watsuji seems to have been oblivious to the possibility that the community could also betray the individual, which was the case for many in the context of total war.

All in all, the ethical choice that Watsuji offered was one of choosing what already exists as the social totality. The question is whether that is really a choice at all.

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1 One form of resistance constituted what can be called an “imperial public,” in which criticism of the state was justified as faith to the true will of the emperor. However, such appeals to imperial will are highly co-optable, for the state controlled ultimate access to the emperor. See Andrew Barshay, *State and Intellectual in Imperial Japan*, (Berkeley: University of California Press, 1988), 9.

2 Andrew Barshay, “Imagining Democracy in Postwar Japan: Reflections on Maruyama Masao and Modernism,” *Journal of Japanese Studies* 18, no. 2 (1992).

3 See Maruyama Masao, “Theory and Psychology of Ultra-Nationalism”, in *Thought and Behavior in Modern Japanese Politics*, ed. Ivan Morris (London: Oxford University Press, 1963), 1-25.

4 Maruyama Masao, “Theory and Psychology of Ultra-Nationalism,” in *Thought and Behavior in Modern Japanese Politics*, ed. Ivan Morris (London: Oxford University Press, 1963), 3.

5 Maruyama Masao, “Theory and Psychology of Ultra-Nationalism,” in *Thought and Behavior in Modern Japanese Politics*, ed. Ivan Morris (London: Oxford University Press, 1963), 9.

6 Barshay, “Imagining Democracy in Postwar Japan”, 388-389.

7 Robert Carter, “Introduction,” Watsuji Tetsuro, *Watsuji Tetsuro’s Rinrigaku*. Translated by Yamamoto Seisaku and Robert E. Carter, (Albany: SUNY Press, 1996), 6. (This is a translation of Volume I (1937) of *Rinrigaku*.)

8 Robert Bellah, “Japan’s Cultural Identity,” *The Journal of Asian Studies* 24, no. 4 (1965): 586.

9 Bellah, “Japan’s Cultural Identity,” 587. William LaFleur argues that Watsuji’s change of course was not a “simple switch from universalized concerns to chauvinistic particularism.” Rather, it was an attempt to move beyond Euro-universalism and narrow particularism by turning to a third option of Asian cosmopolitanism, through an appreciation of Japan’s Buddhist heritage. However, as LaFleur notes, such a move also was highly susceptible to co-optation by the ideology of the Greater East Asian Co-Prosperity Sphere. In any event, it was a reorientation toward communalism and culturalism. See William LaFleur, “A Turning in Taisho: Asia and Europe in the Early Writings of Watsuji Tetsuro,” in *Culture and Identity* ed. Thomas Rimer, (Princeton: Princeton University Press, 1990), 234-257.

10 David Dilworth, “Watsuji Tetsuro: Cultural Phenomenologist and Ethician,” *Philosophy East and West* 24, no. 1 (January 1974): 9.

11 David Dilworth, “Watsuji Tetsuro: Cultural Phenomenologist and Ethician,” *Philosophy East and West* 24, no. 1 (January 1974): 9-10.

12 David Dilworth, “Watsuji Tetsuro: Cultural Phenomenologist and Ethician,” *Philosophy East and West* 24, no. 1 (January 1974): 10.

13 Robert Carter, “Interpretive Essay,” in Watsuji, *Watsuji Tetsuro’s Rinrigaku*, 334.

14 Watsuji Tetsuro, *A Climate: A Philosophical Study*, translated by Geoffrey Bownas (Japan: Government Printing Bureau, 1961), 4.

- 15 Watsuji Tetsuro, *A Climate: A Philosophical Study*, translated by Geoffrey Bownas (Japan: Government Printing Bureau, 1961), 4.
- 16 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 29-45.
- 17 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 10-11.
- 18 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 15.
- 19 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 18-19.
- 20 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 148.
- 21 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 20-21.
- 22 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 74.
- 23 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 22.
- 24 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 117.
- 25 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 80.
- 26 Sakai Naoki, "Return to the West/Return to the East: Watsuji Tetsuro's Anthropology and Discussions of Authenticity," in *Japan in the World*, eds. Miyoshi Masao and Harry Harootunian (Durham: Duke University Press, 1993), 237-270. (especially p. 250)
- 27 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 99.
- 28 William LaFleur, "Buddhist Emptiness in the Ethics and the Aesthetics of Watsuji Tetsuro," *Religious Studies* 14 (1978): 244-245.
- 29 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 226.
- 30 Carter, "Interpretive Essay," 342-243.
- 31 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 284.
- 32 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 343.
- 33 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 271.
- 34 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 275.
- 35 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 281.
- 36 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 282.
- 37 Watsuji, *Watsuji Tetsuro's Rinrigaku*, 280.
- 38 Gino Piovesana, *Recent Japanese Philosophical Thought: 1862-1962*, (Tokyo: Japan Library, 1968), 144-145.
- 39 Unfortunately, Volume II of *Rinrigaku*, which contains Watsuji's ideas on the state, has not been translated. This paper is based mostly on the translation of Volume I.
- 40 Quoted in LaFleur, "A Turning in Taisho," 235.
- 41 Sakai, "Return to the West/Return to the East," 268-270.



# The Bush Administration and the Korean Peninsula

INTERVIEW WITH DR. SUH SANG-MOK

Albert J. Suh

**MOST EXPERTS PREDICT THAT THE NEW BUSH ADMINISTRATION WOULD TOUGHEN ITS POLICY TOWARD NORTH KOREA WITH FIRM PRINCIPLES OF "RECIPROCITY." WHAT COULD BE THE POSITIVE ASPECTS OF THIS, AND PERHAPS THE NEGATIVE ONES?**

For one thing, we don't know exactly what the Bush administration's policy is toward North Korea as of yet. And the South Korean government recently formed some kind of task force, to review U.S. policy toward North Korea. It is too early to presuppose what the Bush policy is going to be. But the general understanding is that the Bush administration is likely to emphasize reciprocity. Experts also emphasize that whatever the U.S. policy is, has to be coordinated closely with the South Korea government. And I think it is very important that South Korea and the U.S. coordinate their policies, in order to be effective in dealing with North Korea. Emphasizing reciprocity can have positive results in the sense that it gives more pressure to North Korea, to do the kinds of things the U.S. and the South Korean government would like them to do. From the U.S. point of view, the main interest is for North Korea to give up the production of their weapons of mass destruction. For the South Koreans, interest lies in the reduction of military tensions along the DMZ, which might entail a reduction of conventional weapons and even troops. And more importantly, we [South Korea] would like to see the North take economic policies very much along the lines of the Chinese. To achieve those two objectives, South Korea and the United States should work closely together.

**HOW DOES THIS CHANGE AFFECT PRESIDENT KIM'S "SUNSHINE POLICY"?**

I actually think the main goal of the "sunshine policy" is to achieve those two objectives: reduction of military tensions and economic reforms by the North Koreans. It's really a question of tactics. Hence, I feel that the direction of Kim's "Sunshine Policy" is ultimately the same as that of the Bush administration. There might be some differ-

ences in style and I hope both governments can work out those differences. Again, what's important is close consultation.

**MANY PEOPLE HAVE CRITICIZED THE SOUTH KOREAN PRESIDENT FOR BEING TOO "SOFT" IN DEALING WITH THE NORTH. DO YOU SEE VALIDITY IN THIS CRITICISM?**

One regret is that neither the South Korean president nor government made much effort in building a national consensus in policies toward North Korea. There is lot of criticism from the conservatives that this incumbent president is too soft. And there are several instances, which can invite criticism to the government. I just hope that President Kim and his administration pay more attention to building the consensus and avoid these sorts of instances.

**WHAT KIND OF INSTANCES?**

Recently, the Head of the Korean Red Cross resigned, because he made some criticism of the North Korean society. Which is very true! [Dr. Suh laughs] The government made him apologize to North Korea before he made the resignation. That kind of measure is ridiculous. The Head of the Red Cross should have his own saying. The fact that North Korea doesn't like what he says cannot be a reason for his resignation. That's just one concrete example.

*PROSPECTS OF ECONOMIC REFORM IN NORTH KOREA*

**WHAT DO YOU MAKE OF NORTH KOREAN LEADER KIM CHONG-IL'S RECENT VISIT TO SHANGHAI?**

Well, everybody is trying to draw positive implications from his visit to Shanghai. He showed a lot of interest in the Chinese experience in economic reform, and he is very impressed with the results. And apparently he told his people, "hey, can you guys do something like this?" [Dr.

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Suh smiles] But one should also keep in mind that, they [the North Korean administration] did not just visit Shanghai, but also Beijing. One of the important purposes in the visit was to consolidate North Korea's common grounds with China, before negotiating with the Bush Administration, you know? Because it's a new administration, as you mentioned, there is some speculation that it might take a tougher stance. And Kim Chong-il wants to consolidate ties with North Korea's closest ally, China.

**SOME EXPERTS STILL CAST DOUBTS ON WHETHER NORTH KOREA WOULD PURSUE THE CHINESE-STYLE ECONOMIC REFORM TO REVIVE ITS ECONOMY. WHAT DO YOU THINK?**

There is an optimistic side as well as a pessimistic side. Both have their individual grounds. The optimistic side points out the fact that North Korea really reached the limit to where it can go in following the present line of economic policies. And Kim Chong-il is not dumb, and he should know this. The pessimistic side, on the other hand, might point out the North Korean trade record. The trade record is not good. One might also argue that if Kim Chong-il opens up, it's good for the economy and good for the people, but may jeopardize the survival of the regime. Liberalization means more contact with the outside world and the people will get more information. They will see their relative position with rest of the world and what's happening in South Korea. But the Chinese experience suggests that the Communist regime can maintain its political status—even consolidate it—while opening up the economy and introducing market principles. Because the present state of the economy is so bad, and many people are starving to death, Kim Chong-il, in the case of a positive result, can say, "I'm the leader who gave economic improvement to the people!" [Dr. Suh smiles] He can use that to consolidate his power base. It's really a question of Kim Chong-il's ability, whether he can maintain his political power base while opening up the economy. And what's important is not to speculate what will happen. But South Korea and U.S. should work together to make North Korea follow the route we'd like North Korea to follow. I'm more in favor of contemplating some positive actions, rather than just engaging in speculations. Nobody can be right. It can go either way.

**HOW MIGHT NORTH KOREA'S CONDITIONS DIFFER FROM CHINA'S?**

At the present time? North Korea's economy is in a miserable shape. It's a more controlled economy, more closed society than any other Communist country in the world. This is a great difference. One positive aspect [of future possibility for reform] is that the planned economic system is virtually destroyed. The state cannot supply the basic

necessities to the people. So many people have to get those these through the black market. The ration system is mostly broken down, and that is why many people are starving to death. So there isn't much left in the planned economy. Ironically enough, this can be a positive factor. In Russia, when they were trying to introduce the market system, it didn't function initially, and neither did the planned system, so they had complete chaos. But in the case of North Korea, they have chaos anyway! By introducing the market system, they cannot lose.

**THE NORTH HAS SEEMINGLY QUICKENED ITS EFFORTS TO IMPROVE RELATIONS WITH WESTERN NATIONS, PARTICULARLY EU MEMBERS INCLUDING GREAT BRITAIN AND BELGIUM. WHAT DO YOU MAKE OF THE NORTH'S IMPROVING RELATIONS WITH NATIONS OTHER THAN THE U.S.?**

I think there have been major changes in diplomatic initiatives. As you said, they opened up diplomatic relationships with many countries, which is quite different. Kim Chong-il is going to China, and it is reported that he may also go to Russia. And having that kind of diplomatic relationship is good in my opinion. North Korea will have more contacts, and will then get some kind of indirect pressures to open up. I think this is a very positive sign that they have changed their diplomatic policies.

*FUTURE FOR SOUTH KOREA?*

**SINCE THE SECOND HALF OF 2000, SOUTH KOREA HAS, AGAIN, BEGUN TO FACE MANY DIFFICULTIES DUE TO UNCONTROLLABLE OVERSEAS FACTORS AND UNCERTAINTIES THROUGHOUT THE DOMESTIC ECONOMY. HOW DO YOU VIEW THE RECENT ECONOMIC REFORM PROGRAMS? DO YOU FEEL THEY ARE EFFECTIVE?**

We had that financial and corporate reform program for the last three years. Initially, it was very successful, and it was more ambitious than any of the other programs instituted in countries dealing with similar experiences in the financial crisis. So I think that's why we [South Korea] had such rapid recovery. But unfortunately, as you remember, we had a General Election in April of last year. And because the recovery was fast, and also partly because the current regime wanted to show the people that it has fixed all the problems, it stopped implementing the restructuring program for six to eight months before the General Election. Many of the reform efforts were incomplete. That's why after the elections, starting this summer, we are beginning to have some problems. So the government has to formulate a second round of reform. They recently asked for 40 trillion won to the National Assembly, for that pur-

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pose. And the economic team says they are going to finish by early February this year. And they have money, so I think the “immediate problems” will be resolved. But we still have longer-term problems. One is a paradigm problem in economic management. We have a long history of government-managed economy paradigms. And clearly, that cannot be effective in a globalized world. That paradigm has to be changed to a market-driven economy, which has to start from the independent financial center. But the financial banks and non-bank financial institutions are now so dependent on the government, particularly after the financial restructuring, because there has been so much government money put there. The government virtually owns many of the financial institutions. Even other financial institutions depend on government funds, so how do we make them independent and efficient? That’s really the issue.

The other issue is that we’ve been losing comparative positions—particularly, vis-à-vis, China. In terms of technology, we cannot compete with Japan or the U.S., and in terms of the cost of labor, we cannot compete with developing China. The emergence of China and its collaboration with the overseas Chinese, including Hong Kong . . . just very tough to compete against. They have both the efficient financial markets and overseas marketing capabilities, but also a production base [in China] based on very low wages. And that’s the challenge.

That’s the way I look at North Korea. If North Korea goes on with its economic reform path, and if it can eliminate some of its political problems, then it may even be the solution even for the South Korean economy. For instance, the South Korean companies, which are suffering from high wages and strong labor unions can invest in North Korea, and take advantage of their fairly good quality of labor at low prices. This may create a new momentum to the South Korean economy.

#### **HOW DO YOU SEE KOREA’S FUTURE IN OPENING UP ITS DOMESTIC MARKET AND PROVIDING A FAVORABLE ENVIRONMENT TO FOREIGN INVESTMENT?**

After the last three years of economic reform, particularly under the IMF programs, South Korea opened up many markets. It opened equity markets and bond markets com-

pletely. Real estate markets for foreigners and areas of foreign direct investment were opened as well. In some companies, especially the good ones (e.g. Samsung Electronics, Pohang Steel), foreigners, as a group, are the largest shareholders. Hence, I think we have eliminated many obstacles, and the response has been very good.

#### **WHAT ABOUT REGIONAL COOPERATION WITH CHINA, JAPAN, AND ASEAN MEMBER COUNTRIES?**

Recently, they are talking about forming a free trading area, with Japan and ASEAN countries. I think this is a very good idea. Korea is one of the few countries that do not have any free trade agreement with anybody. So we can have a free trade agreement with ASEAN countries, Japan, and Australia, even New Zealand. And it can also go to the United States. I look forward to these free trade discussions occurring in the regime.

#### **WITH THE CURRENT ECONOMIC CRISIS IN SOUTH KOREA, HOW WOULD THIS AFFECT FUTURE COOPERATION WITH NORTH KOREA?**

In the short-run, there will definitely be an adverse effect, for South Korea will have less money for economic aid. Public support for giving too much economic aid to North Korea will diminish. But there is another side. I don’t think giving excessive aid is good to North Korea anyway.

What North Korea needs is change toward a more favorable environment for South Korean investment. If they make efforts in that direction and South Korean companies go to North Korea to make profits, it will be good for both nations. Thus, the current economic hardship has a short-term negative implication, but in the longer-term perspective, it can be a blessing.

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*Dr. Suh Sang-Mok is a former member of the Korean National Assembly, and visiting fellow at the Hoover Institution at Stanford University. The interview is from January 31, 2001.*

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# Prospects for Closer Economic Integration in East Asia

Wei Kiat Yip

Regional trade agreements (RTAs) have existed in most geographical regions since the early days of the multilateral trade system. For example, the European Union was first established as the European Economic Community through the Treaty of Rome in 1957. Latin America and Central America followed soon after with the formation of the Latin American Free Trade Association and the Central American Common Market in 1960. By 1965, regional integration had also begun to take root in North America with the conclusion of the Automobile Products Trade Agreement between Canada and the United States.

In comparison, East Asia<sup>1</sup> was conspicuously late in jumping onto the regionalism bandwagon. RTAs were non-existent in East Asia until ASEAN<sup>2</sup> reached agreement on its Preferential Trading Arrangements in 1977. Several further attempts to forge closer economic integration among the East Asian countries were made during the 1990s but all proved unsuccessful. Why did regionalism fail to take off in East Asia? Is the recent revival of interest in Asian regionalism also likely to be unsuccessful? In this paper, I will review the economic rationale for regionalism in East Asia and examine the main reasons why some of the past efforts at economic integration failed. I will also discuss several recent developments in Asia and whether the prospects for East Asia regionalism have changed.

## *ECONOMIC INTERDEPENDENCE — PUSH AND PULL FACTORS*

The main impediment to closer economic integration among the East Asian countries can be attributed more to political rather than economic factors. Historically, the East Asian economies have always been highly interdependent and closely interlinked. This characteristic is underpinned by three historical developments. First, the establishment of a network of treaty ports by Western imperialistic powers during the late nineteenth century had built a foundation for intra-regional trade. Second, Japanese imperialism in the early twentieth century created a high level of economic integration among the northern East Asian econo-

mies such as Korea and Taiwan. Third, the rapid economic development of the East Asian countries over the last few decades has generated linkages that have an intra-regional bias. This long history of sustained economic interdependence among the East Asian countries is reflected in the consistently high level of intra-regional trade. By 1913, intra-regional trade already accounted for 42 percent of the region's total trade compared to 46 percent in 1938 and 47 percent in 1993.<sup>3</sup>

The economic explanation for the high degree of East Asian interdependence draws upon empirical studies that have shown that bilateral trade flows are inversely related to distance. Increasing distance impacts negatively on trade flows because of higher transaction costs. In the past, transportation costs were a significant factor but this is no longer the case given the advancements in transportation technology. Instead, the level of international transaction costs now depends more on the cost of investments in human and physical assets that would facilitate trade. These assets include building a network of business relationships and knowledge about the trade partner's language, culture, markets and business practices. Naturally, investments in such assets are more likely to take place among physically and culturally proximate trade partners.<sup>4</sup> The effect of this factor in East Asia is evident in the development of treaty ports and communications infrastructure during the period of Western imperialism, reforms and modifications to the Korean and Taiwanese economies under Japanese rule, and the more recent diffusion of industrialization and market development from Japan to the rest of the region.

The regional bias in East Asia's trade patterns experienced a sharp dislocation in the aftermath of World War II and prior to 1985. The shift in East Asian trade toward the United States during this period was not surprising because of the preponderance of U.S. military power in the Pacific and the fact that it was the only country that emerged from the War with its economy largely intact. As economic development in East Asia gathered momentum, developments in the international economy continued to pull its trade away from regional partners towards global markets. These developments included: (a) a general integration and liberal-

ization of the global economy spurred by several successful rounds of multilateral trade negotiations, steady progress towards currency convertibility and marked improvements in international communications and transport; (b) economic development and expansion of trade in the East Asian countries provided the scale needed to justify the expansion and development of new markets beyond the region; and (c) similar patterns of economic development along the “flying geese” model<sup>5</sup> meant that the East Asian economies were more competitive rather than complementary. East Asian intra-regional trade only began to surge again from 1985 as new waves of investment flows from Japan and subsequently from the East Asian newly industrializing economies<sup>6</sup> (NIEs) to the rest of the region revitalized and intensified the long-standing regional linkages.<sup>7</sup>

The main reasons why regionalism in East Asia was slow to take off despite the strong economic grounds are political in nature. Since the end of World War II, the United States has sought to protect and advance its major interests in East Asia. These interests include preventing any single power from dominating the region, maintaining a reasonable degree of order and regional stability, and safeguarding its economic partnerships in the region.<sup>8</sup> To achieve this, the United States has arrogated the role of regional hegemon. There has been no indication that the United States is willing to allow any East Asian country, not even an ally such as Japan, to share equal responsibility in preserving stability in the region. This explains why the United States has been highly sensitive to any move, economic or otherwise, that would bring the East Asian countries together to the exclusion of the United States. Closer economic integration in East Asia could adversely affect the influence of the United States and its interests in the region in three ways. First, it enhances the economic growth that enables the East Asian countries to develop their own military capabilities. This could lead to the resurface of suppressed rivalries and raise the probability of instability and conflict in the region. Second, economic development increases the intensity of conflicts between East Asian societies and the West and strengthens the ability of East Asian states to prevail in those struggles. Third, economic integration may encourage bandwagoning behavior among the smaller East Asian countries around a regional power such as China or Japan as a counter to U.S. hegemony.<sup>9</sup>

At the same time, political resistance to East Asian integration can also be found within the region. Historically, China has never shown any strong proclivity towards formalized cooperation structures, whether economic or political, that could constrain its policy decisions and limit its maneuverability. This is one of the reasons for its previous lack of interest in joining the GATT or WTO. Furthermore, there remain strong underlying animosities and rivalries

among the East Asian countries that go back to Japanese imperialism during the early part of the twentieth century and its role in the Pacific War. Many East Asian countries continue to be suspicious and wary of Japan because it has never formally acknowledged or apologized for the atrocities it committed against its East Asian neighbours during the Pacific War. Japan’s refusal to do so has been, and continues to be, a psychological obstacle to closer integration among the East Asian countries, let alone the question of Japan playing a leading role within a East Asian trade bloc.

### *TWO RECENT FAILURES*

The difficulty in forging closer economic integration in East Asia was clearly demonstrated by the failure of two initiatives launched during the 1990s. In late 1990, Malaysia proposed the formation of an East Asian Economic Group (EAEG) comprising the ASEAN countries, China, Japan and Korea. Although the objectives of the EAEG were not explicitly spelt out, the launch of this initiative at a time when the WTO Uruguay Round negotiations appeared to be running into a stalemate raised concerns that it was conceived as an alliance of the East Asian states to counter emerging trade blocs in Europe and North America. Malaysia’s undeclared objective was to also persuade the other East Asian countries to shift their economic perspectives towards the region along the lines of its own “Look East” policy with Japan as the economic focal point. The EAEG proposal received lukewarm support from the other East Asian countries but was strongly opposed by the United States, Australia, and New Zealand, ostensibly because they felt that the EAEG would undermine the Asia Pacific Economic Cooperation (APEC) forum. Although some Japanese officials viewed the EAEG proposal favorably, the Japanese government nevertheless had to oppose it publicly in the face of the strong opposition of the United States. Without the support of Japan, Malaysia had to recast the EAEG proposal as an East Asian Economic Caucus (EAEC), which called for periodic consultations among the East Asian countries on economic issues of common concern. This reformulation of the initiative implied that the EAEC would only serve as a platform for accelerating economic integration in East Asia by promoting the coordination of economic policies.<sup>10</sup> Nevertheless, the continued suspicions and strong objections of the United States meant that the EAEC was for all intents and purposes a stillborn proposal.

The second setback for East Asian regionalism was the rejection of Japan’s proposal in September 1997 to create a \$100 billion fund to help regional governments cope with currency crises. As envisioned by the Japanese government, the fund (which later evolved into the idea of an Asian

Monetary Fund) was to be financed and managed by the East Asian countries independently from the IMF.<sup>11</sup> Unlike the IMF, assistance from the “AMF” would be unconditional and would take into account the Asian perspective and the different needs of the Asian countries. This proposal received a mixed reaction from the East Asian countries. As in the case of the EAEC proposal, several Southeast Asian governments were wary of Japanese domination of a regional institutional that would preclude the involvement of the United States. The United States and several European countries were expectedly unequivocal in their objections to the idea of an AMF for two main reasons. First, unconditional financial assistance for crisis-stricken countries would increase the risk of moral hazard (i.e. governments and corporations would be less discerning when lending or borrowing funds because of the knowledge that they could be bailed out when their investments failed). Second, an independent AMF could undermine the IMF because of potential conflicts in their policy guidelines for member states.<sup>12</sup> Furthermore, for political reasons, the United States was also dubious of any initiative that did not include them because it would mean a loss of influence over developments in the region.<sup>13</sup>

### *RECENT DEVELOPMENTS*

Despite these unsuccessful initiatives and persistent resistance of the United States and other Western countries, the prospects for further economic integration in East Asia remain positive. Following are some recent developments that suggest that regionalism in East Asia may in fact be gathering pace.

#### **(a) ASEAN Free Trade Area (AFTA)**

ASEAN was, and continues to be, an important foundation for broader regionalism in East Asia. The agreement on ASEAN preferential trading arrangements in 1977 was the first ever RTA concluded in East Asia. However, it did not have any significant impact on intra-ASEAN trade vis-à-vis the region's overall trade with the rest of the world. This relatively low volume of trade flows among the ASEAN countries reflected their lack of economic complementarity and their similar levels of industrial competence at that time. There was also a lack of serious intent to promote intra-regional trade because of the perception of zero-sum competition and the continued pursuance of import substitution policies. The turning point came in 1992 when ASEAN reached a milestone agreement to establish a free trade area to help its member economies to achieve greater trade and investment competitiveness in the global economy. The pooling of resources and markets was aimed at making ASEAN more attractive to regional and foreign investors. Multinational corporations locating in ASEAN would be

able to exploit economies of scale and to rationalize production by allocating different segments of production processes among the ASEAN countries according to their respective competitive advantage. With the development of intra-regional production networks and intra-industry trade, ASEAN economies were expected to become more complementary and integrated.<sup>14</sup>

The original AFTA agreement had envisaged that tariffs within ASEAN would be reduced to 0-5 percent by 2008. However, this time frame was subsequently brought down to 10 years (2003) and further to nine years (2002) in view of the agreements reached in the Uruguay Round, the proposals for APEC trade and investment liberalization, and the competitive challenges from other developing countries for export markets and foreign investments. In 1995, the ASEAN governments also extended the sectoral coverage to all goods, including unprocessed agricultural products.<sup>15</sup> AFTA has had a dramatic impact on ASEAN economic integration. Intra-ASEAN trade doubled from \$43.3 billion in 1993 to \$86.3 billion in 1997. Although intra-ASEAN trade was adversely affected by the Asian financial crisis from 1997-1999, commitment to AFTA trade liberalization remained generally on track. By 2000, 85 percent of all products in the Inclusion List<sup>16</sup> would have fallen to the 0-5 percent tariff rate. This proportion is expected to rise to 90 percent by the end of 2001. This continued liberalization of intra-ASEAN trade will bring the average Common Effective Preferential Tariff (CEPT) for all the ASEAN countries down from 4.43 percent in 2000 to 3.96 percent by 2001.<sup>17</sup> Apart from conventional tariff reductions, ASEAN has since 1995 also concluded a number of framework agreements aimed at enhancing regional cooperation in areas such as trade facilitation, investment, intellectual property rights, services, e-commerce, and transport and communications. The intent of these framework agreements is to push regional cooperation beyond the efforts undertaken at the multilateral level.<sup>18</sup>

#### **(b) ASEAN Plus Three (East Asia Summit)**

With very little fanfare, ASEAN has effectively resurrected Malaysia's original proposal of an EAEC over the last three years in the form of informal “ASEAN+3” (i.e. ASEAN plus China, Japan and Korea) meetings. Since 1997, informal ASEAN+3 Summits have been convened on an annual basis. Structurally, ASEAN+3 is beginning to resemble the G7. It has set up a “vision group” to explore ideas for cooperation and has also been holding regular meetings of its Finance Ministers. Unlike other more established regional groupings, cooperation among the ASEAN+3 thus far has been proceeding more rapidly on financial issues than on trade matters. Trade agreements in East Asia are as politically difficult to reach and as slow to organize as in other regions partly because of the diversity in approaches to trade

liberalization. Financial cooperation, on the other hand, can proceed more quickly to some extent without discrimination against outsiders. In this respect, the financial crisis in 1997 provided a strong impetus for East Asia to push ahead with financial cooperation.<sup>19</sup> ASEAN+3 has already implemented a region-wide system of currency swaps to help countries in the region deal with possible future financial crises. This currency swap system will reinforce the surveillance mechanism that ASEAN has created to anticipate and head off future crises through sophisticated early-warning indicators. These developments are positive signs that the AMF initiative may yet materialize after it was rejected barely three years ago.

At its latest Summit in Singapore in November 2000, ASEAN+3 took a further step towards a more institutionalized form of regionalism when its leaders agreed to a study on the feasibility of holding an annual "East Asia Summit". Chinese Premier Zhu Rongji went as far as suggesting that apart from trade, the forum might even discuss security and political issues.<sup>20</sup> A decision on this proposal is expected at the end of 2001 when the study is completed.

#### (c) Free Trade Agreements (FTAs)

Regionalism in the form of FTAs has also burst into prominence in the Asia-Pacific region in the past year. A growing number of bilateral and plurilateral FTAs involving such countries as China, Japan, Korea, Singapore, Mexico, Canada, New Zealand and Chile are currently being negotiated. Significantly, this trend is gathering momentum not least because of a change of sentiments in some countries in the region, such as China, Japan and Korea, which had been strongly opposed to preferential arrangements in the past.

Among the East Asian countries, a major breakthrough was achieved when Japan and Singapore agreed in October 2000 to begin negotiations on a bilateral FTA with a view to concluding the talks by the end of 2001. On the surface, there seems to be little to be gained from a FTA between these two countries which already have minimal tariffs, open investment regimes, and little trade in the sensitive area of agriculture. However, the proposed FTA between Japan and Singapore will go beyond the boundaries of a conventional FTA in that it embraces key aspects of the so-called new economy. Among the unique features of the Japan-Singapore FTA are a commitment to establish mutual recognition of certification authorities for digital signatures, the harmonisation of legal frameworks, and coordinated corporate privacy standards. Once the various systems of the FTA are in place, many Japanese firms will find it convenient to run their Southeast Asian operations from Singapore. In that respect, the Japan-Singapore FTA will benefit not only the two signatories, but will also have positive spillover effects for all the other countries of Southeast

Asia. A Japan-Singapore FTA is also strategically important in that it is the first institutionalized link between Northeast Asian and Southeast Asian economies. It therefore has a potentially positive demonstration effect that could catalyse closer economic integration in East Asia as a whole. The momentum generated by the proposed Japan-Singapore FTA appears to have already achieved some of its desired effects. At the ASEAN+3 Summit in November 2000, the East Asian leaders agreed to a study on the feasibility of an East Asian Free Trade Zone to be completed by the end of 2001.<sup>21</sup> In fact, the idea of an East Asia FTA is not new. The proposal was first raised by the Philippines during the 1999 ASEAN+3 Summit, but it failed to take off because of a general lack of support from the other East Asian countries at that time. The quick turnaround in sentiments on an East Asia Free Trade Area could be attributed to not only the proposed Japan-Singapore FTA but also a change in China's position. On the eve of the recent ASEAN+3 Summit, a Chinese Foreign Ministry official made a public statement indicating that "China stands ready to explore the possibility of setting up links with the ASEAN free trade area or of creating a free-trade zone between China and ASEAN".<sup>22</sup>

#### *FACTORS DRIVING RENEWED INTEREST IN EAST ASIAN REGIONALISM*

Why is East Asia suddenly showing a much greater interest in formal economic integration as opposed to the hitherto loose and informal economic interdependence? The reasons are three-fold: (a) the failure of the WTO and APEC to make any significant headway on trade liberalization; (b) a broad disquiet about the widening and deepening economic integration in Europe and North America; and (c) the Asian financial crisis.

The failure to launch a new round of trade negotiations during the WTO Ministerial Meeting in Seattle has prompted many countries, including those in East Asia, to reassess their positions and approaches towards further trade liberalization. Since many of the East Asian countries are heavily dependent on exports to sustain their economic growth and recovery from the financial crisis, it is important for them to safeguard their continued access to foreign markets. If the global trading system does not continue to liberalize, there is always the risk of a relapse into protectionism.<sup>23</sup> Hence, the perception that a new round of WTO trade negotiations had failed to materialize due to a lack of enthusiasm and political will in both the US and Europe has fueled concerns among the East Asian countries about the direction that the global trading system is heading. The fact that trade liberalization within APEC has also stalled has cast a further shadow on the near-term outlook. Because of domestic drag in the United States and sharp dif-

ferences between the United States and Japan, East Asian countries cannot envisage a revival of U.S. leadership or even active U.S. participation in further trade liberalization without the imposition of conditions the East Asian countries oppose, including extensive agricultural reforms and trade-related labor and environmental standards.<sup>24</sup> Under the circumstances, a non-integrated East Asia is likely to be greatly disadvantaged when matched up against Europe and the Americas where economic integration has continued to both widen and deepen<sup>25</sup>.

On the monetary side, the single greatest push for East Asian regionalism was the financial crisis of 1997-1999. Many East Asians felt that they were both let down by the West during the crisis. In their view, western banks and other financial institutions had created and exacerbated the crisis by pulling out their funds from the region. The leading financial powers then either declined to take part in the rescue operations (as was the case of United States with Thailand) or built in excessively stringent demands into their financial assistance programs such that these funds could never really be tapped into. At the same time, there was a negative perception among East Asians that the IMF and the United States were dictating their policy responses to the crisis by controlling their access to funds and private capital markets. This resentment was further fueled by the widespread view that the IMF's rescue programs had worsened the situation for the East Asian economies by pushing them into a deeper economic recession than was necessary to begin with.<sup>26</sup> Whether these views were justified, the East Asian countries have decided that they do not want to be beholden to the West should a crisis recur in the future. While they are not rejecting multilateral institutions and international capital markets altogether, the East Asian countries also realize that these institutions are not infallible. In other words, they want their own institutions and a bigger say on decisions that will determine their fates.

### CONCLUSION

Recent developments suggest that East Asia is finally coming around to giving more serious consideration to regionalism either as a complement or an alternative to the multilateral trading system. As discussed above, the economic grounds for closer economic integration among the East Asian countries have existed for many years. However, political obstacles and, to a lesser extent, economic

factors have prevented them from pushing through initiatives to foster closer economic cooperation in the region. Rapid economic development over the past few decades, reinforced by changes in the global economic environment and an uncertain outlook for the international trading system, appears to have convinced the East Asian countries that potential benefits of closer regional economic cooperation outweigh the costs at least for now. As long as this confluence of factors persist, regionalism in East Asia is likely to pick up momentum. However, as in the case of RTAs in other regions, the pace of economic integration in East Asia will probably wax and wane in tandem with developments at the multilateral level. Historically, activities in RTAs have tended to rise whenever the trade liberalization within the WTO stalls.

An East Asian RTA, if it materializes, will have a significant impact for the rest of the world. In terms of aggregate output, trade and reserves, East Asia as a whole is already about as large as both the EU and the United States (see table below). The emergence of an East Asian bloc

FIGURE 1

1997 (\$bn)	Aggregate output	Trade with rest of world	Official monetary reserves
East Asia	6,382	1,380	668
European Union	8,093	1,640	380
United States	7,834	1,580	140

Source: Institute for International Economics, Washington, D.C.

and the shift towards a tripartite world, as pointed out by Fred Bergsten, Director of the Institute of International Economics, is not necessarily a negative development. Whichever way East Asian regionalism leans will depend as much on the policies and actions of the East Asian countries as on the responses of the EU and United States. An outward-looking East Asian RTA could catalyse the global trading system in much the same way that European integration had stimulated the three major post-war multilateral trade negotiations. Likewise, positive responses by the United States and the EU could both limit the discriminatory effects of an East Asian RTA and embed it in revitalized global regimes.

<sup>1</sup> In this paper, East Asia refers to China, Japan, Republic of Korea and the ten Association of Southeast Asian Nations (ASEAN members comprising Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.

<sup>2</sup> Comprising only the founding members: Indonesia, Malaysia, the Philippines, Singapore and Thailand.

- <sup>3</sup> Peter Petri, "The East Asian Trading Bloc: An Analytical History", in Regionalism and Rivalry: Japan and the US in Pacific Asia, ed. Jeffrey A. Frankel and Miles Kahler (Chicago: University of Chicago Press, 1993), 22, 30.
- <sup>4</sup> Petri, "The East Asian Trading Block," 26-27.
- <sup>5</sup> The "flying geese" model described by Japanese economist Kaname Akamatsu in 1962 is analogous to the Marxist theory of imperialism. According to the model, Asian economies are initially pushed by the political dominant and economically more developed Western countries into producing goods and developing markets that are complementary to the latter's. However, diffusion of Western capital and technology allowed the Asian economies to gradually develop their production capacities and sophistication to the extent that their products and markets become increasingly homogenous with those of the Western economies. These more advanced Asian economies than assume the role of the Western countries in East Asia vis-à-vis other less developed Asian economies thus repeating the development cycle in a cascading pattern (Akamatsu, 1962. 3-25).
- <sup>6</sup> Korea, Taiwan, Singapore and Hong Kong.
- <sup>7</sup> Petri, "The East Asian Trading Block," 37-39.
- <sup>8</sup> Ted G. Carpenter, "From Intervenor of First Resort to Balancer of Last Resort", in Asia after the "Miracle", ed. Selig Harrison and Clyde Prestowitz (Economic Strategy Institute, Washington: Brookings Institution Press, 1998), 294-295.
- <sup>9</sup> Samuel Huntington, The Clash of Civilisations and the Remaking of World Order (New York: Touchstone, 1996), 218.
- <sup>10</sup> Petri, "The East Asian Trading Block," 45.
- <sup>11</sup> "An Asian IMF?" The Economist, 27 September 1997, p. 80.
- <sup>12</sup> M.G. Quibria, "Viewpoint: The Case for an Asian Fund," Asiaweek, 25 June 1999.
- <sup>13</sup> "An Asian IMF?" The Economist, 27 September 1997, p. 80.
- <sup>14</sup> Siow Yue Chia, "Regionalism and Subregionalism in ASEAN: The Free Trade Area and Growth Triangle Models", in Regionalism versus Multilateral Trade Arrangements, ed. Ito Takatoshi and Anne O. Krueger (Chicago: University of Chicago Press, 1997), 282-288.
- <sup>15</sup> Chia, "Regionalism and Subregionalism in ASEAN," 289.
- <sup>16</sup> Products in the Inclusion List are those that have to undergo immediate liberalization through reduction in intra-regional tariff rates, removal of quantitative restrictions and other non-tariff barriers. (CEPT) tariff rates, removal of quantitative restrictions and other non-tariff barriers.
- <sup>17</sup> ASEAN Secretariat 2000. (<http://www.aseansec.org>) Date accessed: 28 November 2000.
- <sup>18</sup> ASEAN Secretariat 2000. (<http://www.aseansec.org>) Date accessed: 28 November 2000.
- <sup>19</sup> Fred Bergsten, "Towards a Tripartite World," The Economist, 15 July 2000, 20-22.
- <sup>20</sup> Larry Teo, "Dialogue Partners to Upgrade Meeting," The Straits Times (Singapore), 25 November 2000, 6.
- <sup>21</sup> Lee Hong Chua, "China 'Open to FTA' with Asean — In Time," The Straits Times (Singapore), 26 November 2000, 10.
- <sup>22</sup> Richard McGregor, "China Signals Interest in Trade Pact," Financial Times, 22 November 2000, 10.
- <sup>23</sup> Fred Bergsten, "Towards a Tripartite World."
- <sup>24</sup> Fred Bergsten, "Towards a Tripartite World."
- <sup>25</sup> In Europe, the EU is expanding into Central and Eastern Europe while proceeding with closer monetary union. In the Americas, talks are already underway to link NAFTA with Latin American RTAs to form a FTA of the Americas within the next few years.
- <sup>26</sup> Fred Bergsten, "Towards a Tripartite World."

