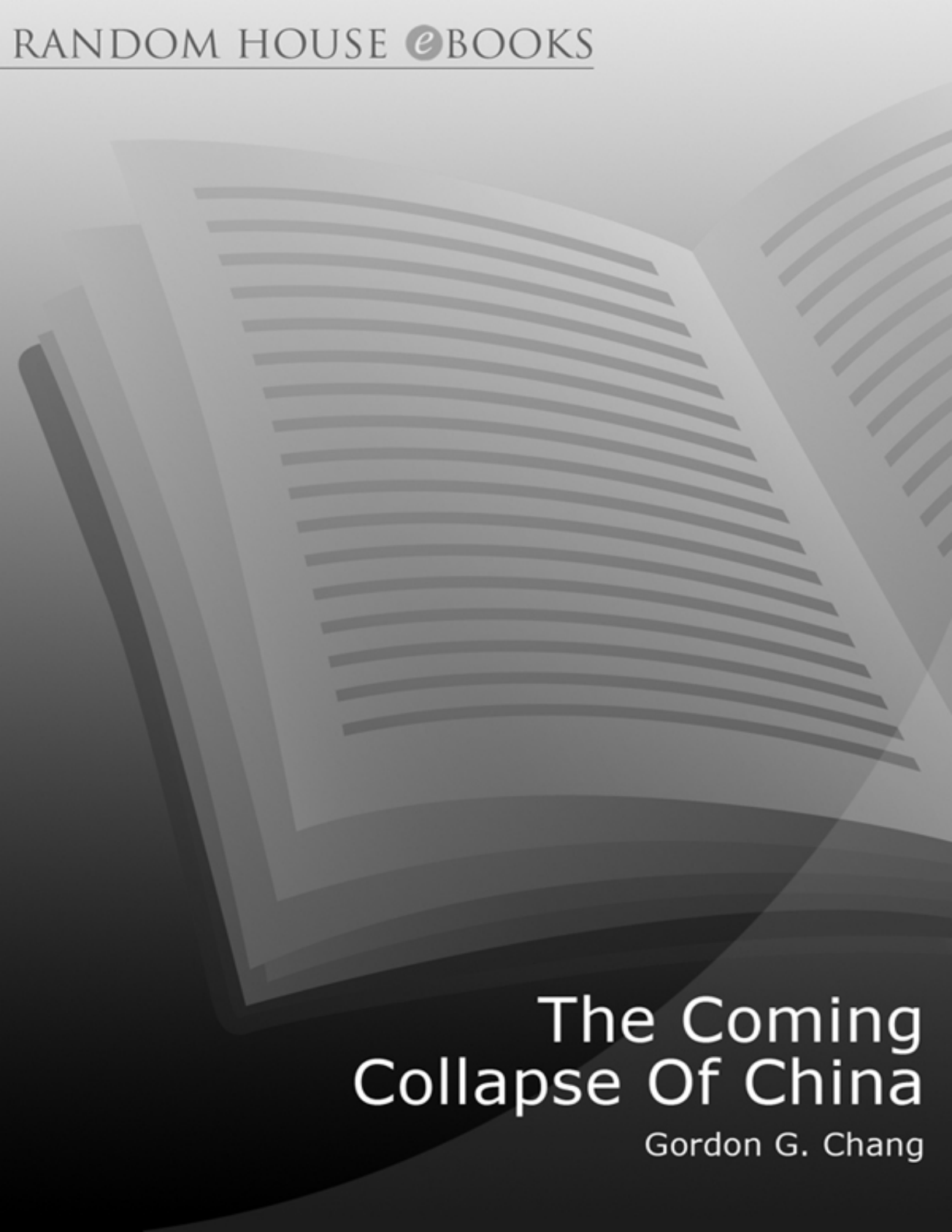


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The Coming Collapse Of China

Gordon G. Chang

THE
COMING COLLAPSE
OF CHINA

Gordon G. Chang



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Version 1.0

Epub ISBN 9781407071428

www.randomhouse.co.uk

Published by Arrow in 2002

9 10 8

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First published in the United Kingdom by Century in 2001

Arrow The Random House Group Limited 20 Vauxhall
Bridge Road, London SW1V 2SA

Random House Australia (Pty) Limited 20 Alfred Street,
Milsons Point Sydney, New South Wales 2061, Australia

Random House New Zealand Limited 18 Poland Road,
Glenfield Auckland 10, New Zealand

Random House (Pty) Limited Isle of Houghton, Corner of
Boundary Road & Carse O'Gowrie, Houghton 2198, South
Africa

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www.randomhouse.co.uk

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The manufacturing processes conform to the environmental
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ISBN 0 09 944534 4

Printed and bound in Great Britain by Cox & Wyman Ltd,
Reading, Berks

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*For the boy who left China in search of a better life—
my father*

THE COMING COLLAPSE OF CHINA

Gordon Chang has lived and worked in China for almost 20 years, most recently in Shanghai, as Counsel to the American law firm Paul Weiss. His articles on China have been published in *The New York Times*, *The Asian Wall St. Journal*, the *Far Eastern Economic Review*, the *International Herald Tribune*, and the *South China Morning Post*. He has been interviewed on developments in China by CNN, CNBC and the BBC. This is his first book.

Revolution is impossible until it is inevitable.

—LEON TROTSKY





FOREWORD TO THE UPDATED EDITION

No Exit

The older workers are not afraid.
They see no difference between starving to death
and being killed.

—Anonymous protestor in Liaoyang

Regimes are most vulnerable when they try to modernize, and the People's Republic is entering its most dangerous period. Unfortunately for them, China's leaders are playing a losing hand.

Mao Zedong created an abnormal society. But he was at least enough of a realist to surround his new republic with high and strong walls so that it could survive almost indefinitely on the inside. His successors have sought to create a more modern nation. But they have not changed the Maoist system, where the Communist Party dictates and the people are supposed to follow. Yet at the same time China's new leaders have successfully opened the country. As they do so, all the forces that apply around the world—economic, political, and social—will begin to apply in China as well. At some point in this process the centrally directed system has to fail. It's as if Mao tried to abolish the law of gravity by decree in his republic. As the country is opened up by his successors, gravity will have to apply in China.

So the issue today is not whether the Chinese government is doing the right things or the wrong things.

The issue is time. In a short period of time, the next five years, China will face many challenges, some of them unprecedented.

First, the government's finances are shaky and getting weaker. Beijing seeks to cope with all its problems with its program of massive fiscal stimulus, which is just about the only thing that is keeping the economy going today. Premier Zhu Rongji has recently admitted that the economy could have "collapsed" without deficit spending.

Deficit spending means that China has more highways, more dams, and more railroads. It also means that the country is running ever-increasing budget deficits, like the record one announced at the National People's Congress meeting in Beijing in March 2002. The economy is hooked on ever-increasing amounts of central government spending, and that spending is not sustainable in the long run.

Second, China has joined the World Trade Organization and during the next few years the worst effects of membership will be felt. The country could be a beneficiary of belonging to the global trading body, but the benefits only come later after structural reform has had an opportunity to take effect. In the beginning there will be pain: more business failures, more layoffs, and more social unrest. That's inevitable—China is trying to cure more than five decades of economic mismanagement with the shock therapy of WTO.

Third, there's the upcoming major political transition as the Third Generation leadership makes way, or doesn't, for the Fourth. Beginning in 2002 and continuing into the following year, almost all the top posts in the Party and the government are supposed to change hands. Neither of the two prior transitions in the history of the People's Republic went according to plan. There's no reason to believe that this one will be any smoother especially now that the Party is already split over various issues and especially because

Jiang Zemin is manoeuvring to retain as much power as he can. So when the challenges to China will be the greatest, the regime will be at its weakest.

If all those factors weren't bad enough, the country is unlucky. In the middle of 2001 it was clear that the world's developed economies were heading into a co-ordinated recession. We could see evidence of that in North America, in Western Europe, and even in Asia. That was bad, but then the horrible terrorist attacks occurred in Washington and New York on September 11. Today we can see that the world situation has adversely affected the Chinese economy. China joined the WTO just as most of the world's economy was turning sour.

Any one of these factors—weak treasury, WTO accession, political transition, September 11—would be difficult for China to take. Add them all together, and we can see why the regime will fail. Scholars dismiss talk of China's collapse as they downplay one concern or another. The point is that China faces many challenges all at once, not one challenge at a time.

All these trends leave China at the "tipping point," to borrow the phrase popularized by Malcolm Gladwell. Gladwell likens social change to epidemics, which begin with the smallest of events. ["Things can happen all at once,](#) and little changes can make a huge difference," he writes. So change does not always occur gradually; sometimes it takes place in one critical moment. China will "tip" when something, and probably just an inconsequential event, goes wrong. In some small village or large town, events will become out of control.

So we should be especially concerned that today, the social order is crumbling. Experts tell us that the country is stable, but the news from China is anything but reassuring. Beginning in November 2001 and continuing into 2002, bombings occurred from one end of the country to another. Some were directed against foreign businesses. Two people

died in an explosion at a McDonald's in the central city of Xian. There were two bombing incidents at French retailer Carrefour, one in southern Shenzhen and the other in northern Qingdao.

In Guangdong Province, in Sichuan, Guangxi, Chongqing, Shanghai, and other places as well, bombings like the above, illustrate the depth of anger and desperation that is being felt. These incidents were the protests of individuals. But we also saw demonstrations involving thousands, tens of thousands actually.

We didn't have to wait too long after WTO accession on November 11, 2001 to see massive worker demonstrations, which began across the nation in March 2002. The largest protests were in China's troubled northeast, in the cities of Daqing and Liaoyang. These cities saw demonstrations of 30,000 workers, maybe 40,000. Some say 50,000 laborers in Daqing were involved, but the body count is not the real story.

The Liaoyang protest was the first in anyone's memory when workers from more than one factory linked up to demonstrate: employees from more than 20 factories were involved. That shows economic failure across a broad spectrum of industries. Liaoyang was the first time that workers aired overtly political messages since the Tiananmen protests of 1989. And it was the first time that disgruntled peasants joined workers in demonstrations.

And there are other firsts. "It's the first time we have seen protests occur in the same industry, over the same issues, in different cities of China," says exile labor activist Han Dongfang. "It's not necessarily organized, but ["it looks like the beginning](#) of a united movement." And a desperate one. "The older workers are not afraid," said a protestor in Liaoyang. "They see no difference between starving to death and being killed."

So protesting workers tell us that time is short for the regime. And so do the experts. "China today, for all the

successes of the past fifteen years, stands at an economic crossroads and at the edge of a [“monumental economic crisis,”](#) says MIT Professor Edward Steinfeld. Beijing is at the centre of the approaching crisis because in the five years before WTO accession, Chinese officials deferred implementation of structural reform. During this period the fast pace of change under Deng Xiaoping was replaced by the gradualism of his successor, Jiang Zemin. For example, the central government under Jiang watched state enterprises shed workers by the millions but did little to provide pensions or severance benefits.

The failure to do so typifies the breakdown of reform in recent years. Senior leaders in Beijing talk about the social security system they created in the middle of the 1990s, but the reality is that their program suffers from the improbable combination of existing mostly on paper and being in tatters and on the verge of bankruptcy. Beijing will need to come up with about [US\\$1 trillion](#), give or take a few hundred billion dollars, in the years ahead to fund benefits. For this purpose Chinese technocrats have devised a general concept that should work: sell more stock of state enterprises. The state still owns a majority of the shares of companies listed on China’s two domestic stock exchanges, some 70 percent according to state media.

In June 2001 the central government announced that companies selling stock on public markets had to contribute a small part of the proceeds to the national social security fund. The leaders of the Communist Party may head an authoritarian state, but they could not command the markets to do as they wished. In reaction to the June announcement, the markets sank, losing more than 30 percent of their value, some US\$181 billion in market capitalization. In October of that year the government suspended the plan, and the markets soared as a result.

Reversing course solved the problem of sinking prices, but it did nothing to take care of the original problem. So Beijing tried to introduce a similar plan in January 2002. Markets plunged again, and again the government abandoned its plan, this time after just a couple of days.

The insolvency of the system doesn't seem to worry Beijing, however. In June 2002, the central government permanently shelved its plans to fund Social Security payments from the proceeds of domestic stock sales. Just think about this: even the massive worker protests have not moved the technocrats in Beijing to act. There will either be a funded social security system or a new government. The choice is entirely in Beijing's hands, and so far it appears incapable of coming up with the right answer.

Now that China has joined the World Trade Organization its leaders must find the right answers soon. For one thing, the economy is decelerating. China's gross domestic product increased by 8.0 percent in 2000. In 2001 growth fell to 7.3 percent. Worse, growth was only about 6.6 percent in the last quarter of that year, well under the 7.0 percent official target for the current five-year plan. The 7.0 percent mark is, according to Beijing, also the minimum necessary to create jobs for laid-off workers and new entrants to the workforce.

Growth in the first quarter of 2002 looked robust at 7.6 percent. The news media said that the economy was back on track, but again the pundits were wrong. Growth in the first quarter of the previous year was 8.1 percent. That means growth declined by a half point year-on-year. We have to remember that in 2001 growth declined in each quarter. So China is starting 2002 from a much lower base.

These are official figures (which are subject to question of course). China commentators are engaged in a lively international debate about the reliability of China's growth statistics. The real story, however, is not whether the numbers are doctored or what the absolute growth figure

is. The real story is how the government creates growth. At the end of the last decade, the central government switched its emphasis from reform to development. Today Beijing keeps the economy growing not through structural change but by fiscal stimulus. Fixed asset investment, the result of stimulus, increased year-on-year in the first quarter of 2002 by an astounding 26.1 percent.

Even if we are to hail the 7.6 percent first quarter GDP number as an achievement (and it is not), it is clear that the central government is buying low-quality growth rather than stimulating genuine improvement. Growth is essentially the product of fiat, in other words, fiscal stimulus. Today the central government accounts for more than two-thirds of investment in the country, and this is, by any standard, alarming. Government spending is inefficient spending: the growth of spending is more than three times the rate of GDP growth. And the story gets worse: state expenditures are having little effect on igniting consumer demand. Deflation has returned to the Mainland.

China has been running large budget deficits even though the economy is growing at a fast pace according to official statistics. That's unusual, to say the least. And disturbing. So we have to ask ourselves a simple question: What will happen when the economy slows further? And what will happen when the country begins to fund its critical needs from pensions to a dozen other major items deferred from the last decade?

We should be concerned now. Even before it spends a single renminbi on these needs, it is apparent that country is running low on funds. The erosion in the finances of the central government was evident in the numbers for the first quarter of 2002. Expenditures rose 23.9 percent during this period while tax revenues increased just 3.4 percent from the same quarter of the previous year. No outside commentary on this turn of events is needed: Finance Minister Xiang Huaicheng himself had one word for the

central government's spending during the first quarter of 2002: ["reckless."](#) He went on to say that, ["The fiscal situation is grim;](#) revenue is growing too slowly and expenditure is growing too fast. Not enough money is being collected and too much is being spent."

Until he can patch up the situation, economists will utter the words "China" and "Argentina" in the same sentence. There is a ["potential time bomb,"](#) writes economic strategist Chi Lo. Like that South American country, the People's Republic can go from boom to bust in just a few short years. Both countries stuffed their banks with their bonds, created growth through fiscal means, attracted foreign direct investment, and pegged their currencies to America's. Argentina was hit when there was a fall in the demand for its debt obligations.

Argentina deferred reforms by living on foreign capital, and China today plays this game too. The former country did not have to undergo the shock therapy of accession to the World Trade Organization; China is doing so now.

Capital flows to a country are dependent on global liquidity. Because China now lives on inward flows, "its ability to sustain investor confidence is crucial," says Chi Lo. And the future? "As and when the flow of international capital tightens again, China's [deteriorating fiscal and debt conditions](#) will come under international scrutiny."

The People's Republic has a few more years to make things right by slowing the spending, collecting more taxes, and implementing reforms. But as the country's economy decelerates something else happens: time becomes even more precious.

So the authorities are short of time. No wonder they resort to force to stop the spread of unrest. But the use of the coercive power of the state is only a short-term solution—force just makes protests even harder to control in the future because it creates new enemies. The government talks about alleviating the conditions of the workers and

the peasants, but it prefers to spend its money trying to send astronauts into orbit or building housing for foreign athletes in Beijing. The leadership will not, or cannot, come to terms with the causes of instability.

All of us can see evidence of solutions in China that with time and political will could work. Whether Beijing is on the right road is not the issue, however. The critical issue is time. Peasants and workers are impatient. They're not about to wait another five decades to see if Communist Party economics will work. Despite all the progress, many Chinese today are hungry, angry, and worst of all, desperate. In Liaoyang, some [60 to 80 percent](#) of the workers are out of work. In rural areas the most common cause of death among the non-elderly is [suicide](#).

To keep society together, the leaders of the regime prefer the easy solutions. They spend money, hoping to get by from one day to the next without fixing the real problems. Even at this late date, leaders cannot bring themselves to undertake most structural reforms. The system in which they operate is losing the capacity to change itself from within.

We should not be surprised. On the surface the problems of the People's Republic appear to be economic. Yet China has all the resources it needs. The underlying problem is the political system, which will not permit the implementation of even the obvious solutions these days. In this period of political transition, the paralysis will become even more apparent.

So the only thing that can save China now is political reform. Such reform can stem the tide of corruption, which now threatens to engulf the regime, re-ignite stalled economic reforms, and result in a more open society, which will relieve many of the pressures building up on the lowest rungs of the social order.

Political change is important, but will it occur? Communist Party members themselves now openly talk of

political reform, although they must do so in polite tones. In an important step, the Chinese are studying social democratic parties in other countries, especially the nations of Western Europe, and analyzing the Singapore system of governance. They even look at the fate of other communist parties as they weathered, or not as the case may be, the transition to democracy.

Beijing permits “grass roots” elections in villages and promotes reforms called “inner party democracy”. Cadres say the right things about a freer political system and there is progress, but there are two problems. First, change is incredibly slow. Second, the Party insists that it remain in control. Can reforms be meaningful if they cannot result in the ousting of the Communist Party? Younger cadres may talk of a more open system of government, but the leaders are only interested in window dressing.

After all, either Hu Jintao will ascend to the most powerful position in China in late 2002 or Jiang Zemin will retain his coveted post. Hu, an enigmatic personality, was selected for this job some 13 years ago by one man, Deng Xiaoping, a man who is no longer alive. Deng also picked Jiang. Isn't that simply amazing? A dead man, by himself, gets to choose the two candidates for the top job in Beijing. Some 1.3 billion living souls do not. For all the reform that we see on the surface, China has changed remarkably little underneath.

Let's not delude ourselves about the People's Republic. It may look modern, but it isn't.

So we should see China the way it actually is, not the way we want it to be. And when we look at reality, we realize one thing: there is no exit strategy. From politics to economics the Communist Party of China has no good options left. Now, senior cadres continue with policies they know don't work because they cannot afford long-term solutions.

A half-decade ago the leaders of the People's Republic had real choices. Today they do not. They have no exit. They have run out of time.

Gordon G. Chang
Bedminster, New Jersey
June, 2002

FOREWORD

The Final Chapter

A single spark can start a prairie fire.

—MAO ZEDONG

“**S**EEK TRUTH FROM FACTS,” said former Chinese leader Deng Xiaoping, who used that Maoist slogan to attack the foundations of Mao Zedong’s China. Today some see the facts as pointing to a glorious future for the world’s most populous country. Extrapolate current trends, we are told, and in 2010 China will have the [world’s largest economy](#).

It is easy to make the case, based on the facts, that China will dominate first Asia and then the rest of the world in some not-too-distant future. Multiply the world’s largest population by extraordinarily high rates of economic growth and you get a giant of awesome proportions. Think of the United States, only three times larger and more powerful. To get a glimpse of what is possible in the future, just look at how far China has come since 1978, when Deng Xiaoping began to junk Mao’s legacy.

The fear, sometimes overtly stated but under the surface if not, is that China will one day push its neighbors out of the areas it claims and America back across the Pacific. The outrage over the supposed Chinese theft of nuclear secrets from Los Alamos is as much a reflection of America’s apprehension as of its indignation. Today China is [the only nation](#) that is targeting the United States with nuclear weapons.

Historical inevitability seems to be on the side of Beijing. China was the [“world’s sole superpower”](#) for fifteen hundred years after the Roman Empire fell. Chinese art, culture, science, trade, and exploration flourished. Next, European society triumphed and then the United States. What could be more appropriate than China starting the new millennium as the world’s leading nation as the torch is returned to its rightful owner?

Foreigners, for various reasons and in many ways, have been fascinated, even blinded, by China, so it has been difficult for them to see the facts. Many have been dazzled by its potential, a theme that binds together most perceptions of China. Others see in China only danger, a threat magnified by the breath of its geography and the mass of its people.

The truth is that China has all the makings of a great nation, one that can fulfill the destiny it sees for itself. And China does not suffer from small vision: President Jiang Zemin is pursuing “Big Country” diplomacy, which seeks recognition of China as an equal to the United States and the European Union on the world stage. It should come as no surprise that Jiang, as a part of these efforts, is pushing China into the World Trade Organization.

On paper, China looks powerful and dynamic even today, less than twenty-five years after Deng Xiaoping began to open his country to the outside world. In reality, however, the Middle Kingdom, as it once called itself, is a paper dragon. Peer beneath the surface, and there is a weak China, one that is in long-term decline and even on the verge of collapse. The symptoms of decay are to be seen everywhere.

The fanaticism that carried Mao from one campaign to another, from the Great Leap Forward to the Cultural Revolution, burned out and left the Chinese empty. Today that spirit has been rekindled as millions follow the teachings of an exile who promises hope. The Communist

Party looks at Li Hongzhi and his [Falun Gong](#) spiritual movement and sees the images of Mao's peasant army of the late 1940s sweeping across the plains. No wonder China's leading political organization acts as if it were fighting for its survival.

The Communist Party has a destiny, and that is to lead the Chinese people for all time. There has never been any tolerance for other voices, and there is none today. Thus China's leaders could do only one thing when the Falun Gong, without warning, surrounded the Party's leadership compound in Beijing in April 1999. The Party banned that group and drove it underground. But the Falun Gong is fighting back; its members have lost their fear.

Cultists, activists, splittists, and others: China is fighting them all. Beijing "strikes hard" against these elements but so far has been able only to muzzle sentiment, not extinguish it. Dissidents may retreat. Their ideas, however, do not.

There are other threats. Resentment against the corruption of Party officials and lawless government smolders and is infinitely harder to handle than protesters. The price the Party has paid for its monopoly on power is the loss of community with the people of the People's Republic. The Party, as a result, is fundamentally unpopular, surviving only by withdrawing from the lives of the masses.

Then there are the armies of the unemployed roaming China, the single most immediate threat to the continued existence of the Party and the government it dominates. At any one time, the unemployed and underemployed exceed the combined populations of France, Germany, and the United Kingdom. When will they speak?

True, the Communist Party thinks about corruption and resentment and unemployment, but it is unwilling to undertake structural reform. The Party rejects most change of consequence and so does not deal with the fundamental

sources of instability. In its fight against its enemies, from the Tibetans to the Taiwanese, the political leadership seeks stability above all else. In seeking stability, the Party is preventing the change that could save the People's Republic.

And change is needed because the symptoms of economic decline are all too evident. State-owned enterprises, or SOEs, the product of Stalinist notions of economic development and Maoist ideas on social planning, are uneconomic. The state-owned banks are hopelessly insolvent, as a group the weakest in the world. Deflation has gripped China for more than three years. Mountains of obsolete inventory scar balance sheets. Foreign investment stagnates. Corruption eats away at the fabric of the economy, and foreign currency flees the country.

If these were simply economic issues, Beijing's technocrats could find answers. Unfortunately, any solutions must first meet the test of ideological correctness. Communist Party theologians have argued, seemingly endlessly, about correct socialist remedies. Deng's contribution to the development of socialist theory was not to let theory get in the way of development. " 'Do not debate!' is one of my inventions," said the late Chinese leader. His heirs take a different approach.

As time passes, the underlying problems fester. Economic dislocations become social ones, with dark political overtones. At some point there will be no solution. Then the economy, and the government, will collapse. We are not far from that time.

Can China's leaders prevent the economic tragedy that is unfolding? The central government is now doing the only thing it can: keeping the economy going through fiscal stimulus on a massive scale. How to pay for all of this? China's budget deficit has mushroomed in the last few years. Add the bad and nonperforming loans of the state-

owned banks to the official national debt, and China's financial status looks precarious.

How much time does China have? No one knows for sure, but China cannot continue to spend at the current pace for much longer. Beijing has about five years to put things right. No government, not even China's, can defy the laws of gravity forever.

Time is in extremely limited supply now that China is on the verge of joining the World Trade Organization. In order to become a member, China has agreed to open its markets. U.S. Trade Representative Charlene Barshefsky says that the changes to be unleashed by WTO accession will be ["profoundly important."](#) That is understating the case: accession will shake China to its foundations.

Commentators assume that Jiang favored WTO membership because he wanted to further reform. It's more likely that he thought that by doing something truly dramatic, he would find a place in history beside Mao and Deng. So now we need to know if China's economy can survive the competition that WTO membership will bring. Are the Chinese leaders being misled by their own reports of improving SOE profitability? Do they really believe that their insolvent and backward banks can compete with modern financial institutions? This would not be the first time that Beijing has been trapped by exaggerated notions of its own accomplishments. In the catastrophic Great Leap Forward tens of millions of peasants died because Mao deluded himself by believing glowing, and completely falsified, reports of crop production. The world can only hope that Jiang Zemin has not made a similar miscalculation. His insistence on maintaining orthodox and gradualist policies and at the same time accepting the shock therapy of WTO membership does not provide much basis for optimism.

Foreign businesses have put so much hope and effort into China's WTO accession. Behind all the lofty talk of the

benefits of world trade is anticipation. They know that on a more level playing field they will prevail. Color them eager. And color an unprepared China endangered.

At present, the Party and the central government are able to control 1.3 billion people. Virtually every day unpaid workers, resentful peasants, and other disaffected elements of society take to the streets, but the mechanisms put into place over the past five decades are still able to maintain social order. One day, the central government will not be able to fight all those who challenge it; there simply will be too many. When that time comes, the consequences will be severe. Virulent protests will spin out of control and meet the full fury of the state. No government can withstand the will of all of its people.

The challenges facing China's current crop of leaders are more difficult than the ones that Deng confronted. Deng had time; Jiang does not. Deng's party stood supreme and for the most part unchallenged. Jiang's is diminished by two decades of reform and a decade of withdrawal. Deng chose to fight only one enemy at a time. Jiang has decided to battle them all, both real and imagined, from those who seek to divide his country to those who merely want to pray in peace. He also wants to be a world leader, a role he does not have time to play.

In 1992, when economic reform efforts flagged, Deng Xiaoping made his famous Southern Tour. By the sheer weight of his personality and vision, he turned China around. Only a few years later, there is no one in Beijing who can, or would, do the same. His successor, Jiang Zemin, also urges the populace to seek truth, though with much less conviction. Today China's political leadership, not liking the facts it sees, blinds itself to the urgency of the problems it faces. Worse, there is little agreement as to what to do about them. As a result, progress is measured at the speed of molasses. In the past, China could muddle along. Now, however, its WTO agreements have put a

specific timetable on structural reform. Unfortunately, the central government is not ready to fulfill the commitments Jiang has made so easily. The consequence of failure will be the end of Chinese institutions as they now exist.

Today China is only halfway to somewhere with no consensus as to the future. It is suffering from the pain of a transition partially completed, yet at the same time it does not enjoy most of the benefits of modernization. Liberalization will help China, but a slowly reforming society stagnates. The center has given up enough control to let destructive forces loose, but not enough to complete the job of transformation. China is drifting, unwilling to go forward as fast as it must and unable to turn back.

Remarkable progress has been made since December 1978, when Deng Xiaoping pushed aside Mao's chosen successor, the hapless Hua Guofeng. The issue, however, is not whether China is doing the right things these days. Look at the country, and you will find evidence of solutions that, with time and political will, could work. If China had, say, thirty years, everything might come out right. But whether China is on the right road is not the matter at hand.

When historians write the final chapter on the People's Republic, they will say that there wasn't enough time. Jiang Zemin's cautious—sometimes glacial—approach to reform is not suited to the severe problems that are plaguing China or, for that matter, a world where the pace of change is accelerating. Although the collapse of the Soviet Union has highlighted the deficiencies of moving too fast, Beijing is erring by progressing too slowly. Misery can hit from either direction.

Mao said that it takes only one spark to start a prairie fire. The next spark could cause the conflagration that history will remember. Now it's only a matter of time.