

Diversionsary Aggression and Elite Welfare Shocks in Autocracies: Evidence from China

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ABSTRACT

This article presents a theory of diversionary aggression in autocracies. The autocrat purchases the support of elites with transfers and the support of the public with public goods. The two sources of support are substitutes: when elite support declines due to economic shocks, the autocrat can inoculate himself against elite leadership challenges by courting popular support. Diversionsary aggression serves precisely this purpose. The theory offers a range of predictions about when diversionary aggression occurs and how autocrats employ it. Using original data on elite transfers, diplomatic interactions, and propaganda from China, I find broad support for the theory.

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“A rising market eases contradictions; a falling market sharpens contradictions.”

—A Chinese commentator, 2003¹

1 INTRODUCTION

How is foreign policy in autocracies conditioned by shocks to political elites: the key figures whose support the autocrat needs to survive? Surprisingly little scholarship exists on this question. Drawing on selectorate theory, international relations scholars suggest that institutions that empower a broad class of political elites limit the autocrat’s power and render his foreign policy nearly as pacific as that of his democratic counterparts.² However, the institutional approaches employed by international relations scholars generally overlook elite power struggles in autocracies. Power struggles are endemic to autocracies, comparativists observe, even beneath the veneer of institutions that privilege the autocrat.³ This observation dates to ancient times: Xenophon’s Hiero complains that the tyrant’s life is one of perpetual fear. Across Latin America, Africa, and the Middle East, autocrats create duplicate government portfolios, build informant networks, and organize compulsory social networks to discourage elite leadership challenges.⁴ These findings share a common premise: the contract between autocrat and elite is written in terms of rent transfers. When transfers decline, so does elite support for the autocrat.

To explore how economic shocks to elite welfare affect foreign policy in autocracies, this paper presents a theory in which autocrats draw support from both elites and the public. Indeed, the two can be substitutes. The dual bases of the autocrat’s support enlarge his strategy set in ways that are particularly salient for foreign policy. When elite support flags, he may bolster public support to discourage leadership challenges. Popular support counteracts such threats because it deters leadership challenges through the threat of revolution. Because plotters know they would face a hostile public if they successfully challenged a popular leader, the expected payoff of a challenge is lower. Therefore, popular affection for the regime—or the appearance thereof—deters potential challengers. Although contemporary

¹Quoted in Naughton (2003, 35).

²de Mesquita et al. (2003); Lai and Slater (2006); Magaloni (2008); Mattes and Rodríguez (2014); Peceny and Beer (2003); Peceny, Beer and Sanchez-Terry (2002); Peceny and Butler (2004); Reiter and Stam (2003); Weeks (2008, 2012).

³Boix and Svobik (2013); Egorov and Sonin (2011); Svobik (2009, 2012).

⁴Aikins (2012); Carter (2015*b,c*); Crassweller (1966); Kapuscinski (1989); Staff (2012).

scholars generally regard autocrats as having to satisfy both their elites and the population, Machiavelli observed that the two are substitutes:

one of the most efficacious remedies that a prince can have against conspiracies is not to be hated and despised by the people, for he who conspires against a prince always expects to please them by his removal; but when the conspirator can only look forward to offending them, he will not have the courage to take such a course, for the difficulties that confront a conspirator are infinite.⁵

More recently, Barbara Geddes captured this intuition when she suggested that an autocrat who faces coup threats may build countervailing political forces such as a mass civilian party.⁶

To generate popular affection, I argue, autocrats may employ diversionary foreign policy. Diversion entails the initiation of an international dispute to generate a rally around the flag effect. By demonizing an out-group, the leader increases in-group identification and his own popularity.⁷

⁵Machiavelli (2012, Ch. XIX).

⁶Geddes (2009). Similarly, Milan Svoblik suggests that dictators must resolve two conflicts: threats from the masses and threats from elites (Svoblik, 2012). If anything, elite threats are the more serious: two thirds of autocrats deposed since World War II were removed by insiders (Svoblik, 2009, 477-478).

⁷Coser (1956); Simmel (1955). A recent review calls diversionary theory “compelling” but the empirical evidence “decidedly mixed” (Baum and Potter, 2008, 48). The literature on diversionary aggression is large but a brief review serves here. Several studies find evidence of diversionary aggression, including: Bennett (2000); Clark (2003); Dassel and Reinhardt (1999); Davies (2002); DeRouen (2000); DeRouen and Peake (2002); Enterline and Gleditsch (2000); Fordham (1998); Gelpi (1997); Heldt (1999); Hess and Orphanides (1995); Howell and Pevehouse (2005); James and Hristoulas (1994); James and Oneal (1991); Lebow (1981); Levy (1988, 1989*a,b*); Mansfield and Snyder (1995); Morgan and Bickers (1992); Oneal and Tir (2006); Ostrom and Job (1986); Russett (1990); Tir (2010). Yet skeptics have amassed opposing evidence: Chiozza and Goemans (2003, 2004); Foster and Palmer (2006); Gowa (1998); Johnston (1998); Lai and Reiter (2005); Leeds and Davis (1997); Lian and Oneal (1993); Meernik (2004, 2000); Meernik and Waterman (1996); Moore and Lanoue (2003); Potter (2007). Others outline scope conditions for diversionary aggression. It is more likely between states with pre-standing rivalries (McLaughlin and Prins, 2004), when leaders are accountable (Kisangani and Pickering, 2011), and in mature democracies, consolidating autocracies, and transitional polities (Pickering and Kisangani, 2005). It is less likely when states avoid provoking troubled adversaries (Clark, 2003; Fordham, 2005; Leeds and Davis, 1997; Miller, 1999). Rallies are more likely when conflict is supported by Security Council authorization (Chapman, 2011; Chapman and Reiter, 2004), and in the presence of media attention, popular leadership, divided government, non election years, and first terms (Baker and Oneal, 2001; Colaresi, 2007). States are more likely to divert when targets evoke feelings of fear or greed from the domestic audience (Jung, 2014). Traditional enemies may elicit diversionary aggression driven by rally logic, while powerful targets elicit diversionary aggression driven by “gambling for resurrection” (Haynes, 2015).

Emerging research on diversion in autocracies is most relevant to this study. Some argue that because autocrats can contain domestic unrest with repression, they need not divert (Gelpi, 1997; Kisangani and Pickering, 2011). In contrast, Pickering and Kisangani (2010) suggest that because single party regimes spend more on public goods than personalist or military regimes, they are relatively cash constrained and

Of course, executives enjoy a range of policy options to resolve political crises. When elites suffer economic shocks, for instance, the autocrat might increase direct transfers. However, this is expensive and risky, given public frustration with corruption. Alternatively, the autocrat might generate public support by providing public goods. However, this is expensive and time consuming. By contrast, diversionary foreign policy is inexpensive and readily implemented. And if the autocrat can signal to his diversionary target that the apparent aggression served only to placate domestic concerns, then diversion entails few international costs as well.

The theory generates several observable implications. Because the autocrat intends to generate public support, he initiates newsworthy conflict rather than that which is unobservable. Because diversion aims to make leadership challenges costlier, it is accompanied by propaganda designed to foster popular affection for the autocrat and the impression thereof. And because the autocrat seeks to avoid international retaliation, he subsequently adopts cooperative policies to placate his diversionary target.

I test the theory in the context of China. I focus on China's foreign policy toward the United States: its strongest potential adversary, and thus the state most likely to produce a rally for the autocrat. China is an appealing case for several reasons. First, it offers a unique opportunity to measure elite transfers. In the early 1990s, by privatizing state owned enterprises (SOEs), the autocrat transferred enormous equity to elites. Indeed, the stock market became the Party's central rent distribution mechanism. Yet because few poor and middle class citizens invest in the stock market, and because stock returns have little effect upon unemployment, there is virtually no connection between stock returns and public interests. Second, the threat of elite challenges is serious in China. Leaders face "incessant threats to their authority."⁸ And finally, the WikiLeaks cables afford rare insight

may employ diversion during a domestic crisis. The authors find that signs of elite unrest such as government crises and purges are associated with the use of external force cross nationally.

Qualitative China scholars argue that domestic politics are important in explaining China's foreign policy. However, they generally focus on public rather than elite discontent. Ross (2009) attributes China's aggression in the South and East China Seas to the public's "naval nationalism." Shirk (2007) argues that China's domestic instability is dangerous for the United States. Christensen (1996, 204-205) attributes Mao's decision to shell Quemoy in 1958 to the need to create a wartime atmosphere to consolidate domestic agricultural collectivization.

However, other China scholars are skeptical about the relationship between public discontent and conflict initiation. Drawing on theories of omnibalancing, Fravel (2008) argues that China's internal threats require policymaker attention and therefore create incentives for compromise abroad. In a detailed study of protests, Weiss (2014) finds that the Party manages nationalist protests to serve its ends and does not change its foreign policy in response to protester demands.

⁸Shih (2008, 48). Elite politics are the heart of Chinese politics. A classic study states, "The informal dimension has always been paramount" (Dittmer and Wu, 1995, 467). *Shili*, informal power, exists astride

into diplomatic communication between the US and Chinese governments. As a result, the paper is able to marshal case study evidence in support of the chief causal mechanism. This, indeed, is a significant asset, for the cross-national empirical evidence in support of diversionary aggression is decidedly mixed.

The empirics employ three original datasets. The first records elite transfers since 1990 with the monthly Shanghai Stock Exchange composite index. The second measures Chinese propaganda published in the official newspaper, the *People's Daily*. It was gathered with the computer programming language Python. The third dataset is a diplomatic history of China's relations with the United States since 1990. It is drawn from two dozen primary and secondary sources and records 2,000 bilateral interactions across a host of issue areas and severity levels.

The evidence suggests that when elite transfers through the Shanghai Exchange decline by 5% to 15%—which happens in a quarter of months—China initiates 1.5 to 2 times as much conflict as usual. Therefore, as much as 40% of China's conflict initiation toward the United States may be diversionary.

This study adds to an emerging literature that carefully connects domestic and international realities in autocracies.⁹ Partly because research in autocracies is difficult, scholarship on autocratic foreign policy has not caught up to that on democratic foreign policy, which gives full attention to the subnational sources of international behavior.¹⁰ The emerging research agenda this article joins focuses more closely on these factors and yields a richer explanation of the international behavior of autocracies.

This paper proceeds as follows. Section 2 presents the theory and offers a series of

and sometimes ahead of *quanli*, official power. Elite factions characterized Chinese politics under Mao Zedong and Deng Xiaoping and continue to animate them today. Andrew Nathan defines a faction as “a vertically organized structure composed of face-to-face (rather than corporate) clientelist ties between leaders and led” (Dittmer and Wu, 1995, 472). See also Bo Zhiyue (2010); Fewsmith (2015); Nathan (1973). The autocrat requires the support of elites below him, most importantly, the seven in the Politburo Standing Committee and 20 in the Politburo.

Examples of elite leadership challenges in China are numerous. They usually stem from civilian political elites rather than the military. In 1978, Deng Xiaoping peacefully sidelined Mao's appointed successor, Hua Guofeng. In the early 2000s, Shanghai mayor Chen Liangyu was purged after criticizing President Hu Jintao's leadership credentials to other Politburo members (US Embassy Beijing, 2006). In 2013, Chongqing mayor Bo Xilai was purged not because his wife murdered a British businessman, many China scholars believe, but because he attempted to assassinate President Xi Jinping. Indeed, Xi once spoke explicitly about the dangers of elite politics. In 2000, he said, “People who have little experience with power, those who have been far away from it, tend to regard these things as mysterious and novel. But I look past the superficial things: the power and the flowers and the glory and the applause. I see the detention houses, the fickleness of human relationships. I understand politics on a deeper level” Osnos (2015).

⁹Carter (2015*a,d*); Goemans and Marinov (2014).

¹⁰For a recent review, see Bueno de Mesquita and Smith (2012).

observable implications. Section 3 introduces the diplomatic data, justifies stock returns as a measure of elite transfers, and tests the implications empirically. Section 4 uses policymaker accounts and WikiLeaks cables to show that after the Chinese stock market crashed in 2010, China adopted diversionary foreign policy toward the United States, communicated the short term nature of its policy to American officials, and adopted private reassurance behavior after the domestic crisis passed. Section 5 concludes.

2 THEORY

Building on extant work, especially Pickering and Kisangani (2010), I develop a theory of why elite unrest may result in diversion in autocracies. Consider a simple political environment in which the autocrat draws from two sources of support, elites and the public. He purchases the support of these groups through transfers and public goods provision, respectively.¹¹ When transfers decline, elites are forced to consider the transfers they might receive under alternative leadership. Because some elites may expect to benefit more from alternative leadership, they become more likely to challenge the autocrat. The autocrat seeks to discourage such challenges because they threaten his personal power. He may employ diversion to generate public support. Public support discourages elites from challenging the autocrat because if they were successful, they might face the threat of popular rebellion. This yields the first hypothesis:

H1: WHEN ELITE TRANSFERS DECLINE, THE AUTOCRAT INITIATES MORE CONFLICT WITH HIS DIVERSIONARY TARGET.

If, as the theory predicts, the autocrat diverts to discourage elite challenges, then we should expect him to attempt to broadcast his increased support—and to foster the nationalism that renders elite conspiracies so costly—through his propaganda apparatus. Autocrats have long believed propaganda crucial to regime survival. Joseph Goebbels, the architect of Nazi Germany’s propaganda apparatus, considered it a science.¹² He wrote, “A dictator’s first task is to make what he wants popular, bringing the will of the nation in tune with his own will. Only then will the broad masses support him in the long run and join his

¹¹In the Chinese context, elites are the highest ranking party members—princelings and senior officials who can credibly challenge the autocrat—and the public includes the rest of the citizens.

¹²For a distillation of Goebbels’ 6,800 page diary into 19 core principles, see Doob (1950).

ranks.”¹³ Joseph Stalin used *Pravda* to threaten potential elite challengers with purges.¹⁴ In the past decade, autocrats across Africa and Asia have developed sophisticated propaganda strategies to generate public support despite the open information environment fostered by globalization.¹⁵

Propaganda provides a multiplier effect for diversionary foreign policy. It can both popularize and editorialize conflict. By creating the impression of public support for the autocrat, it can reduce the expected utility of leadership challenges. Thus, when leadership challenges arise, the autocrat will employ propaganda to discourage them. The propaganda apparatus will emphasize how well the autocrat serves popular interests and how widely he is supported by the people. Informed elites may not believe the propaganda, but they will know that it shapes popular beliefs and therefore will update their assessment of the autocrat’s popularity.¹⁶ This yields the next hypothesis:

H2: WHEN ELITE TRANSFERS DECLINE, PROPAGANDA EMPHASIZES THE AUTOCRAT’S PUBLIC POPULARITY.

The theory also yields hypotheses about the nature of diversion. Most obviously, it will be newsworthy. Diversion serves no use if it is unobserved by the public. A state can harm another’s interests in many private ways, such as denying requests or engaging in aggression which remains classified. These forms of interaction are highly consequential, but because the autocrat diverts to increase popular support, diversionary conflict will be public. Moreover, it will occur in newsworthy, nationalism-generating areas, such as deploying the military or asserting territorial claims. The autocrat will avoid conflict initiation in areas that are important to its diversionary target but less nationalism-generating, such as economic affairs, and in areas that are unlikely to win domestic approval, such as punishing the diversionary target on human rights issues. This yields the next hypothesis:

H3: DIVERSION TAKES FORMS THAT ARE PUBLIC AND NATIONALISM-GENERATING.

As the autocrat is strategic with his domestic audience, so too is he strategic with foreigners. Diversion must first produce a rally and second avoid retaliation from the target of diversionary aggression. In the language of the theory, the autocrat balances the desire for a rally

¹³Goebbels (1932).

¹⁴Roxburgh (1987).

¹⁵Baggott and Carter (2015).

¹⁶See e.g. Truex (2014).

against the risk of international retaliation. After the autocrat employs diversion, he faces international consequences. Diversion risks teaching the target of diversion that the autocrat aims to upset the status quo. Therefore, the autocrat should remedy his target’s suspicions after the domestic crisis passes. The most obvious way to do so is with cooperation: reassuring the target verbally and coming to its assistance materially. I expect that the autocrat will employ such charm offensives after diverting to recenter his target’s prior about the autocrat’s intentions. Moreover, those charm offensives will be private rather than public, lest the autocrat’s citizens penalize him for backing down. This yields the final hypothesis:

H4: AFTER A DIVERSIONARY EPISODE, THE AUTOCRAT WILL ADOPT PRIVATE COOPERATIVE INITIATIVES TO HELP HIS TARGET RECENTER ITS PRIOR ABOUT THE AUTOCRAT’S INTENTIONS.

3 EMPIRICAL APPROACH

To test the theory, I focus on China: on the struggles between its political elite and paramount leader, and how these struggles manifest themselves in its bilateral relationship with the United States. Section 3.1 introduces the original diplomatic data, which record all bilateral interactions between China and the United States since 1990. To measure elite transfers, I exploit the fact that Chinese elites were compensated during the sample period with shares in state owned enterprises. This is explained in Section 3.2. Sections 3.3 through 3.6 assess the theory’s observable implications.

3.1 DIPLOMATIC DATA

I constructed a dataset of over 2,000 bilateral interactions between 1990 and 2014 from two dozen primary and secondary sources listed in the appendix. I drew from secondary sources, policymaker memoirs, case studies, periodicals that follow Chinese politics such as the *China Leadership Monitor*, declassified primary source documents, and leaked American diplomatic cables provided by WikiLeaks.¹⁷

In my coding scheme, a bilateral interaction is an episode of contact between the two states. For example, in 1950 the United States voted against replacing the Chinese Nationalists with the People’s Republic in the United Nations. Later that year, Premier Zhou Enlai

¹⁷Wikileaks covers US-China relations between 2003 and the end of 2009 with the greatest frequency. However, some cables cover the 1990-2002 period.

warned the United States not to invade Korea through the Indian ambassador to China. In 1957, Mao Zedong criticized the United States publicly in Moscow, proclaiming that the east wind prevails over the west wind. In 1980, the two countries cooperated to install monitoring equipment in western China to spy on the Soviets. In 1986, the Reagan administration secretly requested Chinese assistance in arming the Nicaraguan contras; China complied. In 1994, Secretary of State Warren Christopher canceled ceremonial appearances on his planned trip to Beijing in retaliation for human rights abuses. After being lobbied by FedEx and UPS in 2009, Secretary of State Hillary Clinton requested that China reduce barriers to entry in the Chinese postal market.

For all these episodes, I recorded the *date* of the interaction. When it was not possible to identify the exact date, I identified the month that it occurred. I next recorded the *source* and *target* of the interaction. Most international events are directional. For example, John F. Kennedy offered food aid to China, while Hank Paulson requested that China appreciate the renminbi. Some, however, involve equal effort by both parties, like negotiating or signing an agreement. I duplicated these events so both sides received credit equally.

I then recorded the *action* itself. Conflictual event types appear in Table 1. Cooperative event types appear in Table 2. *Diplomacy* involves friendly verbal overtures, whereas *cooperation* involves material cooperation. *Criticism* involves negative verbal interactions, whereas *conflict* involves material conflict.¹⁸ Examples of all event types appear in the online appendix.¹⁹

I then recorded the *issue area* of the interaction, such as arms sales or intellectual property rights, as well as its private or public *venue*. Finally, I recorded a *description* of the event and its *source*. Because Taiwan, Tibet, and Chinese dissidents are salient in the bilateral relationship, I record American cooperation with these actors as conflict with China (and vice versa).

The primary outcome variable in this study is *Chinese conflict initiation*, which is substantive bilateral conflict in military, diplomatic, economic, or human rights areas. Figure 1 visualizes the outcome variable since 1990. The red line shows the number of costly conflicts

¹⁸ In keeping with the literature, I drew the line between cheap and costly interactions at audience cost generating leader threats (Fearon, 1994; Weeks, 2008). Some studies suggest that autocrats are only able to generate audience costs by inciting domestic nationalist protests (Kinne and Marinov, 2013; Weiss, 2013, 2014). The results are robust to this modification.

¹⁹A note is appropriate on routine military patrols. There are many of these and they are difficult to record accurately. I record policy changes that alter military patrols—making them more aggressive, for instance, or mandating them in new areas—rather than the specific patrols themselves. This is appropriate because policymakers respond to changes in the other side’s assertiveness rather than to status quo patrols.

Table 1: Types of Conflict

Action	
Negative statement	} Diplomacy
Congressional hearing	
Postpone	
Downgrade protocol	
Refuse	
Demand	
Warn	
Private threats	
Public low ranking threats	
Public leader threats	
Obstruct	
Withdraw support	
Cancel exchanges	
Punitive economic action	
Congressional act	
Infringe upon human rights	
Intervene on behalf of dissident	
Incite protest	
Arrest nationals	
Espionage	
Develop weapon system	
Assert territorial claim	
Proliferate	
Downgrade relationship	
Military exercise	
Military conflict	

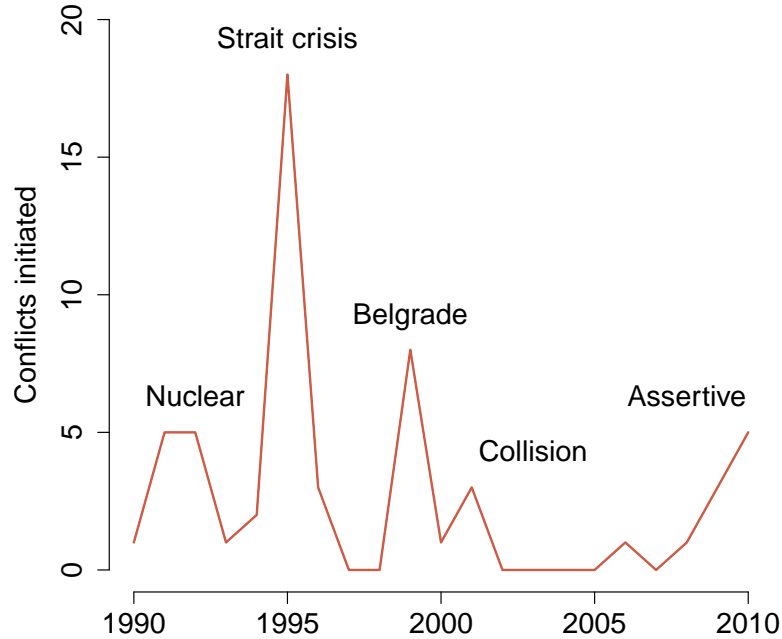
* See online appendix for definitions and examples.

Table 2: Types of Cooperation

Action	
Positive statement	} Criticism
Request	
Meet	
Negotiate	
Invite	
Visit	
Explain	
Reassure	
Offer	
Express regret	
Propose	
Promise	
Apologize	
Release nationals	
Cooperative congressional action	
Concede	
Aid	
Sign agreement	
Hold summit	
Yield militarily	

* See online appendix for definitions and examples.

Figure 1: Chinese Costly Conflict Initiation Toward US



that China initiated with the United States each year. The dataset records 171 episodes of costly conflict that occurred in 58 months.²⁰ The measure has high construct validity: conflict peaked during the standoff at sea over nuclear proliferation in 1993, the 1995 Taiwan Strait crisis, the 1999 accidental US bombing of the Chinese embassy in Belgrade, the 2001 collision between a Chinese fighter jet and a US spy plane, and China’s “assertive” behavior in 2010.²¹

I eschewed existing event datasets for straightforward reasons. The popular Militarized Interstate Dispute dataset records only three US-China conflicts since 1990—one involving the 1995 Taiwan Strait Crisis and two involving the 2001 spy plane collision. In reality, there have been many episodes of serious contention over this period—most prominently, a

²⁰Episodes of costly conflict are, unsurprisingly, clustered.

²¹While some of these crises were exogenous, like the Belgrade bombing or the aircraft collision, the results are not driven by exogenous shocks to international politics. Theoretically, although an exogenous crisis may occur, a state’s response to it is conditional on many things, including domestic politics. Moreover, many of the conflicts that China initiated in the dataset were not associated with exogenous crises. This is shown in the online appendix, which reproduces Figure 1 at the monthly level.

standoff at sea over nuclear proliferation in 1993, the accidental US bombing of the Chinese embassy in Belgrade in 1999, and China’s assertive behavior in 2010.

Daily event datasets such as GDELT or Gary King’s “10 million events” record bilateral disputes with much greater frequency, but with tremendous noise. By my estimation, 20-30% of these events are false positives or false negatives: respectively, events that were omitted by the automated event coding process and events that were included mistakenly. Additionally, I identified many more diplomatic action types than recorded in standard event ontologies like Conflict and Mediation Event Observations (CAMEO). Existing ontologies were constructed from news wires, which omit some important types of diplomatic interaction. Examples include: demurring, canceling an invitation, postponing talks, expressing restraint, passing a congressional resolution, or offering asylum to a dissident.

Moreover, much diplomacy takes place out of the public eye and is captured only in policymaker accounts. For example, China allowed dissidents to quietly emigrate to the United States, sent diplomats to Pyongyang to pressure North Korea on US policy priorities, and agreed to the US request to not dump treasury bonds in the wake of the 2008 financial crisis. Omissions are also considerable for classified military interactions. For example, China has occasionally initiated aggressive aircraft tails and submarine dogfights. These episodes are highly significant, but appear only in policymaker memoirs or declassified documents. By hand coding some 10,000 pages of historical documents, my original dataset is the most complete account of the bilateral relationship since 1990.

3.2 MEASURING ELITE TRANSFERS

As in the post-Soviet states, the privatization of state owned enterprises (SOEs) in China became a convenient way for the autocrat to transfer rents to elites in the 1990s. Privatization created three streams of transfers to elites. First, the Party set artificially low share prices for SOE initial public offerings (IPOs). It appointed chosen elites to SOEs and offered management buyout provisions to ensure they would benefit from arbitrage. As a result, high-level officials and their families were “among the biggest beneficiaries” of management buyout provisions.²² “About 10 or 15 years ago,” Gu Xuewu comments, “those in power sold many state-owned companies to people who were close to them. At a very low price.”²³

The shares retained by elites after an IPO generated dividends. But most importantly, the Party employed corporate financing arrangements to allow elites to benefit from subse-

²²He Qinglian (2015).

²³Rimmele (2012).

quent arbitrage opportunities. SOEs provide 40-50% of the financing for the IPOs of other SOEs. The Party appoints “strategic investors” and therefore controls access to arbitrage opportunities. For example, China Unicom’s IPO was financed by strategic investors with few ties to the communications industry: Beijing Capital Airport Group, Shanghai Auto, Sinochem, and COFCO Foods, a food distributor.

More, the Party has repeatedly intervened to restore elite transfers when they have declined. After a policy announcement depressed returns in 2001, the Party canceled the policy in question, established an investor protection fund, halted IPOs, increased foreign investment quotas, and raised interest rates on bank loans. In September 2004, Premier Wen Jiabao pledged that the state would support the stock market. In December 2005, he declared the financial sector “critical to national security.”²⁴ Most recently, after the Shanghai Exchange lost a third of its value in June 2015, the state spent over a trillion US dollars trying to stabilize the market. Indeed, its liquidity provision efforts were so vast that it was forced to devalue the renminbi in August for the first time in two decades. Generations of American policymakers considered that goal practically unattainable. China devalued again only a few weeks later.

Because of this precedent, elites hold the autocrat responsible for stock returns. The state has provided an “implicit guarantee to prop up the market,” according to economist Barry Naughton.²⁵ Leaked cables reveal that in August 2007, a Chinese financial researcher told American embassy personnel that the Shanghai Exchange was a “policy market” “controlled by the central government and subject to political tinkering.” First and foremost, the Party aimed “to maintain a ‘Harmonious Society’ among the retail investors.” What this meant was that “the government wanted to avoid getting blamed for any negative outcomes from its policy.”²⁶ One Western analyst concluded that “There’s an expectation of the government adjusting policy to suit the market, in a cheerleading fashion.”²⁷ A Chinese equity analyst said, “We just calmly wait for the government’s next step to see if there will be more positive incentives to invest.”²⁸

In contrast, stock returns have virtually no relationship with public welfare. This is evident from two facts. First, contrary to some reporting in the popular financial press, there are very few retail investors in China. Economists estimate there are between 500,000

²⁴Walter and Howie (2006, xvii-xi).

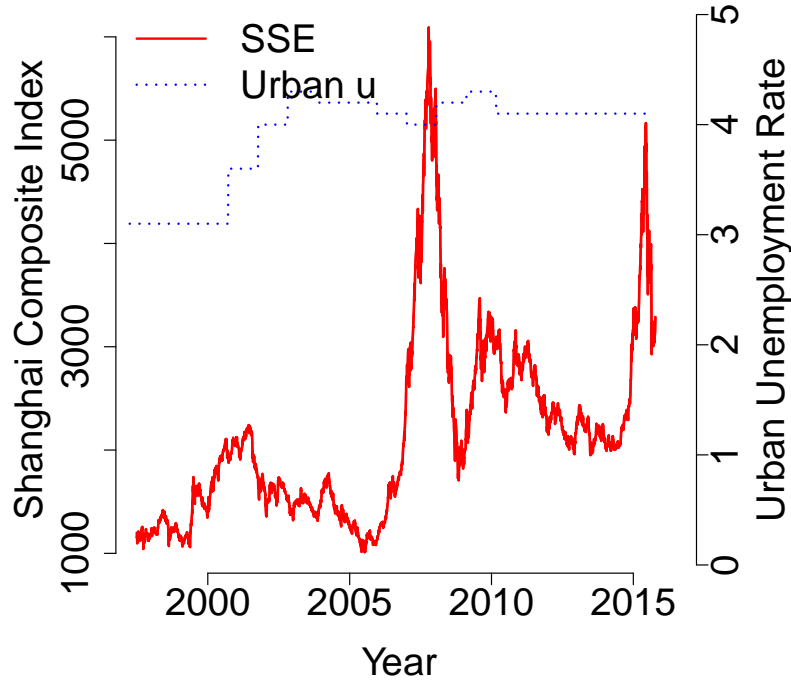
²⁵Naughton (2007, 474).

²⁶US Embassy Beijing (2007).

²⁷Deng (2015).

²⁸Walter and Howie (2006, 219).

Figure 2: Stock Returns and Urban Unemployment



Annual urban unemployment data are from China’s National Bureau of Statistics.

and 2 million active investors.²⁹ The estimate is conservative because many brokers operate hundreds of illegal “ghost accounts” opened with villagers’ identification cards purchased in the countryside. In short, between 0.001% to 0.1% of China’s population invests in its securities market: an extremely small proportion of the population.

Second, although SOEs account for nearly 30% of urban employment, urban employment is not sensitive to SOE stock market performance. SOE employment is centrally regulated due to the legacy of “iron rice bowl” welfare policies. The Party does not allow SOEs to engage in mass layoffs during downturns. Figure 2 shows that there is virtually no relationship between stock returns and urban unemployment.

Today, SOEs account for 40% of China’s GDP and the vast majority of its equity market: 65% of firms and 89% of market capitalization.³⁰ Stock returns are extraordinarily volatile.

²⁹See Walter and Howie (2006, p. 10 and Ch. 7) for a fascinating account. Green (2003) cites similar statistics.

³⁰Pei (2012, 34), Piotroski and Wong (2012, 219).

The worst month on the Shanghai Exchange lost 31% while the best month gained 177%.³¹ Average monthly returns were 2% with a standard deviation of 17 percentage points. In contrast, S&P 500 returns during the period were much less volatile, ranging from losses of 20% to gains of 12%.

3.3 EVIDENCE FOR DIVERSION

The first hypothesis suggests the autocrat will initiate more conflict with the United States when elite transfers decline. To test this hypothesis I explore the impact of the percentage change in the Shanghai Stock Exchange in month $t - 1$ on the number of costly conflicts that China initiates toward the United States in month t . Conflict data are drawn from my bilateral event dataset. The monthly percent change in the SSE composite index is drawn from the exchange.³²

I employ a count model to examine Chinese conflict initiation as a function of stock market performance, recent bilateral interaction, and other covariates. To control for popular dissatisfaction, I include monthly *consumer price inflation*.³³ I control for the six month period leading up to a *party congress*, as these events are the focal point of Chinese elite politics and often result in the announcement of new policies that could simultaneously affect stock returns and conflict initiation. Party congresses are held every fifth autumn. To account for the possibility that financial crises migrate across borders, I include *US stock market returns*.³⁴ It is important to include this variable because Dow losses might simultaneously depress the Shanghai Stock Exchange and generate Chinese critiques of US economic policy. Finally, I include year and month fixed effects to account for unobserved sources of variation (e.g., if Beijing initiates more conflict in October due to National Day celebrations). The estimating equation is thus

³¹Why would the autocrat choose to deliver rents through such a volatile mechanism? Only the least significant stream of rents—dividends—is affected by volatility. For IPOs and corporate financing, the regime selects which elites benefit and sets initial share prices. If the stock market is performing poorly, the regime can simply set initial share prices lower than usual, enabling more arbitrage.

³²Shanghai Stock Exchange (2015). The composite index is analogous to the S&P 500. In 2010, the exchange also began reporting data for the SOE 50 and SOE 100 indices, which track the performance of the 50- and 100-largest SOEs, respectively. These indices are almost perfectly correlated with the composite index over 2010-2015, as shown in the online appendix. This is to be expected, as SOEs account for 89% of market capitalization. I use the Composite Index in the analysis because it is available for a wider time frame.

³³Neither *Unemployment* nor *GDP growth* can be used to measure public economic interests, as they were recorded annually for most of the sample and exhibited relatively little variation.

³⁴Data on monthly S&P 500 returns are drawn from Standard and Poor (2013).

$$\begin{aligned}
\text{neg bin (PRC conflict)}_t &= \beta_1(\Delta SSE)_{t-1} \\
&+ \beta_2(\text{Number of PRC-USA costly conflicts})_{t-1} \\
&+ \beta_3(\text{Number of USA-PRC costly conflicts})_{t-1} \\
&+ \beta_4(\text{PRC consumer price inflation})_{t-1} \\
&+ \beta_6(\text{Party Congress})_{t:t-6} \\
&+ \beta_8(\Delta \text{S\&P 500})_{t-1} \\
&+ \gamma_y + \lambda_t + \epsilon
\end{aligned} \tag{1}$$

where γ_y represents year fixed effects and λ_t represents month fixed effects. Augmented Dickey-Fuller tests indicate that Chinese conflict initiation and SSE returns are stationary. A one month lag minimizes the Akaike information criterion (AIC).

Results appear in Table 3. Model (1) shows that SSE returns are inversely correlated with Chinese conflict initiation in a bivariate context. The relationship is robust to the introduction of recent bilateral interactions in Model (2), Chinese domestic factors in Model (3), US stock returns in Model (4), and year and month fixed effects in Models (5-6).

The results are visualized in Figure 3. I simulate values of predicted Chinese conflict initiation at various levels of SSE returns: the mean monthly return of 2% and at losses of 5%, 10%, and 15%. Other variables are held at their means. For ease of simulation, I employ Model (4), which contains all control variables save year and month fixed effects, yet is quite similar to Models (5-6) which do employ fixed effects.

The simulation indicates that when stock returns decline by 5% to 15%, China initiates 1.5 to 2 times as much conflict as usual. Since 1990, China has initiated one conflict every ten months, on average. When a negative shock occurs, China initiates one conflict every three to five months. Therefore, as much as 40% of China's conflict initiation may be diversionary.

Losses of 5% to 15% are not atypical in the Chinese context. Figure 4 shows a kernel density plot of monthly SSE returns since 1990 in red. For comparison, monthly S&P 500 returns since 1990 are shown in blue. S&P 500 returns are normally distributed. However, SSE returns are characterized by an abundance of extremely positive and extremely negative returns. Indeed, as shown by the shaded areas, the SSE lost 5% or more of its value in a *quarter* of months. Overall, the evidence suggests that China's conflict behavior is extremely responsive to SSE downturns, which occur regularly. More, there is no evidence that Chinese foreign policy responds to one plausible indicator of public interests, inflation.

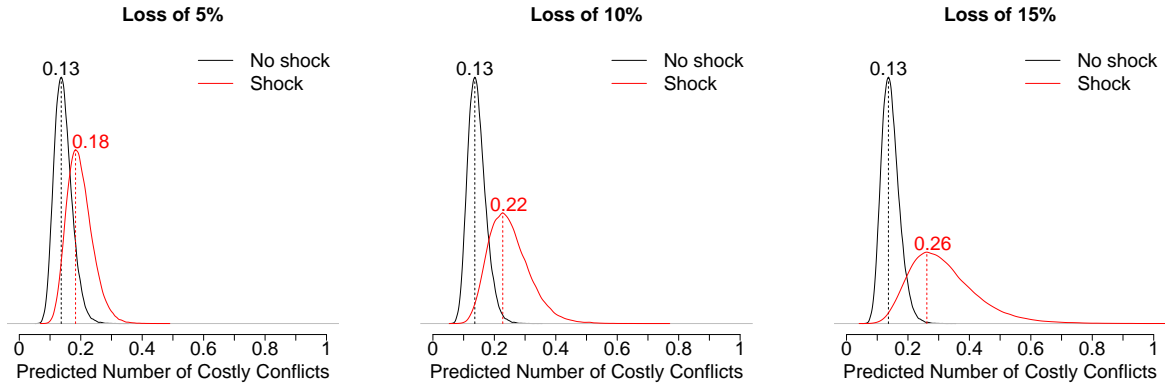
Table 3: Evidence for Diversion

	<i>Dependent variable:</i>					
	PRC costly conflict _t					
	(1)	(2)	(3)	(4)	(5)	(6)
ΔSSE_{t-1}	-3.933* (2.194)	-5.047** (2.254)	-4.756** (2.244)	-4.771** (2.260)	-4.216** (2.108)	-4.535** (2.142)
PRC costly conflict _{t-1}		0.353 (0.225)	0.215 (0.212)	0.198 (0.208)	-0.072 (0.193)	0.059 (0.192)
USA costly conflict _{t-1}		0.201 (0.377)	0.075 (0.346)	0.081 (0.340)	0.113 (0.305)	-0.033 (0.298)
CPI _{t-1}			0.041 (0.029)	0.040 (0.028)	-0.003 (0.091)	-0.002 (0.090)
Party Congress _{t:t-6}			-2.331* (1.269)	-2.159* (1.227)	-1.151 (1.461)	-1.609 (1.513)
$\Delta \text{S\&P500}_{t-1}$				0.095 (0.062)	0.038 (0.061)	0.021 (0.055)
Constant	-1.682*** (0.219)	-1.851*** (0.234)	-5.890* (3.054)	-5.852* (3.007)	-0.670 (9.593)	-32.687 (4,037,414)†
Year fixed effects	No	No	No	No	Yes	Yes
Month fixed effects	No	No	No	No	No	Yes
Observations	288	288	240	240	240	240
Log Likelihood	-133.165	-131.545	-119.982	-118.849	-100.239	-91.592
Akaike Inf. Crit.	270.329	271.091	251.965	251.698	254.477	259.183

*p<0.1; **p<0.05; ***p<0.01

† In Model (6), the standard error for the constant is very large because after including month fixed effects, there is not enough variation to generate a meaningful estimate for the constant. This does not affect the interpretation of the other coefficients in the model.

Figure 3: SSE Shocks and Chinese Conflict Initiation



3.3.1 ROBUSTNESS CHECKS

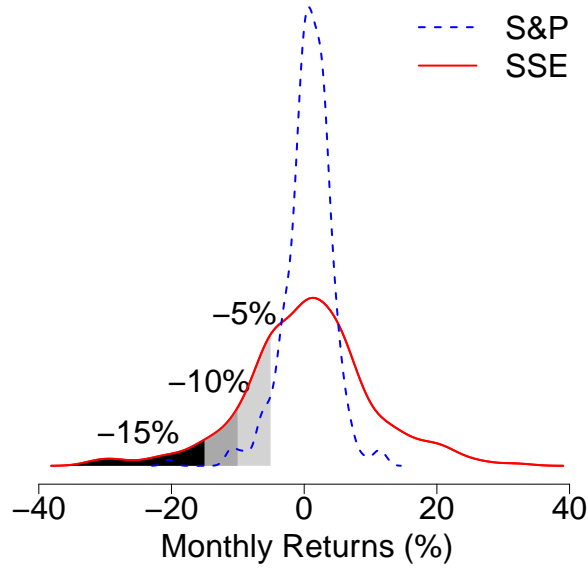
Results are robust to several different approaches presented in the online appendix. First, results are robust to placebo tests. Above, elite transfers are operationalized as a continuous variable. Instead, in the online appendix I operationalize them as dichotomous shocks of $+/-$ 5%, 10%, or 15%. Negative shocks are associated with conflict but not with cooperation. Positive shocks are associated with neither outcome. Indeed, this is what one should expect: the theory describes how declining transfers lead the autocrat to employ diversionary foreign policy, but proffers no reasons why ample transfers would make the autocrat pursue a more cooperative foreign policy with the United States.

Second, results are robust to subsetting the data to make reverse causality as unlikely as possible. In the research design above, reverse causality would be a problem if investors anticipated conflict and withdrew from the market before it occurred. If investors had this anticipatory power, declines in share prices caused by sell offs would precede conflict and render the result spurious.

Investors can anticipate conflict in two ways. First is through conflict in the previous period, which is already in the model. Second is through China's statements about its future behavior. If China threatens to initiate conflict in the next period, investors might exit the market. Therefore I record all Chinese threats toward the United States. I include private threats in addition to public threats, since rumors about diplomatic developments could conceivably spread through the small group of Chinese political elites. China issued 16 such threats in 13 months between 1990 and 2010. The result is robust to dropping observations in which China threatened the United States privately or publicly in $t - 1$.

Investors might also decide to sell based on American threats toward China, which oc-

Figure 4: Kernel Density Plot of SSE Returns



curred 24 times (publicly or privately) between 1990 and 2010. The result is robust to dropping observations in which either side threatened the other in $t - 1$.³⁵ Thus, the relationship between elite transfers and conflict initiation persists even when investors have virtually no information with which to anticipate future conflict. This suggests the result is not driven by an informational omitted variable which enables investors to anticipate bilateral conflict and dump stocks before it occurs.

Third, results are robust to operationalizing the outcome variable differently. Conflict rarely occurs, and when it does, its importance may be dwarfed by the volume of cooperation in other areas. Therefore I develop a measure of *Net conflict* to capture the bilateral relationship's overall tendency:

$$(\text{Net conflict})_t = \frac{(\text{conflict} + \text{criticism})_t}{(\text{conflict} + \text{criticism} + \text{cooperation} + \text{diplomacy})_t} \quad (2)$$

While this measure may capture the overall tenor of the bilateral relationship better than a simple count of conflict, it yields fewer observations for analysis because months with

³⁵This more restrictive model entails dropping 26 months (since the United States and China sometimes threatened each other in the same month).

zero events prompt division by zero and fall out of the model. ADF tests indicate the new outcome variable is stationary and a one month lag minimizes the AIC. An OLS model is appropriate. The result is robust: When elite transfers decline, the overall relationship becomes more conflictual.

Fourth, results are robust to additional control variables. I include a dummy variable for *NPC Meetings*, the National People’s Congress and Chinese People’s Political Consultative Conference meetings that occur each March. These meetings are far less important than party congresses, but nonetheless could plausibly affect China’s foreign policy. Next, I control for whether a given month experienced a *public crisis*. Crises like corruption scandals, large protests, sensitive anniversaries, natural disasters, epidemics, and product safety scandals increase public dissatisfaction with the regime. The *public crisis* variable is thus much like inflation in the main analysis: if the autocrat diverts for public interests rather than elite interests, this variable should be significant, and should cast doubt upon the theory. A list of public crises appears in the online appendix. Finally, I control for elites’ other main source of illicit wealth. While the stock market has been the primary vehicle of elite transfers in contemporary China, elites have access to other rents. Construction bribes are the most important among these. When companies break ground on new facilities, they are expected to bribe officials. Results are robust to approximating bribe volume with monthly changes in *new floorspace construction*. This model is temporally limited, however, because floorspace construction data are only available from China’s National Bureau of Statistics since 2002.³⁶ Results are robust to the inclusion of all additional covariates.

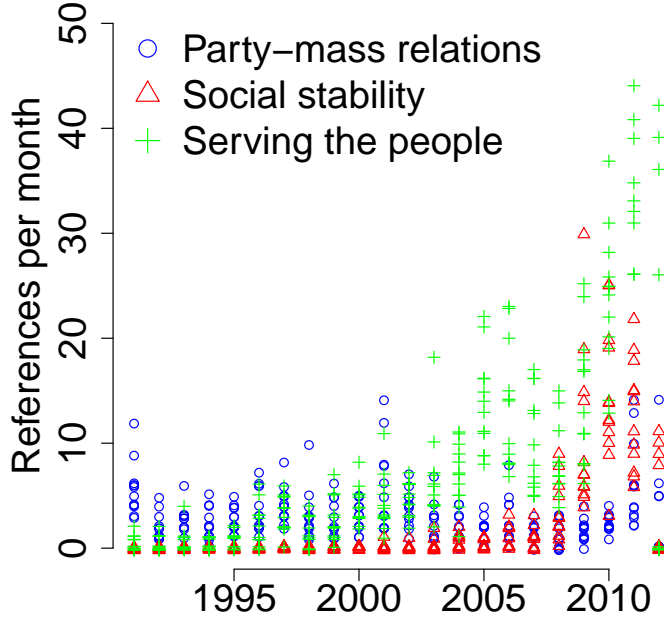
3.4 PROPAGANDA

The Chinese autocrat enjoys direct control over the official newspaper, the *People’s Daily*.³⁷ The third hypothesis argues that because diversion aims to discourage leadership challenges, propaganda should emphasize the leader’s popularity when elite transfers decline. To test

³⁶More fundamentally, I exclude construction bribes from the main analysis for theoretical reasons. Elites hold the autocrat responsible for stock market rents because of his interventionist precedent, however, they cannot reasonably hold him accountable for construction bribes paid by individuals.

³⁷Mao, for example, personally revised draft editorials. In the 1990s, Jiang Zemin launched an initiative to “guide public opinion” with tighter reporting controls and the Patriotic Education Campaign, which revised curricula and encouraged “red tourism” to foster loyal citizens. In the 2000s, Hu Jintao spearheaded a revised program to “channel public opinion.” In the 2010s Xi Jinping elevated the effort to a “struggle for public opinion” in the face of robust online political discussion (Qian Gang, 2013). These pressures are only intensifying. In 2013, Xi called for a “strong army” to “seize the ground of new media” (Huang and Zhai, 2013). Scholars find that China employs online propagandists to delete posts about collective action (King, Pan and Roberts, 2013).

Figure 5: Propaganda



this hypothesis, I gathered the corpus of nearly 4,000 articles containing the phrases “party-mass relations” (*dangqun guanxi*), “social stability” (*weiwen*), and “serving the masses” (*fuwu qunzhong*) published by the *People’s Daily* between 1990 and 2012. These terms have been identified as important in the secondary literature and feature prominently in the newspaper.³⁸

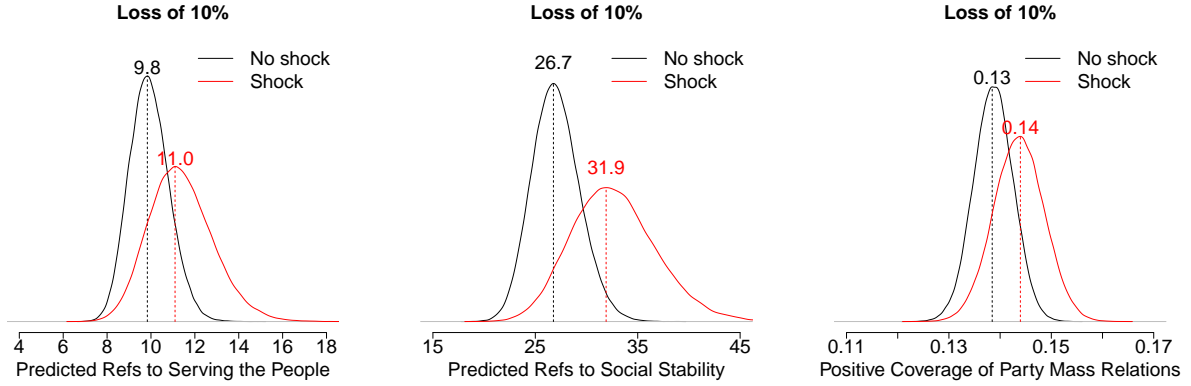
Figure 5 shows the temporal popularity of these terms. Discussion of party-mass relations has held constant—about 5 articles per month—over the period. In the 2000s, discussion of “serving the masses” rose exponentially, from 5 to 50 articles per month. Discussion of “social stability” also increased over the period.

I formatted these documents for text analysis in the programming language Python. Because “party-mass relations” is a neutral term, I used the concordance method, which records the share of positive words in the ten words on either side of the term.³⁹ I computed the

³⁸Stern and O’Brien (2012); Zhang Yong (2000).

³⁹Results are robust to using the 5 or 20 words on either side of the term.

Figure 6: SSE Shocks and Chinese Propaganda



percentage of positive words in all concordance segments published each month.⁴⁰ Because “serving the masses” and “social stability” are normatively charged terms, I simply recorded the frequency with which they were mentioned each month.

I model propaganda as a function of bilateral events and domestic factors. The estimating equation is identical to that in Section 3.3 save two changes. The outcome variable is the number of references to a given term in month t . I control for the number of references to the term in $t - 1$. When the outcome is positive coverage of “party-mass relations,” I employ an OLS model with the same covariates.

Table 4 presents the results. The evidence suggests that declining transfers are associated with more positive coverage of “party-mass relations” and more frequent discussion of “serving the masses” and “social stability.” The results are visualized in Figure 6. When transfers decline by 10%, the propaganda apparatus publishes 11% more on “serving the people,” 20% more on “social stability,” and discusses “party-mass relations” 8% more positively. All results are significant at the 95% level.

Overall, the results suggest that declining transfers compel propaganda about how the autocrat serves the masses and is supported by them. Propaganda may improve public assessments of the regime because many Chinese citizens are nationalist. But also, because elites *believe* citizens are nationalist, propaganda will lead them to update their assessment of public support for the regime.

⁴⁰Dong and Dong (2015).

Table 4: Propaganda Model

	<i>Dependent variable:</i>		
	Positive relations _t	Refs to serving _t	Refs to stability _t
	<i>OLS</i>	<i>negbin</i>	
	(1)	(2)	(3)
Δ SSE _{t-1}	-0.053** (0.025)	-1.090** (0.444)	-1.004** (0.409)
Positive coverage _{t-1}	0.001 (0.075)		
Number of references _{t-1}		0.014*** (0.001)	0.002 (0.002)
PRC costly conflict _{t-1}	-0.002 (0.006)	-0.099 (0.088)	0.026 (0.072)
USA costly conflict _{t-1}	-0.007 (0.007)	-0.400*** (0.134)	-0.169 (0.110)
CPI _{t-1}	0.003 (0.002)	-0.065*** (0.010)	0.005 (0.034)
Popular crises _{t-1}	0.028 (0.019)	0.457** (0.212)	0.079 (0.211)
Party Congress _{t:t-6}	-0.017 (0.016)	-0.152 (0.186)	0.032 (0.186)
Lianghui _{t-1}	-0.010 (0.014)	0.159 (0.216)	0.188 (0.188)
Δ S&P500 _{t-1}	0.002* (0.001)	-0.018 (0.016)	0.021 (0.015)
Constant	-0.203 (0.240)	8.564*** (1.081)	0.437 (3.561)
Year fixed effects	Yes	No	No
Month fixed effects	Yes	No	No
Observations	199	240	240
R ²	0.178		
Adjusted R ²	0.038		
Log Likelihood		-804.260	-979.913
Akaike Inf. Crit.	23	1,628.520	2,019.827

Note:

*p<0.1; **p<0.05; ***p<0.01

3.5 DIVERSION IN THE PUBLIC EYE

However, when the autocrat is motivated by the desire for public support, he will employ foreign policy that is observable to the public and which will generate a nationalist rally. These policies will take *military* forms—such as announcing weapons systems, proliferating, or initiating exercises or conflicts—or high profile *diplomatic* forms—such as obstructing American initiatives, withdrawing support, canceling exchanges, or downgrading the relationship. Diversion will not occur in low politics. Issues like WTO negotiations, though important, are unlikely to arouse nationalist sentiment. Nor will diversion involve *human rights* issues. Human rights cases are important to the United States, but they are often negotiated privately. Moreover, Chinese citizens may not view punishing the United States on human rights issues as a compelling defense of national interests.

Table 5 reproduces the analysis in Section 3.3 but disaggregates Chinese conflict initiation into military, diplomatic, economic, and human rights areas. Models (1-4) show that diversion occurs in military and diplomatic affairs but not in economics or human rights. Figure 7 visualizes the results. Overall, the newsworthy character of Chinese conflict initiation suggests it targets nationalist citizens rather than American interests.

Conflict initiation can be further disaggregated into *moderate* and *severe* levels. From Table 1, moderate conflict includes obstructing American policies, withdrawing support, canceling exchanges, punitive economic actions, congressional actions, infringing upon human rights, inciting protests, and arresting the other country's nationals. In contrast, severe conflict includes selling arms to Taiwan, espionage, developing weapons systems, asserting territorial claims, proliferating, downgrading the relationship, conducting military exercises, and engaging in armed conflict.

Models (5-6) show that declining transfers generate severe conflict rather than moderate conflict. Figure 8 visualizes the results. This supports my theoretical expectations: Severe conflict is especially likely to generate a rally because it sharpens ingroup-outgroup differences.

3.6 UNLEARNING DIVERSION

The final hypothesis contends that to avoid containment, the autocrat should help the United States unlearn the lessons of diversion. Chinese leaders have long been wary of provoking American containment. Partly because many American politicians believe that China aims to challenge American hegemony, Chinese leaders have been meticulous about presenting

Table 5: Issue Area Model

	<i>Dependent variable:</i>					
	Mil conflict _t (1)	Dip conflict _t (2)	Econ conflict _t (3)	Rights conflict _t (4)	Moderate _t (5)	Severe _t (6)
ΔSSE_{t-1}	-5.911** (2.886)	-10.836** (5.143)	4.358 (8.949)	4.220 (4.933)	-0.121 (1.006)	-5.639** (2.824)
PRC costly conflict _{t-1}	0.032 (0.352)	-0.600 (0.446)	-0.569 (1.498)	0.130 (0.300)	-0.269 (0.192)	0.068 (0.326)
USA costly conflict _{t-1}	0.039 (0.389)	2.120* (1.106)	0.856 (0.996)	-0.488 (0.846)	0.482 (0.299)	0.011 (0.390)
CPI _{t-1}	0.091 (0.133)	0.056 (0.134)	-0.219 (0.464)	-0.106 (0.137)	-0.037 (0.090)	0.082 (0.129)
Party Congress _{t,t-6}	-0.590 (1.467)	-29.032 (2,278,143)	-20.493 (25,882)	0.596 (8,871,994)	-36.707 (14,069,841)	-0.590 (1.452)
Lianghui _{t-1}	0.619 (0.854)	-28.566 (2,961,496)	-21.185 (28,212)	0.030 (1.371)	-1.314 (1.129)	0.557 (0.833)
$\Delta S\&P500_{t-1}$	-0.041 (0.096)	-0.064 (0.151)	0.358* (0.186)	-0.074 (0.128)	0.072 (0.071)	-0.065 (0.090)
Constant	-11.080 (14.034)	-42.185 (10,583,370)	18.097 (47.493)	8.585 (14.379)	2.661 (9.465)	-10.165 (13.616)
Year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Month fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	240	240	240	240	240	240
Log Likelihood	-41.546	-28.236	-10.056	-23.772	-91.516	-43.773
Akaike Inf. Crit.	141.092	114.472	78.112	105.544	241.032	145.546

Note: *p<0.1; **p<0.05; ***p<0.01

Figure 7: SSE Shocks and Chinese Conflict by Issue Area

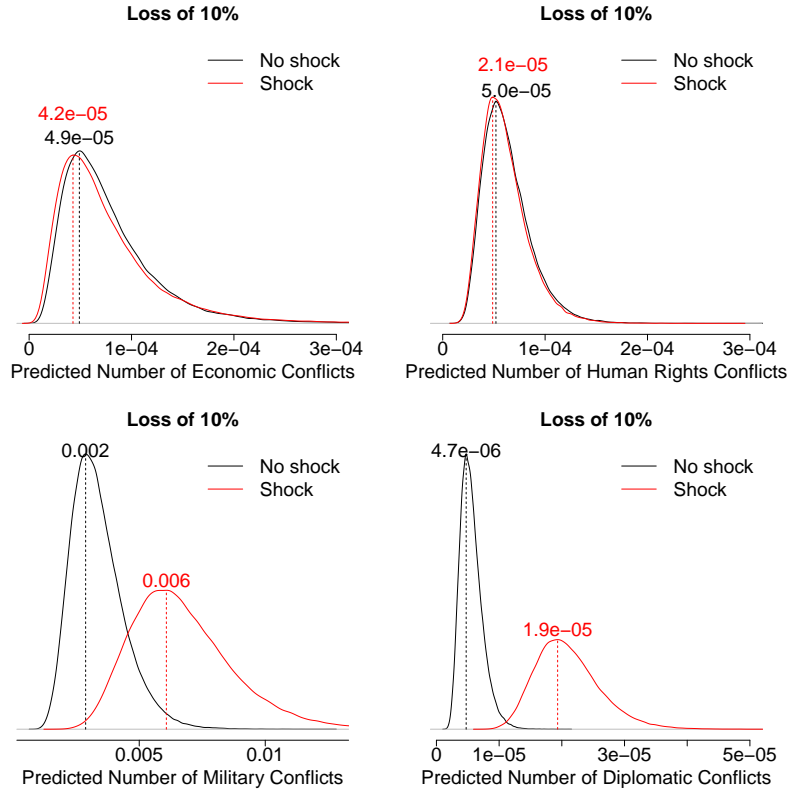
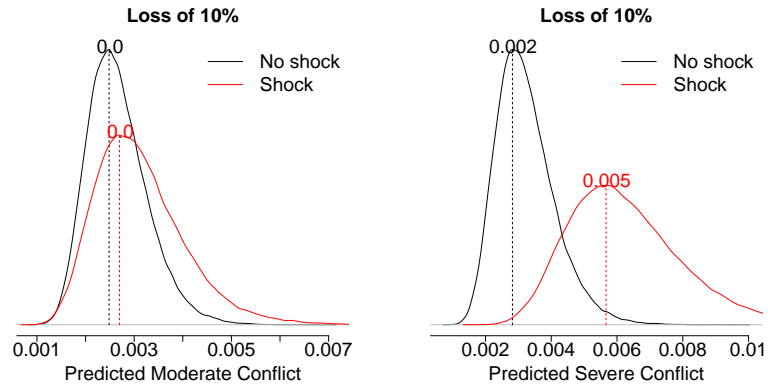


Figure 8: SSE Shocks and Chinese Conflict by Severity Level



their country’s rise as peaceful. After China held military exercises in the Taiwan Strait in 1995, Vice Minister of Foreign Affairs Liu Huaqiu traveled to Washington and told National Security Adviser Anthony Lake that the exercises “were normal and no threat to the United States.”⁴¹ In January 2007, China conducted a missile test that destroyed a weather satellite and created the largest collection of space debris in history. The American response was stern. “It wasn’t clear what their intent was,” said General Peter Pace. “When the intent isn’t clear, and when there are surprises and you confuse people, you raise suspicions.”⁴² When China conducted another test three years later, *Xinhua* announced the exercise the day it was conducted and described it as “defensive in nature.” The following day, the Ministry of Foreign Affairs repeated the assurance and added that the test did not create any debris.⁴³ These examples illustrate that when the United States becomes suspicious of Chinese motives, Beijing often employs reassurance behavior. They make clear that China is sensitive to American perceptions.

To assess the hypothesis that China employs diplomacy to recenter American perceptions after diverting, I examine whether conflict in month $t - 1$ is associated with cooperation in month t , *conditional* on a negative transfer shock occurring in month $t - 2$. That is, I subset the dataset to observations characterized by decline in transfers of at least 5% in $t - 2$. This allows me to examine the impact of specifically *diversionary* conflict upon the autocrat’s propensity to initiate verbal or substantive cooperation in the next period:

$$\frac{\partial \text{PRC Cooperation}_t}{\partial \text{PRC Costly Conflict}_{t-1}} \Bigg|_{\Delta \text{SSE}_{t-2} \leq -0.05}$$

Because the analysis now spans three months, I included lagged variables in $t - 1$ and $t - 2$. I also introduce the interaction term $\Delta \text{SSE}_{t-2} \times \text{PRC costly conflict}_{t-1}$, which captures the additional degree to which conflict is diversionary beyond the 5% decline stipulated by the subset.

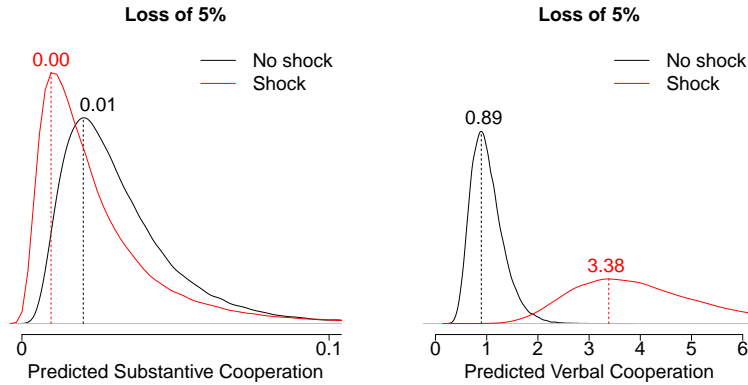
Table 6 presents the results and Figure 9 visualizes them. Conditional on a negative transfer shock, conflict is associated with verbal cooperation the following month. It is not associated with substantive cooperation the following month. This suggests that the autocrat employs a verbal charm offensive to recenter American perceptions after diverting. However, he does not employ public forms of cooperation that might be penalized by his

⁴¹Suettinger (2003, 254).

⁴²Mulvenon (2007, 5).

⁴³Mulvenon (2010, 1-2).

Figure 9: Post-Diversion Cooperation



The data are subset to simulate the effect of conflict in t on cooperation in $t + 1$ conditional on a negative transfer shock occurring in $t - 1$.

domestic audience.

4 CASE STUDY

4.1 SUMMARY

There is little direct evidence of diversionary aggression in the scholarly literature, since leaders who employ it would never actually admit it. Indeed, admitting that conflict is diversionary would undermine its objective. In this respect, China's bilateral relationship with the United States constitutes a particularly attractive case study. For the WikiLeaks cables that were released in 2010 and 2011 provide an unprecedented opportunity to observe diversionary aggression from primary source documents. And, indeed, one particularly well documented episode in 2010 affirms that diversionary aggression proceeds exactly as the quantitative evidence above suggests.

In the first months of 2010 the Shanghai Exchange plummeted, as shown in Figure 10. Meanwhile, GDP growth increased and unemployment declined. As returns fell, China initiated high profile conflicts with the United States. However, China secretly warned the United States to expect aggression over the next few months and that its bellicosity would be temporary. It continued to cooperate with the United States on issues that could be kept private. Propaganda mirrored foreign policy. When the market sustained its steepest losses that spring, the level of social stability propaganda was three times as high as during the rest

Table 6: Unlearning Diversion

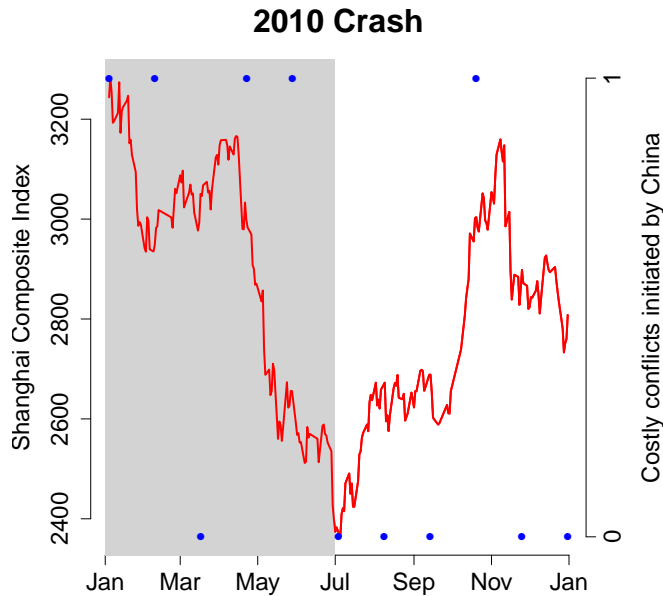
	<i>Dependent variable:</i>		
	PRC costly coop _t		PRC cheap coop _t
	(1)	(2)	(3)
Δ SSE _{t-1}	3.908 (4.212)	0.048 (6.073)	-3.244 (4.648)
PRC costly conflict _{t-1}	-0.263 (0.196)	0.555** (0.229)	1.225*** (0.420)
USA costly conflict _{t-1}	0.395 (0.466)	-0.233 (0.435)	-1.426** (0.580)
CPI _{t-1}	0.097*** (0.026)	0.036 (0.036)	0.033 (0.043)
Popular crises _{t-1}	-0.001 (1.147)	0.215 (0.607)	0.133 (0.694)
Party Congress _{t:t-6}	2.414** (0.973)	1.570** (0.634)	1.961*** (0.469)
Lianghui _{t-1}	-36.160*** (0.495)	-0.968* (0.569)	-0.773 (0.878)
Δ S&P500 _{t-1}	0.108 (0.118)	-0.036 (0.065)	-0.105** (0.052)
Δ SSE _{t-2}			4.199** (2.072)
PRC costly conflict _{t-2}			-0.185 (0.166)
USA costly conflict _{t-2}			-0.484 (0.653)
Δ SSE _{t-2} \times PRC costly conflict _{t-1}			8.646*** (1.653)
Constant	-11.982*** (2.986)	-3.693 (3.559)	-3.777 (4.285)
Observations	29	63	63
Log Likelihood		-35.031	-100.403
Akaike Inf. Crit.		88.061	218.805

Note:

*p<0.1; **p<0.05; ***p<0.01

* Analysis restricted to observations with decline of $\geq 5\%$ in SSE in $t - 2$.

Figure 10: 2010 Crash and “Assertive China”



of the year.⁴⁴ After the stock market stabilized in July, China reassured the United States privately. Through diversion and reassurance, as well as the careful separation of public and private interactions, China was able to navigate its domestic crisis without damaging bilateral relations.

4.2 THE CRASH

The Shanghai index faltered in late 2009, but recovered toward the end of the year. In January 2010, Defense Secretary Robert Gates visited Beijing and President Hu visited Washington. Both meetings were considered successful. In late January, the White House announced a \$6 billion Taiwan arms sales package. The package was conservative in comparison to its predecessors and American officials took pains to ensure all equipment “could reasonably be described as ‘defensive.’”⁴⁵ The arms sale was unwelcome but expected by the Chinese. While Ambassador Zhou Wenzhong “relayed Beijing’s anger over the sale,” he “noticed not only what was authorized for sale to Taiwan but also what was not authorized.” Zhou told American officials he “believed that would mitigate Beijing’s reaction.” More, he

⁴⁴Propaganda about serving the people was more volatile, but also peaked that spring.

⁴⁵Gates (2014, 415).

proposed steps to improve bilateral relations. National Security Council senior director for East Asian affairs Jeffrey Bader recalls,

I came out of the breakfast thinking for the first time that Hu would in fact come to Washington for the Nuclear Security Summit, that that event could restore positive momentum to the relationship, and that the damage would be relatively short lived.⁴⁶

Shortly thereafter the Shanghai index began to plummet. Chinese policy changed abruptly. Beijing's rhetoric over the sale "sharpened considerably," Bader wrote. In February, China publicly threatened unusually strong retaliation for the arms sale, including a ban on Boeing, the largest US exporter to China. However, Bader "did not see a serious prospect of the Chinese carrying through on these threats."⁴⁷ Beijing also made headlines by canceling Secretary Gates' upcoming visit.⁴⁸

As these troubling events were unfolding, the editor of China's most nationalist state-affiliated newspaper, the *Global Times*, met with American embassy officials in Beijing. Such a high ranking Party member would not have met with American officials without the approval of the Chinese leadership. He told embassy officials "not to be concerned" about China's recent policies. Ambassador John Huntsman cabled a summary of this meeting to Washington:

The Chinese government had a clear vision of China's interests, [the *Global Times* editor] said, and it was most important to maintain a "favorable foreign policy environment" for the government to pursue pressing economic and social development goals at home. A good relationship with the United States was essential, a view he had heard recently expressed by Chinese officials. China's statements criticizing the United States on the Google case, Internet freedom, Taiwan arms sales and the President's planned meeting with the Dalai Lama were all "necessary to satisfy the Chinese people," but China's actions in 2010 would be aimed at preserving China's relationships with the rest of the world. Quoting a Chinese phrase

⁴⁶Bader (2012, 73-74).

⁴⁷Bader (2012, 74).

⁴⁸In mid-February, President Obama met with the Dalai Lama. This might seem to be a provocative act but in fact was not. The Dalai Lama had visited Washington in autumn, but Obama declined to meet with him then to avoid provoking China before President Hu's visit in January. It was the first time an American president had declined to meet with the Dalai Lama since 1991, and it incurred substantial domestic costs for the president. More, the February meeting was held in the White House Map Room—considered part of the presidential residence—rather than the Oval Office. This "was considered by many observers to be a sign of Washington's acknowledgement of Beijing's political sensitivities" (CNN, 2010).

used to describe Deng Xiaoping’s strategy for mollifying ideological Communists with socialist rhetoric while pursuing capitalist economic reforms, [the editor] said we should expect China in its 2010 foreign policy to “put on the left turn signal in order to turn right.”

Other Party members communicated similar messages in early 2010. A senior fellow at the Chinese Academy of Social Sciences told embassy officials that the Chinese media was “deliberately misleading the public to sell more newspapers.” As a result, Huntsman predicted that China would “stomp around and carry a small stick” over the coming months. “This attitude,” he told Washington, “has more form than substance and is designed to play to Chinese public opinion.”⁴⁹

After sending private assurances, China initiated public conflict. In March, US policy-makers were presented with a “lengthy presentation” on China’s rights in the South China Sea, newly deemed a “national priority.” On Taiwan, they were presented with a series of “ritualistic demands.”⁵⁰ After the meetings, the Western press deemed Beijing “incensed.”⁵¹ The Chinese press described bilateral relations as “strained” and “at a low point.”⁵² Chinese policymakers told journalists the United States was trying to contain China. Of course, the accusation made Asian headlines.⁵³ In response, a senior Obama administration official told reporters, “With these issues, such as arms sales to Taiwan and meetings with Dalai Lama, there are things said for domestic consumption.”⁵⁴

The claim, however, slid beneath the mounting discussion of bilateral tension. In May, Beijing scuttled an American UN initiative to blame North Korea for the sinking of a South Korean vessel in March.⁵⁵ When Secretary of State Hillary Clinton traveled to Beijing later that month, Chinese leaders described the South China Sea as a “core interest” and “warned they would not tolerate outside interference.”⁵⁶ Clinton believed the meetings to be a “carefully choreographed summit.” Rear Admiral Guan Youfei, who, she believed, had “gotten at least a tacit go-ahead from his military and party bosses,” “stood up and launched into an angry rant accusing the United States of trying to encircle China and suppress its rise.”⁵⁷ A senior Chinese official told reporters, “It may not have been politically correct,

⁴⁹US Embassy Beijing (2010).

⁵⁰Bader (2012, 76-77).

⁵¹Wall Street Journal (2010).

⁵²Cheng Guangjin and Tan Yingzi (2010); Yan Feng (2010).

⁵³Huang (2010).

⁵⁴Batson, Poon and Oster (2010).

⁵⁵Clinton (2014, 56).

⁵⁶Clinton (2014, 76).

⁵⁷Clinton (2014, 76).

but it wasn't an accident. ...The army follows the Party. Do you really think that Guan did this unilaterally?"⁵⁸ After the meetings, the Western press concluded the two sides had made "modest progress" on economic issues. In contrast, the Chinese press emphasized that Beijing had demanded that Washington "respect its core interests and major concerns."⁵⁹

In June, China continued to block American efforts to punish North Korea in the United Nations. China watchers concluded "That China is becoming more assertive on many foreign policy issues is widely recognized by both Western and Chinese observers."⁶⁰ Indeed, discussion of "assertive China" quintupled in US news articles in 2010.⁶¹

More, what cooperation transpired in this period was assiduously kept private. In April, China finally agreed to American requests to work together on an Iran resolution at the United Nations. China had one condition: that it would not announce its assistance publicly.⁶²

4.3 THE RECOVERY

In July, the stock market reversed course. So too did China's foreign policy. Conflict subsided. Diplomacy and then cooperation rose. Beijing agreed to support a Security Council statement condemning North Korea. In August, Chinese officials clarified that they "had not authoritatively called the South China Sea a 'core interest.'"⁶³ In September, China employed "quiet diplomacy" to inform US officials that it "was willing to begin expert talks on a code of conduct in the South China Sea."⁶⁴

The charm offensive culminated with meetings in Beijing that month. Organization Department Minister Li Yuanchao gave National Security Adviser Tom Donilon a "lengthy personal presentation explaining in detail why China would not challenge the United States for global leadership and why there was no inevitable conflict in their interests." He assured Donilon of China's "unyielding opposition" to North Korea's nuclear weapons program. Simultaneously, General Xu Caihou informed American policymakers that China would resume military exchanges with the United States.⁶⁵ Bader recalls,

⁵⁸Pomfret (2010*b*).

⁵⁹Landler and Wines (2010); Xinhua News Agency (2010).

⁶⁰Swaine (2010, 8).

⁶¹Johnston (2013, 12). This article rebuts ahistorical critiques of Chinese foreign policy as newly assertive in 2010. However, Johnston's point that Chinese assertiveness is not new does not contradict the thesis advanced here that episodes of assertiveness result from domestic conditions.

⁶²Bader (2012, 78).

⁶³Bader (2012, 106).

⁶⁴Bader (2012, 106).

⁶⁵Bader (2012, 116, 118).

The Chinese reaction in all the meetings was a steady drumbeat of references to their desire for cooperation with the United States. By the time we left, even Donilon knew the Chinese word for cooperation, *hezuo*, having heard it many times. Little was said about Taiwan and even less about Tibet.⁶⁶

In an October meeting at the Asian defense ministers forum in Hanoi, Defense Minister Liang Guanglie quietly reinvited Secretary Gates to Beijing.⁶⁷ *Xinhua* reported the meeting but not the invitation. Gates met with President Hu in Beijing later that month. In November, President Obama met President Hu at the G20 meeting in Seoul. Shortly thereafter, State Councilor Dai Binguo traveled to North Korea on the United States' behalf to warn Pyongyang not to respond to ongoing South Korean military exercises. The assistance went unreported in China. In December, Beijing accepted an outstanding offer for President Hu to visit Washington. The visit in January was successful. Observers noticed the improvement in bilateral relations. In February, Swaine noted that "In recent weeks, Beijing seems to have stepped back from the most strident and activist words and actions of winter 2009-2010."⁶⁸

4.4 TAKING STOCK

This case shows that in 2010, China pursued a foreign policy of diversion and reassurance. That year, Beijing initiated four times as much conflict when elite transfers were falling compared to when they were rising. Social stability propaganda peaked when the market suffered its steepest declines. While American embassy cables that year routinely attributed China's aggressive foreign policy to domestic problems, they failed to distinguish between mass and elite interests. Certainly, Chinese operatives had few interests in hinting at regime instability by clarifying the contours of leadership struggles. However, the remarkable fact that stocks crashed while employment and GDP growth improved suggests that elite transfers, not popular economic interests, were the source of the aggression that China warned was "necessary to satisfy the Chinese people."⁶⁹

More, patterns in public versus private interaction suggest that Chinese behavior in late 2010 was not regression to the mean. Instead, it was strategic. As elite transfers fell in the first half of the year, Beijing warned American officials to expect diversionary foreign policy. Then it employed diversion and propaganda while continuing to cooperate with the

⁶⁶Bader (2012, 118).

⁶⁷Gates (2014, 524).

⁶⁸Swaine (2011, 9).

⁶⁹Similarly, inflation cannot explain China's foreign policy in 2010 because it rose almost continually throughout the year, making the mid-year reversal in Chinese foreign policy incongruous.

United States privately. Thereafter, it successfully reassured American policymakers once the domestic crisis had passed.

5 CONCLUSION

This study contributes to the literature on autocratic foreign policy by demonstrating that the economic interests of political elites condition autocrats' international behavior. In China, the economic interests of political elites may be responsible for 40% of China's conflict initiation toward the United States. When elite transfers through the Shanghai Stock Exchange decline by 5% to 15%, China initiates 1.5 to 2 times as much conflict as usual the following month. More, Chinese propaganda is most likely to emphasize public support for the autocrat when elite transfers decline, suggesting that the autocrat is principally interested in inoculating himself against elite leadership challenges.

The theory may explain the foreign policy of other autocracies as well. Former ambassador Michael McFaul argues that financial sanctions have diminished Vladimir Putin's ability to transfer rents to elites, and that this may explain Putin's popular adventures abroad.⁷⁰

Future research should proceed in three directions. First, scholars might consider how the opinions and living standards of a broader segment of the population condition foreign policy in other autocracies. Chinese foreign policy responds strongly to elite interests, but is the public sometimes more influential—for example, when urban bias is lower, rendering popular economic interests more uniform?

Second, I focus on Chinese behavior toward the United States, yet China may target other countries for diversion as well. Indeed, many other embassies complained to Ambassador Huntsman about such behavior in 2010. In particular, anti-Japanese statements are popular with Chinese citizens.⁷¹ Future research might consider how autocrats choose between diversionary targets.

Finally, researchers should consider whether diversion may target domestic groups. In China, the autocrat sometimes initiates propaganda campaigns that portray local officials as corrupt. The center's prosecution of high level corruption cases has been very popular.

⁷⁰Robins-Early (2015).

⁷¹See the interesting account in Pomfret (2010*a*), which suggests that Chinese policymakers engaged in at least some diversion toward Japan while the Shanghai Exchange plummeted in April and May 2010. The Japanese foreign minister said of his Chinese counterpart Yang Jiechi, "He's always been a peace lover. I guess the Chinese felt like yelling."

“Domestic diversion” has precedent elsewhere: Mexico’s single party presidents periodically attacked business elites to bolster their popularity among ordinary people.⁷² Thus, diversion might emerge in the domestic class politics of autocracies as well.

This research agenda is pressing because if economic projections are correct, China may employ diversion more frequently in the future. The relative economic position of Chinese elites will deteriorate as China increases household consumption as a share of GDP.⁷³ In the long run, slowing GDP growth will depress stock returns and the autocrat will run out of SOEs to privatize, diminishing the value of the Shanghai Exchange as a vehicle for transfers. Such dynamics led elites in post-Soviet countries to oppose reform because of their interests in the rents from partial privatization.⁷⁴ Chinese elites may become similarly discontented in an era of normal growth. The autocrat might attempt to ameliorate their discontent by topping off transfers outside the stock market, but this will be difficult because the public is increasingly critical of corruption. In short, popular demands for clean government combined with elite demands for new transfers will put future Chinese leaders in a difficult position. Lacking tools to placate elites, they may resort to diversion more frequently.

⁷²See e.g. González (2008).

⁷³Keck (2014); Naughton (2012).

⁷⁴Huang (2008); Murphy, Shleifer and Vishny (1992); Pei (2006).

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