Elite Welfare Shocks and Autocratic Foreign Policy:
Evidence from China

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Abstract

This paper presents a theory of diversionary foreign policy in autocracies. The autocrat purchases elite support with transfers and public support with public goods. The two sources of support are substitutes: when elite support declines due to economic shocks, the autocrat can inoculate himself against leadership challenges by cultivating popular support. Diversionary 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 assembled through archival research and computational methods, I find broad support for the theory. When elite transfers decline by 5% to 15%—which happens in a quarter of months—China reports on public support for the autocrat more effusively and initiates 1.5 to 2 times as much conflict as usual.

Word Count: 9,731

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1 Introduction

How is foreign policy in autocracies influenced by political elites: the key figures whose support the autocrat needs to survive? International relations scholars suggest that when institutions empower elites, autocrats are constrained and therefore less likely to initiate international conflict.\(^1\) However, institutional approaches to autocratic foreign policy overlook elite power struggles. These are endemic to autocracies, even beneath the veneer of institutions that privilege the autocrat.\(^2\)

This observation dates to ancient times: Xenophon’s Hiero complained 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.\(^3\) These findings share a common premise: the contract between autocrat and elite is written in terms of rent transfers.\(^4\) When transfers decline, so does elite support for the autocrat.

This paper explores how economic shocks to elite welfare affect autocratic foreign policy. I develop a theory in which the autocrat draws support from elites and the public. Indeed, the two are substitutes. These two potential sources of support enlarge the autocrat’s strategy set in ways that are particularly salient for foreign policy. When elite support flags, the autocrat may cultivate public support in order to discourage leadership challenges. Popular support deters leadership challenges through the threat of revolution. Because a challenger would face public opposition if she replaced a popular leader, the expected payoff of her challenge is lower. Therefore, popular affection for the regime—or the appearance thereof—deters elite challengers. Although contemporary scholars generally regard autocrats as having to satisfy both their elites and the population,\(^5\) 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.\(^6\)

Geddes (2009) similarly suggested that an autocrat who faces coup threats may build countervailing political forces such as a mass civilian party.

To generate popular affection, I argue, autocrats may employ diversionary foreign policy: the initiation of an international dispute to generate a rally effect. Of course, autocrats enjoy a range

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\(^1\) de Mesquita et al. (2003); Lai and Slater (2006); 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).
\(^3\) Carter (2015a,b); Kapucinski (1989).
\(^4\) Blaydes (2011); Gandhi (2008); Gandhi and Przeworski (2007); Geddes (2005); Magaloni (2008).
\(^5\) See e.g. Svolik (2012).
\(^6\) Machiavelli (2012, Ch. XIX).
of policy options to remedy elite dissatisfaction. For instance, the autocrat might increase direct
transfers to elites. However, this is risky because of public frustration with corruption. Alter-
natively, the autocrat might generate countervailing public support by providing public goods.
However, these are difficult to supply immediately. In contrast, diversionary foreign policy is read-
ily implemented and may be relatively inexpensive due to pre-authorized military budgets. 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 will initiate newsworthy conflict rather than that which is unobservable. Be-
cause diversion aims to make leadership challenges costlier, it will be accompanied by propaganda
designed to foster the impression of popular affection for the autocrat. And because the autocrat
seeks to avoid international retaliation, he will subsequently adopt cooperative policies to placate
his diversionary target.

I test the theory in the context of China’s foreign policy toward its most powerful rival: the
United States. China is an appealing case for three reasons. First, it offers a unique opportunity
to measure elite transfers. In the early 1990s Deng Xiaoping transferred enormous equity to elites
by privatizing state owned enterprises (SOEs). The stock market soon became a leading rent
distribution mechanism. Yet because few 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. This is consistent with supranormal elite returns since 1990 and
the rise of inequality in China, which is well documented.7 Second, the threat of elite challenges
is serious in China, where autocrats face “incessant threats to their authority.”8 And finally, the
WikiLeaks cables afford rare insight into diplomatic communications 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 represents the first evidence of leaders actually admitting diversionary
conflict.

The empirics employ three original datasets that cover the 1990 to 2010 period. I measure elite
transfers with the Shanghai Stock Exchange (SSE) composite index. To my knowledge, this is the
first attempt to measure elite transfers in an autocracy. Using computational methods, I record
propaganda on “party-mass relations” published in the People’s Daily, China’s leading state-run
newspaper. Finally, by hand coding over 10,000 pages of historical documents, I assembled the
most complete record of the US-China bilateral relationship between 1990 and 2010. The evidence
suggests that when elite transfers decline by 5% to 15%—which happens in a quarter of months—
China reports on public support for the autocrat far more effusively. In comparative terms, the
coverage gap is equivalent to how positively Fox News covers Democrats versus Republicans. Si-
multaneously, China initiates 1.5 to 2 times as much conflict as usual. As much as 40% of China’s

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7Huang (2008); Shi, Sato and Sicular (2013); Walter and Howie (2006).
8Shih (2008a, 48).
conflict initiation toward the United States may be diversionary.

This study adds to an emerging literature that links domestic politics with foreign policy in autocracies. The literature on democratic foreign policy gives full attention to the subnational sources of international behavior. Partly because it is more difficult to analyze subnational politics in autocracies, the literature on autocratic foreign policy has primarily focused on the influence of fixed institutions. This paper demonstrates that elite welfare concerns are an important source of variation in autocratic foreign policy. Indeed, they explain nearly half the conflict initiation of the world’s most populous autocracy. The research agenda this article joins focuses more closely on domestic politics in autocracies and yields a richer explanation of autocratic foreign policy.

This paper proceeds as follows. Section 2 develops the theory and deduces a series of observable implications. Section 3 introduces the data on bilateral interactions, elite transfers, and propaganda. Section 4 tests the hypotheses. Section 5 presents a case study of China’s stock market crash in 2010. In that episode, policymaker memoirs and leaked cables reveal, China adopted diversionary foreign policy toward the United States, communicated the short term nature of its aggression to American officials, and adopted private reassurance behavior after the domestic crisis passed. Section 6 concludes.

2 THEORY

There is a large literature on diversionary conflict in international relations. It is based in social identity theory, which suggests that leaders can increase ingroup affinity by making intergroup distinctions more salient. A review concludes that though the internal logic of diversionary conflict is “compelling and theoretically well supported,” the empirical evidence is “decidedly mixed” (Baum and Potter, 2008, 48). Several studies find evidence of diversionary aggression in US foreign policy and elsewhere. Yet skeptics have amassed opposing evidence. Some cases are hard to reconcile with the theory: in Britain, there were rallies in the Falklands War and the Gulf War but not in other cases in which rallies would be expected, such as the Korean, Suez, and Kosovo wars. Some go so far as to call diversionary aggression a “myth” (Meernik and Waterman, 1996).

Others have developed scope conditions for diversionary aggression. It is more likely between
states with pre-standing rivalries\textsuperscript{16}, when leaders are accountable\textsuperscript{17}, and in mature democracies, consolidating autocracies, and transitional polities.\textsuperscript{18} It is less likely when states avoid provoking troubled adversaries.\textsuperscript{19} Diversion appears more likely to produce a rally when supported by Security Council authorization\textsuperscript{20}, when the White House draws attention to a dispute\textsuperscript{21}, and in conditions of media attention, popular leadership, divided government, non election years, and first terms.\textsuperscript{22}

Research on diversionary foreign policy in autocracies is most relevant to this study. Because autocrats can contain domestic unrest with repression, some argue, 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 may employ diversion during a domestic crisis. Indeed, they find that signs of elite unrest such as government crises and purges are associated with the use of external force cross nationally.

Many scholars argue that domestic politics may influence China’s foreign policy. However, they tend to focus on popular nationalism rather than elite dissatisfaction. Christensen (1996) attributes Mao’s decision to shell Quemoy in 1958 to his desire to galvanize support for agricultural collectivization. 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 could lead to conflict with the United States. Others are more skeptical. Drawing on theories of omnibalancing, Fravel (2008) argues that secessionist movements create incentives for China to compromise abroad. Weiss (2014) finds that Chinese foreign policy has not proven responsive to nationalist protests.

Building on extant work, especially Pickering and Kisangani (2010), I develop a theory of why elite unrest may result in diversion in autocracies. The theory is illustrated in Figure 1.

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\textsuperscript{16}McLaughlin and Prins (2004)
\textsuperscript{17}?.
\textsuperscript{18}(Pickering and Kisangani, 2005).
\textsuperscript{19}Clark (2003); Fordham (2005); Leeds and Davis (1997); Miller (1999).
\textsuperscript{20}Chapman (2011); Chapman and Reiter (2004).
\textsuperscript{21}Baker and Oneal (2001).
\textsuperscript{22}Colaresi (2007).
respectively. When transfers decline, elites are forced to consider the transfers they might receive under alternative leadership. Consequently, the likelihood of elite challenges rises. Elites who expect to benefit more under alternative leadership become more likely to challenge the autocrat. To discourage such challenges, the autocrat may employ diversion to generate public support. Public support for the autocrat discourages potential elite challengers, because if those challengers successfully replaced the autocrat, they might face the threat of popular rebellion. This yields the first hypothesis:

**H1: When elite transfers decline, the autocrat will initiate diversionary conflict.**

The theory also yields hypotheses about the nature of diversion. Most obviously, it will be observable. 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 classified forms of aggression. These forms of interaction are consequential and common in US-China relations. For example, China quietly allowed dissidents to emigrate to the United States on several occasions, agreed to the US request not to sell treasury bonds during the 2008 financial crisis, and often employs aggressive aircraft tails to signal its discontent. US policymakers care deeply about these forms of conflict...

But because diversion aims to increase popular support, it will be public. It will take newsworthy forms that are likely to generate nationalism, such as deploying the military or asserting territorial claims. Diversion will not take forms that are geopolitically important but less likely to generate a rally, such as imposing economic penalties or cracking down on human rights. US policymakers care about these issue areas a great deal. For instance, religious minority protections, forced abortions, currency manipulation, anti-dumping, and intellectual property rights have been cardinal issues for all US presidents, particularly during Republican administrations.

However, these issue areas are negotiated mostly privately. Moreover, conflict in these areas would be unlikely to generate a rally among Chinese citizens because these issues do not cue images of group conflict between the United States and China in the visceral way that territorial and military issues do. Therefore, Chinese foreign policy will not divert in these areas. This yields the next hypothesis:

**H2: Diversion will take forms that are observable and likely to generate nationalism.**

Autocrats have long believed propaganda crucial to regime survival. Joseph Stalin used *Pravda* to threaten elites with purges. Mao Zedong described propaganda as “the most important job” facing the Red Army. Chinese autocrats since have devoted considerable attention to their propaganda

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23In the Chinese context, elites include the highest ranking party members—princelings and senior officials who can credibly challenge the autocrat—and the public includes the rest of the citizens.


25Mao Zedong (1929).
strategies. After the Tiananmen Square pro-democracy movement, Deng Xiaoping faulted the newspapers for failing to cultivate patriotism. In the 1990s, Jiang Zemin launched an initiative to “guide public opinion.” In the 2000s, Hu Jintao spearheaded a revised program to “channel public opinion.” In the 2010s Xi Jinping elevated this effort to a “struggle for public opinion” and called for a “strong army” to “seize the ground of new media.”

In a cross-national context, Carter and Carter (2017) find that electoral constraints determine incumbents’ recourse to propaganda. In China, where there are none, many scholars consider propaganda to be an important part of China’s “authoritarian resilience.” “Rather than being dead, dying, or in decline since 1989,” Brady and Wang Juntao (2009) conclude, “the propaganda state has actually been reborn and revitalized.” Survey evidence indicates that propaganda is influential in China: it affects citizens’ opinions, even in the presence of competing narratives in commercial, foreign, or social media. In a causally identified framework, Carter and Carter (2018) find that by doubling the number of references to “stability” or “harmony,” China’s propaganda apparatus halves the number of protests over the course of the subsequent week.

Chinese propaganda is also highly strategic. It is most effusive about regime performance during the anniversaries of pro-democracy movements past and most threatening during the anniversaries of secessionist movements. In other words, Chinese propaganda is motivated by concerns for regime survival.

If diversion aims to discourage elite challengers, then we should expect the autocrat to broadcast his increased support—and to foster the nationalism that renders elite conspiracies so costly—through propaganda. When elites become dissatisfied, the autocrat will employ propaganda to emphasize how widely he is supported by the people. Informed elites may not believe the propaganda, but they will know it shapes popular beliefs and therefore will update their assessment of the autocrat’s popularity. By fanning public nationalism through propaganda, the autocrat may make it more difficult for elites to stage coups. This yields the next hypothesis:

H3: When elite transfers decline, propaganda will emphasize the autocrat’s public popularity.

As the autocrat is strategic with his domestic audience, so too is he strategic with his foreign audience. The autocrat must balance his desire for a rally against the risk of international retaliation. After the autocrat employs diversion to fix a domestic problem, he faces international consequences. Diversion risks teaching the target state that the autocrat aims to upset the status quo. Chinese

\[26\] Huang and Zhai (2013); King, Pan and Roberts (2013); Qian Gang (2013).
\[28\] Huang and Yeh (2016); Stockmann (2010); Stockmann and Gallagher (2011); Zhu, Lu and Shi (2012).
\[30\] See e.g. Truex (2014).
policymakers are aware that this is a major risk in US-China relations. Partly because many American politicians believe that China seeks to challenge American hegemony, Chinese leaders have been meticulous about presenting their rise as peaceful. After China held military exercises in the Taiwan Strait in 1995, for instance, 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.”

In January 2007, China conducted a missile test that destroyed a weather satellite and created the largest collection of space debris in history. Following a stern American response, the next time China conducted a test, it announced it the day it was conducted and described it as “defensive in nature.” The following day, the Ministry of Foreign Affairs added that the test did not create any debris. These examples illustrate that China is sensitive to American perceptions. When the United States becomes suspicious of Chinese motives, Beijing often employs reassurance behavior.

I expect these sensitivities to apply to diversionary episodes much as they apply to Chinese foreign policy making in general. After a domestic crisis that necessitates diversion passes, the autocrat should placate the diversionary target in order to avoid a containment response. These “charm offensives” aim to recenter the target state’s prior about the autocrat’s intentions. Again, I expect Chinese policymakers to be sensitive to the differences between public and private behavior, and the actions that are more or less likely to be noticed by Chinese citizens. Post-diversionary “charm offensives” will be private rather than public, lest the autocrat’s citizens penalize him for backing down. They will take the form of verbal assurances and private material cooperation: actions that the diversionary target can see but that typical Chinese citizens cannot. This yields the final hypothesis:

H4: After a diversionary episode, the autocrat will privately cooperate with his target state in order to recenter its prior about his intentions.

3 Data

To test the theory, I focus on China: on the struggles between its autocrat and political elites, and how these struggles manifest themselves in its bilateral relationship with the United States. Section 3.1 introduces my dataset of bilateral interactions, which records all state-to-state interactions between China and the United States between 1990 and 2010. Section 3.2 introduces the data on elite transfers. To measure these, I exploit the fact that Chinese elites were compensated during the sample period with shares in state owned enterprises. Section 3.3 describes my measure of propaganda about public support for the autocrat.

3.1 Diplomatic Data

I constructed a dataset of over 2,000 bilateral interactions between 1990 and 2010 from two dozen primary and secondary sources listed in the online appendix. I drew from English- and Chinese-language history textbooks, policymaker memoirs, case studies, periodicals, declassified primary source documents, and leaked American diplomatic cables.

In my coding scheme, a bilateral interaction is an episode of contact between the two states. For example, in 1994, Secretary of State Warren Christopher canceled his ceremonial appearances in Beijing in retaliation for Chinese human rights abuses. In 2009, after being lobbied by FedEx and UPS, Secretary of State Hillary Clinton requested that China reduce barriers to entry in its postal market.

For 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, Treasury Secretary Hank Paulson requested that China allow the yuan to appreciate, whereas the United States criticized China’s unannounced anti-satellite test. Others involve equal effort by both parties, like meeting, negotiating, or signing an agreement. I duplicated these events so both sides received credit equally.

I then recorded the action itself. Event types are reported in Table 1. Diplomacy involves friendly verbal or written interactions. Cooperation involves substantive material assistance. Criticism involves hostile verbal or written interactions, and conflict involves substantive material disputes.33 Examples of all event types appear in the online appendix.34

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. 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.

Figure 2 visualizes US-China interactions since 1990. Diplomacy appears in light blue, cooperation in dark blue, criticism in light red, and conflict in dark red. The top panel shows the number of events that China initiated each year. The bottom panel reports similar data for the United States. Between 1990 and 2010, the states engaged in verbal or written interaction approximately four times as often as they interacted materially. Diplomacy was twice as common as criticism, and cooperation three times as common as conflict. Conflict and cooperation are correlated. Indeed they should be, as international crises are characterized by bursts of all forms of interaction, as

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33Fearon (1994) and Weeks (2008) suggest that verbal statements that generate audience costs are costly. Therefore I consider official apologies cooperation. Because public leader threats generate audience costs, I consider these conflict. Because public threats by low-ranking officials do not generate audience costs, I consider these criticism. Weiss (2013), Weiss (2014), and Kinne and Marinov (2013) suggest that autocrats can only generate audience costs by inciting nationalist protests. The results are robust to this modification.

34A note is appropriate on routine military patrols, which occur frequently. Instead of recording the patrols themselves, I record policy changes to the patrols—making them more aggressive, for instance, or mandating them in new areas. This is appropriate because policymakers respond to changes in a rival’s assertiveness rather than to status quo patrols.
Table 1: Event Types. See online appendix for examples.

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<tr>
<th><strong>Diplomacy</strong></th>
<th><strong>Criticism</strong></th>
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<tr>
<td>Positive statement</td>
<td>Negative statement</td>
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<td>Request</td>
<td>Postpone</td>
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<td>Meet</td>
<td>Downgrade protocol</td>
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<td>Negotiate</td>
<td>Refuse</td>
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<td>Invite</td>
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<td>Visit</td>
<td>Warn</td>
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<td>Explain</td>
<td>Private threat</td>
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<td>Reassure</td>
<td>Public low ranking threat</td>
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<td>Offer</td>
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<td>Express regret</td>
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<td>Propose</td>
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<td>Promise</td>
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<th><strong>Cooperation</strong></th>
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<td>Apologize</td>
<td>Public leader threat</td>
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<td>Release national</td>
<td>Obstruct</td>
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<tr>
<td>Concede</td>
<td>Withdraw support</td>
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<tr>
<td>Aid</td>
<td>Cancel exchange</td>
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<td>Sign agreement</td>
<td>Punitive economic action</td>
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<td>Hold summit</td>
<td>Infringe on human rights</td>
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<td>Yield militarily</td>
<td>Intervene for dissident</td>
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<td>Incite protest</td>
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<td>Arrest national</td>
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<td>Espionage</td>
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<td>Develop weapon system</td>
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<td>Assert territorial claim</td>
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<td>Proliferate</td>
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<td>Downgrade relationship</td>
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<td>Military exercise</td>
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<td>Military conflict</td>
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states simultaneously spar and use diplomacy to defuse tension.

My dependent variable is *Chinese conflict initiation*: substantive bilateral conflict in military affairs, diplomatic affairs, economics, or human rights. The dataset records 171 episodes of conflict in 58 months. The measure has high construct validity, as shown with black arrows in Figure 2. The most conflictual years in the dataset were indeed characterized by major crises: a dispute over alleged nuclear proliferation in 1993, the Taiwan Strait crisis in 1995, the bombing of the Chinese embassy in Belgrade in 1999, and the collision between a Chinese fighter jet and a US spy plane in 2001. 2010 – characterized by scholars as a year of “assertive” Chinese behavior – was also a high-conflict year in the dataset.\(^{35}\)

I chose not to use existing event datasets for three reasons. First, they are insufficiently accurate for this sort of exercise. The 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. Daily event datasets constructed by automated coding of news wires, such as GDELT or Gary King’s “10 million events,” record bilateral disputes with much greater frequency but tremendous noise. As event data scientists themselves admit, 20% to 30% of these events are false positives or false negatives.\(^{36}\) Second, the ontologies used to construct these datasets omit important types of interstate interactions. Examples include: demurring, canceling an invitation, postponing talks, expressing restraint, passing a congressional resolution, or offering asylum to a dissident. All of these are important in US-China relations. And finally, much diplomacy takes place out of the public eye. As discussed above, these events are crucial in US-China relations, but appear only in policymaker memoirs or declassified documents. By hand coding some 10,000 pages of historical documents, I assembled the most complete record of the bilateral relationship between 1990 and 2010.

### 3.2 Elite Transfer Data

China’s equity markets are unlike their Western counterparts in three crucial ways: they are dominated by state-owned enterprises (SOEs), are extremely volatile, and reflect expectations about government intervention more than macroeconomic indicators. Though SOEs accounted for 40% of China’s GDP in 2010, they accounted for 65% of listed firms and 89% of market capitalization.\(^{37}\) Figure 3 shows the volatility of Chinese stock returns between 1990 and 2010. S&P 500 returns, in blue, were normally distributed over this period. In contrast, Shanghai Stock Exchange (SSE)

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[^35]: While some of these crises were exogenous, like the Belgrade bombing or the aircraft collision, the results are not driven by exogenous shocks. Theoretically, although an exogenous crisis may occur, a state’s response to it is conditional on many things, including domestic politics. Moreover, most 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 2 at the monthly level.

[^36]: Schrodt (2012).

[^37]: Pei (2012, 34), Piotroski and Wong (2012, 219). Indeed, this statistic reflects a downward trend over my sample period.
Figure 2: Bilateral Interactions

[Graph showing bilateral interactions between PRC and USA from 1990 to 2010, with events such as nuclear proliferation standoff, Taiwan strait crisis, Belgrade embassy bombing, spy plane collision, and 'assertive' Chinese behavior. The graph indicates the number of events in each category (criticism, diplomacy, conflict, cooperation) for both countries over time.]
returns had fat tails, indicating an excess of very positive and very negative returns. On average, the SSE gained 2% a month, but with a staggeringly large standard deviation of 17 percentage points. Indeed, the index lost 5% or more in a quarter of months.

Figure 3: Kernel Density Plot of Stock Market Returns Since 1990

A brief history of Chinese equity markets explains these unusual facts. In the early 1990s, Deng Xiaoping transformed China’s nascent equity markets into a remarkable patronage system. Through the China Securities Regulatory Commission, Deng controlled the listing queue of which SOEs went public and when. He then dictated share prices for each initial public offering (IPO). Crucially, he set these far below market value. Shortly before an IPO, Deng appointed chosen elites to senior positions, where they could avail themselves of management buyout provisions. This was a massive arbitrage opportunity. Consequently, high-level officials and their families became “among the biggest beneficiaries” of privatization.\(^{38}\) According to Li Gan, who fielded China’s 2011 Household Finance Survey, downturns since have primarily affected a small group of ultra-high net worth individuals who had “taken big risks with mostly borrowed money.”\(^{39}\)

Equally important, the autocrat developed a reputation for intervening in the stock market to protect elite transfers.\(^{40}\) For example, after a policy announcement depressed returns in 2001, Jiang Zemin canceled the policy in question, established an investor protection fund, halted IPOs,

\(^{38}\) He Qinglian (2015). See also Rimmelle (2012) and Naughton (2002, 6-7). Pei (2012, 33-34) writes that the Party “keeps extensive and tight control over China’s state-owned enterprises so that it can dole out political patronage.”

\(^{39}\) Bradsher (2015).

\(^{40}\) Walter and Howie (2006, xvii-xi). See also Naughton (2007, 474), who writes that the state has provided an “implicit guarantee to prop up the market.”
increased foreign investment quotas, and raised interest rates on bank loans to force money into the stock market. 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.” After the Shanghai Exchange lost a third of its value in June 2015, Xi Jinping spent over a trillion US dollars trying to stabilize the market.

Consequently, elites hold the autocrat responsible for returns. Wikileaks cables reveal that in August 2007, a Chinese financial researcher told American officials that the SSE 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.” Or more precisely, to “avoid getting blamed for any negative outcomes from its policy.” One Western analyst concluded that “There’s an expectation of the government adjusting policy to suit the market, in a cheerleading fashion.” “We just calmly wait for the government’s next step,” said one Chinese equity analyst, “to see if there will be more positive incentives to invest.”

In contrast, China’s equity markets have virtually no relationship with public welfare. Contrary to popular reports, there are few retail investors in China. The 2011 China Household Finance Survey found that only 9% of Chinese households traded shares. Among those households, the mean value of financial assets was USD$9,000 and the median value was USD$1,000. This discrepancy confirms Li Gan’s assessment that Chinese equity markets are dominated by a small group of large investors. Economists estimate that there may be only between 500,000 and 2 million active investors due to reporting fraud. In order to obscure the identities of their clients, many brokers operate hundreds of “ghost accounts” opened with identification cards purchased in the countryside. In short, somewhere between 0.001% to 9% of Chinese citizens store wealth in the stock market: a remarkably small proportion.

Equally important, although SOEs account for nearly 30% of urban employment, urban employment is not sensitive to stock market performance. SOE employment is centrally regulated due to the legacy of “iron rice bowl” welfare policies. Despite the structural downsizing of SOEs over the past 25 years, the Party does not allow SOEs to engage in mass layoffs during downturns. Figure 4 shows that there is virtually no relationship between stock returns and urban unemployment.

For all these reasons, stock returns are an unique measure of elite transfers in China. Chinese elites are heavily invested in the stock market, which regularly experiences downturns that threaten their net worth. However, stock returns have virtually no impact on non-elites, who typically do not own stocks, and whose employment is not responsive to stock performance.

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41 Walter and Howie (2006, xvii-xi).
42 This is not incredible in light of the fact that the autocrat also sets inflation policy and the exchange rate in response to elite economic interests (Shih, 2008b; Steinberg and Shih, 2012).
46 Li et al. (2013).
3.3 Propaganda Data

I gathered propaganda from the People’s Daily, China’s leading state-run newspaper. Chinese autocrats have enjoyed direct control of the People’s Daily since its founding in 1946. Mao Zedong personally revised draft editorials. The People’s Daily has a daily national circulation of 3 million. Its audience is primarily elite. Until recently, government offices and major organizations were required to maintain a subscription. I downloaded all 783 articles published between 1990 and 2010 that contained the phrase “party-mass relations (dangqun guanxi).” This term describes citizens’ supposed affinity for the regime that rules them. It was popularized in the early years of communism and remains salient today.48

To convert newspaper text into time series data on propaganda, I used the computer programming language Python to identify each instance that the People’s Daily referenced “party-mass relations” in month t. I then extracted the 10 words before and after each reference, a string known as a “concordance segment.” Drawing on standard semantic dictionaries, I measured how fulsome or critical were these 20 words. This method allows the researcher to focus on the valence

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of coverage about a specific term.\textsuperscript{49} I then recorded the total number of positive and negative words published in concordance segments each month. The variable $Propaganda_t$ is a measure of net positive coverage of party-mass relations in month $t$, and it is standardized to take values between 0 and 1:

$$Propaganda_t = \frac{(Positive \ Words_t) - (Negative \ Words_t)}{(Positive \ Words_t) + (Negative \ Words_t)}$$

The result is a time series that records how positively the People’s Daily covered party-mass relations each month between 1990 and 2010. Descriptive statistics appear in Table 2. The appendix contains more information on how this variable was constructed, provides a series of quotes to validate my measure of propaganda, and visualizes the data.

On average, the People’s Daily discussed party-mass relations 3.3 times per month. Typically, party-mass relations were discussed quite favorably, with an average valence of 0.75. Due to space constraints, for a full discussion of the substantive scaling of this variable I refer readers to Carter and Carter (2017), who compare Chinese propaganda to that in other autocracies and in other languages. They report that a 0.1 unit change in this variable is equivalent to the difference in how effusively Fox News covers Republicans versus how it covers Democrats. The standard deviation for $Propaganda_t$ is 0.3, three times the magnitude of Fox News’ partisan bias. Therefore there is meaningful substantive variation in how positively the People’s Daily covers party-mass relations.

4 Analysis

4.1 Testing H1: Elite Transfers and Diversion

To test Hypothesis 1, I probe the relationship between elite transfers – measured as the month over month change in the SSE composite index – and Chinese conflict initiation the following month. The estimating equation is:

$$\text{neg \ bin} \left( Conflict_t^{PRC} \right) = \alpha + \beta (\Delta \ SSE_{t-1})$$
$$+ \kappa X_{t-1} + \psi W_s + \gamma_t + \lambda_s + \epsilon \quad (1)$$

where $t$ indexes month and $s$ indexes year. The vectors $X_{t-1}$ and $W_s$ include all relevant month- and year-level covariates, which I discuss below. The terms $\gamma_t$ and $\lambda_s$ represent month- and year-fixed effects, which are included to soak up any unobserved characteristics. Augmented Dickey-Fuller tests indicate that Chinese conflict initiation and SSE returns are stationary. A one month

\textsuperscript{49}I removed numbers, symbols, and punctuation from the corpus, and segmented all words, before generating the concordance segments from which I extracted my measure of tone. See Grimmer and Stewart (2013).
lag minimizes the Akaike information criterion.

Month-level covariates in $X_{t-1}$ include the following. Because interstate interactions are path dependent, I record the number of conflicts initiated by each state the previous month. Because popular dissatisfaction, some argue, may constrain Chinese foreign policy, I control for China’s leading monthly indicator of popular economic hardship: the consumer price index. Because domestic political meetings may result in the announcement of new foreign policies, I control for the six month period leading up to China’s quinquennial party congress. Finally, because animal spirits cross borders, I control for US stock market returns. It is important to include this variable because Western stock market losses could simultaneously depress Chinese returns and generate Chinese critiques of US economic policy.

Year-level covariates in $W_s$ include two economic indicators that were only measured annually during the study period: unemployment and GDP per capita. Both proxy popular dissatisfaction, and are included because the scholars mentioned in Section 2 suggest that popular dissatisfaction may influence Chinese foreign policy. Descriptions of all variables and the sources from which they are drawn appear in Table 2.

The results appear in Table 3. 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, international financial indicators in Model 4, year fixed effects in Model 5, and month fixed effects in Model 6.

The results are visualized in Figure 5. Using Model 4 – which includes all control variables save fixed effects – I simulate 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. When stock returns decline by 5% to 15%, China initiates 1.5 to 2 times as much conflict as usual. Per Section 3.2, negative shocks this large are not atypical. For context, China has initiated one conflict every ten months since 1990, on average. In the presence of a negative shock to elite transfers, China initiates one conflict every three to five months. Therefore, as much as 40% of China’s conflict initiation may be diversionary.

### 4.2 Testing H2: Diversion in the Public Eye

To generate a rally effect, Hypothesis 2 suggests, the autocrat will employ observable policies. Diversion will take military forms—such as announcing weapons systems or initiating military exercises—or high profile diplomatic forms—such as obstructing American initiatives, withdrawing support, canceling exchanges, or downgrading the relationship. In contrast, diversion is less likely in economic affairs, because trade policy is less likely to arouse nationalist sentiment. Nor will diversion involve human rights issues. Chinese citizens may not view punishing the United States on human rights issues as a compelling defense of the national interest.

To test Hypothesis 2, Table 4 reproduces the analysis in Section 4.1 but disaggregates Chinese
Table 2: Variable Definitions

<table>
<thead>
<tr>
<th>Variable</th>
<th>Range</th>
<th>Mean</th>
<th>Description</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Month Level Variables</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PRC diplomacy(_t)</td>
<td>([0, 21])</td>
<td>1.60</td>
<td>Number of positive verbal interactions initiated by PRC toward USA in month (t).</td>
<td>Author</td>
</tr>
<tr>
<td>PRC cooperation(_t)</td>
<td>([0, 3])</td>
<td>0.29</td>
<td>Number of episodes of material cooperation initiated by PRC toward USA in month (t).</td>
<td>Author</td>
</tr>
<tr>
<td>PRC criticism(_t)</td>
<td>([0, 20])</td>
<td>0.90</td>
<td>Number of negative verbal interactions initiated by PRC toward USA in month (t).</td>
<td>Author</td>
</tr>
<tr>
<td>PRC conflict(_t)</td>
<td>([0, 7])</td>
<td>0.19</td>
<td>Number of episodes of material conflict initiated by PRC toward USA in month (t).</td>
<td>Author</td>
</tr>
<tr>
<td>USA diplomacy(_t)</td>
<td>([0, 31])</td>
<td>2.14</td>
<td>Number of positive verbal interactions initiated by USA toward PRC in month (t).</td>
<td>Author</td>
</tr>
<tr>
<td>USA cooperation(_t)</td>
<td>([0, 6])</td>
<td>0.24</td>
<td>Number of episodes of material cooperation initiated by USA toward PRC in month (t).</td>
<td>Author</td>
</tr>
<tr>
<td>USA criticism(_t)</td>
<td>([0, 19])</td>
<td>0.76</td>
<td>Number of negative verbal interactions initiated by USA toward PRC in month (t).</td>
<td>Author</td>
</tr>
<tr>
<td>USA conflict(_t)</td>
<td>([0, 3])</td>
<td>0.12</td>
<td>Number of episodes of material conflict initiated by USA toward PRC in month (t).</td>
<td>Author</td>
</tr>
<tr>
<td>(\Delta\text{SSE}_{t})</td>
<td>([-0.31, 1.77])</td>
<td>0.02</td>
<td>Month-over-month change in SSE composite index.</td>
<td>SSE</td>
</tr>
<tr>
<td>CPI(_{it})</td>
<td>([97.8, 128.0])</td>
<td>104.9</td>
<td>PRC consumer price index in month (t).</td>
<td>NBS</td>
</tr>
<tr>
<td>Party Congress(_t)</td>
<td>([0, 1])</td>
<td>0.12</td>
<td>Assumes value 1 if a Party Congress occurred within the past six months.</td>
<td>Author</td>
</tr>
<tr>
<td>(\Delta\text{S&amp;P500}_{t})</td>
<td>([-0.20, 0.12])</td>
<td>0.006</td>
<td>Month-over-month change in S&amp;P500 index.</td>
<td>S&amp;P</td>
</tr>
<tr>
<td>Instability(_t)</td>
<td>([0, 1])</td>
<td>0.06</td>
<td>Assumes value 1 if China experienced social instability on month (t).</td>
<td>Author</td>
</tr>
<tr>
<td>Propaganda(_t)</td>
<td>([-1, 1])</td>
<td>0.75</td>
<td>Degree of positive coverage of party-mass relations in month (t).</td>
<td>People’s Daily</td>
</tr>
<tr>
<td><strong>Year Level Variables</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unemployment(_s)</td>
<td>([3.80, 4.90])</td>
<td>4.41</td>
<td>Percent of PRC total labor force unemployed in year (s).</td>
<td>World Bank</td>
</tr>
<tr>
<td>Log GDP per capita(_s)</td>
<td>([5.76, 8.95])</td>
<td>7.24</td>
<td>Natural log of PRC per capita GDP in year (s).</td>
<td>World Bank</td>
</tr>
</tbody>
</table>

conflict initiation into military, diplomatic, economic, and human rights areas. Models 1-4 show that diversion occurs in military and diplomatic areas but not in economic or human rights areas. Figure 6 visualizes the results. A negative transfer shock of 10% results in three times as many military and diplomatic conflicts as usual. In contrast, a shock of this magnitude does not affect the number of economic or human rights conflicts.

Another way to test Hypothesis 2 is by disaggregating conflicts into severity levels rather than issue areas. Severe conflict is especially likely to generate a rally because it sharpens ingroup-outgroup differences. From Table 1, moderate conflict includes public leader threats, obstruction, withdrawal of support, canceled exchanges, punitive economic actions, infringement upon human rights, intervention on behalf of dissidents, incitement of protests, and arrest of the other side’s
Table 3: Evidence for Diversion

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Δ SSE_{t-1}</strong></td>
<td>-3.933*</td>
<td>-5.047***</td>
<td>-5.579**</td>
<td>-5.516**</td>
<td>-4.566**</td>
<td>-5.569**</td>
</tr>
<tr>
<td></td>
<td>(2.194)</td>
<td>(2.254)</td>
<td>(2.269)</td>
<td>(2.275)</td>
<td>(2.130)</td>
<td>(2.197)</td>
</tr>
<tr>
<td><strong>PRC conflict_{t-1}</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.353</td>
<td>0.138</td>
<td>0.129</td>
<td>-0.065</td>
<td>0.307</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.225)</td>
<td>(0.203)</td>
<td>(0.201)</td>
<td>(0.188)</td>
<td>(0.187)</td>
<td></td>
</tr>
<tr>
<td><strong>USA conflict_{t-1}</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.201</td>
<td>0.159</td>
<td>0.158</td>
<td>0.051</td>
<td>0.028</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.377)</td>
<td>(0.313)</td>
<td>(0.310)</td>
<td>(0.302)</td>
<td>(0.302)</td>
<td></td>
</tr>
<tr>
<td><strong>CPI_{t-1}</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Unemployment_{s}</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.081**</td>
<td>0.080**</td>
<td>0.036</td>
<td>0.070**</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.038)</td>
<td>(0.038)</td>
<td>(0.097)</td>
<td>(0.034)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Log GDPpc_{s}</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.630</td>
<td>0.638</td>
<td>530.400</td>
<td>0.537</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.434)</td>
<td>(0.431)</td>
<td>(18,865,445)</td>
<td>(0.398)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Party Congress_{t-1:t-6}</strong></td>
<td>-1.996*</td>
<td>-1.879</td>
<td>-1.258</td>
<td>-1.940</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(1.201)</td>
<td>(1.180)</td>
<td>(1.483)</td>
<td>(1.193)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Δ S&amp;P500_{t-1}</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Constant</strong></td>
<td>-1.682***</td>
<td>-1.851***</td>
<td>-32.703***</td>
<td>-31.426***</td>
<td>-2.623.6</td>
<td>-61.161</td>
</tr>
<tr>
<td></td>
<td>(0.219)</td>
<td>(0.234)</td>
<td>(12.086)</td>
<td>(11.883)</td>
<td>(167,846,335)</td>
<td>(11,877,603)</td>
</tr>
<tr>
<td><strong>Year fixed effects</strong></td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Month fixed effects</strong></td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Observations</strong></td>
<td>288</td>
<td>288</td>
<td>240</td>
<td>240</td>
<td>240</td>
<td>240</td>
</tr>
</tbody>
</table>

\*p<0.1; **p<0.05; ***p<0.01
† In Model (5), the point estimates and standard errors for unemployment and GDP per capita are very inflated. This is because these two variables are observed annually. After including year fixed effects, there is not enough variation to generate a meaningful estimate for these variables. This does not affect the interpretation of the other coefficients in the model.
nationals. Severe conflict includes Taiwan arms sales, espionage, development of weapons systems, assertion of territorial claims, proliferation of nuclear weapons, downgraded diplomatic relations, military exercises, and military conflicts.

Models 5-6 show that declining transfers generate severe conflict rather than moderate conflict. Figure 7 visualizes the results. A negative transfer shock of 10% makes severe conflict more than twice as likely as usual. It does not affect the probability of moderate conflict. In short, the newsworthy character of Chinese conflict initiation suggests that it targets a nationalist audience rather than American interests.

4.3 Testing H3: Elite Transfers and Propaganda

Hypothesis 3 suggests that the autocrat will use propaganda to discourage elite leadership challenges by creating the illusion of widespread popular support. To test this hypothesis, I focus on positive coverage of party-mass relations in the People’s Daily. I employ the following estimating equation:

\[
\text{OLS (Propaganda}_t) = \alpha + \beta (\Delta \text{SSE}_{t-1}) + \kappa X_{t-1} + \psi W_s + \gamma_t + \lambda_s + \epsilon
\]  

As before, the vector \( X_{t-1} \) includes Chinese and US conflict initiation, inflation, and a dichotomous variable for whether a party congress occurred within the past six months. All these variables could affect propaganda for the same reasons they affect foreign policy. I also control for two new variables observed at the monthly level. The first is propaganda in \( t - 1 \), since propaganda may be employed in campaigns. The second is a dichotomous measure for popular instability. To discourage collective action, the Party might emphasize the warmth of party-mass relations precisely when the population is most dissatisfied: moments characterized by corruption scandals, epidemics,
Table 4: Issue Area Model

<table>
<thead>
<tr>
<th>Dependent variable: Type of PRC conflict</th>
<th>Military(_t) (1)</th>
<th>Diplomatic(_t) (2)</th>
<th>Economic(_t) (3)</th>
<th>Human rights(_t) (4)</th>
<th>Moderate(_t) (5)</th>
<th>Severe(_t) (6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(\Delta \text{SSE}_{t-1})</td>
<td>-5.895**</td>
<td>-10.346**</td>
<td>12.858</td>
<td>3.581</td>
<td>-0.241</td>
<td>-5.574**</td>
</tr>
<tr>
<td></td>
<td>(2.915)</td>
<td>(4.365)</td>
<td>(12.422)</td>
<td>(4.028)</td>
<td>(1.025)</td>
<td>(2.836)</td>
</tr>
<tr>
<td>PRC conflict(_t-1)</td>
<td>-0.057</td>
<td>0.095</td>
<td>-0.866</td>
<td>-0.181</td>
<td>-0.506*</td>
<td>-0.014</td>
</tr>
<tr>
<td></td>
<td>(0.426)</td>
<td>(0.517)</td>
<td>(1.269)</td>
<td>(0.354)</td>
<td>(0.302)</td>
<td>(0.400)</td>
</tr>
<tr>
<td>USA conflict(_t-1)</td>
<td>0.042</td>
<td>0.998</td>
<td>1.911</td>
<td>-0.179</td>
<td>0.732**</td>
<td>-0.004</td>
</tr>
<tr>
<td></td>
<td>(0.568)</td>
<td>(1.271)</td>
<td>(1.543)</td>
<td>(1.035)</td>
<td>(0.371)</td>
<td>(0.565)</td>
</tr>
<tr>
<td>CPI(_t-1)</td>
<td>0.089</td>
<td>0.189</td>
<td>-0.678</td>
<td>-0.084</td>
<td>-0.036</td>
<td>0.083</td>
</tr>
<tr>
<td></td>
<td>(0.137)</td>
<td>(0.165)</td>
<td>(0.774)</td>
<td>(0.132)</td>
<td>(0.100)</td>
<td>(0.135)</td>
</tr>
<tr>
<td>Unemployment(_t-1)</td>
<td>-148.601</td>
<td>-42.482</td>
<td>68.415</td>
<td>15.032</td>
<td>10.554</td>
<td>-156.447</td>
</tr>
<tr>
<td></td>
<td>(13,284,618)</td>
<td>(72,176,106)</td>
<td>(165,282)</td>
<td>(72,745,578)</td>
<td>(72,033,010)</td>
<td>(15,344,324)</td>
</tr>
<tr>
<td>Log GDPpc(_t-1)</td>
<td>305.202</td>
<td>276.693</td>
<td>147.789</td>
<td>289.406</td>
<td>516.336</td>
<td>296.604</td>
</tr>
<tr>
<td></td>
<td>(23,090,126)</td>
<td>(19,650,697)</td>
<td>(222,055)</td>
<td>(23,207,863)</td>
<td>(12,939,047)</td>
<td>(33,298,585)</td>
</tr>
<tr>
<td>Party congress(_t-1; t-6)</td>
<td>-0.452</td>
<td>-30.321</td>
<td>-17.076</td>
<td>1.452</td>
<td>-29.605</td>
<td>-0.467</td>
</tr>
<tr>
<td></td>
<td>(1.519)</td>
<td>(2,353,075)</td>
<td>(23,257)</td>
<td>(8,272,414)</td>
<td>(1,902,552)</td>
<td>(1.505)</td>
</tr>
<tr>
<td>(\Delta \text{S&amp;P500}_{t-1})</td>
<td>-0.048</td>
<td>-0.034</td>
<td>0.482</td>
<td>-0.106</td>
<td>0.086</td>
<td>-0.069</td>
</tr>
<tr>
<td></td>
<td>(0.098)</td>
<td>(0.148)</td>
<td>(0.323)</td>
<td>(0.123)</td>
<td>(0.066)</td>
<td>(0.092)</td>
</tr>
<tr>
<td>Constant</td>
<td>-1,055.293</td>
<td>-1,455.473</td>
<td>-1,130.091</td>
<td>-1,748.389</td>
<td>-3,048.290</td>
<td>-966.301</td>
</tr>
<tr>
<td></td>
<td>(161,260,378)</td>
<td>(372,024,839)</td>
<td>(1,696,441)</td>
<td>(380,911,556)</td>
<td>(360,841,895)</td>
<td>(230,490,222)</td>
</tr>
</tbody>
</table>

Year fixed effects | Yes | Yes | Yes | Yes | Yes | Yes

Observations | 240 | 240 | 240 | 240 | 240 | 240

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

† The point estimates and standard errors for unemployment and GDP per capita are inflated because these variables are observed annually. After including year fixed effects, there is not enough variation to generate a meaningful estimate for these variables. This does not affect the interpretation of the other coefficients in the model.
Figure 6: SSE Shocks and Chinese Conflict by Issue Area

- **Loss of 10%**
  - **Economic Conflicts**
    - No shock: $4.9e^{-05}$
    - Shock: $4.2e^{-05}$
  - **Human Rights Conflicts**
    - No shock: $5.0e^{-05}$
    - Shock: $2.1e^{-05}$
  - **Military Conflicts**
    - No shock: $0.005$
    - Shock: $0.006$
  - **Diplomatic Conflicts**
    - No shock: $4.7e^{-05}$
    - Shock: $1.9e^{-05}$

Figure 7: SSE Shocks and Chinese Conflict by Severity Level

- **Loss of 10%**
  - **Moderate Conflict**
    - No shock: $0.0$
    - Shock: $0.0$
  - **Severe Conflict**
    - No shock: $0.002$
    - Shock: $0.005$
natural disasters, large protests, and sensitive anniversaries, for instance. I provide a full list of such moments in the online appendix.

As before, the vector $W_s$ includes unemployment and logged GDP per capita, and $\gamma_t$ and $\lambda_s$ represent month- and year- fixed effects. Augmented Dickey-Fuller tests confirm that my measure of propaganda is stationary. A one month lag minimizes the Akaike information criterion.

The evidence suggests that declining transfers are associated with more positive coverage of party-mass relations. The results appear in Table 5. In a bivariate setting, SSE returns are negatively correlated with positive coverage. This relationship is robust to the inclusion of domestic covariates, international covariates, and fixed effects in Model 2, and to the inclusion of the domestic instability variable in Model 3. The results are visualized in Figure 8. When transfers decline by 10%, the propaganda apparatus discusses party-mass relations 8% more positively. This difference is substantively meaningful. According to Carter and Carter (2017)’s scaling, it is approximately equal to the coverage gap in how effusively Fox News covers Democrats relative to Republicans. In short, elite dissatisfaction compels propaganda about mass support for the autocrat.

Figure 8: SSE Shocks and Chinese Propaganda
### Table 5: Diversionary Propaganda

<table>
<thead>
<tr>
<th>Dependent variable:</th>
<th>Propaganda&lt;sub&gt;t&lt;/sub&gt;</th>
<th>( \Delta \text{ SSE}_{t-1} )</th>
<th>Propaganda&lt;sub&gt;t-1&lt;/sub&gt;</th>
<th>PRC conflict&lt;sub&gt;t-1&lt;/sub&gt;</th>
<th>USA conflict&lt;sub&gt;t-1&lt;/sub&gt;</th>
<th>CPI&lt;sub&gt;t-1&lt;/sub&gt;</th>
<th>Unemployment&lt;sub&gt;s&lt;/sub&gt;</th>
<th>Log GDP per capita&lt;sub&gt;s&lt;/sub&gt;</th>
<th>Party Congress&lt;sub&gt;t-1:t-6&lt;/sub&gt;</th>
<th>Instability&lt;sub&gt;t-1&lt;/sub&gt;</th>
<th>Constant</th>
<th>Year fixed effects</th>
<th>Month fixed effects</th>
<th>Observations</th>
<th>R²</th>
</tr>
</thead>
<tbody>
<tr>
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<td>( 1 ) (2) (3)</td>
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<tr>
<td>( \Delta \text{ SSE}_{t-1} )</td>
<td>(-0.270^*) (0.156)</td>
<td>(-0.526^{**}) (0.246)</td>
<td>(-0.524^{**}) (0.243)</td>
<td>(-0.165^{**}) (0.079)</td>
<td>(-0.166^{**}) (0.078)</td>
<td>(-0.005) (0.043)</td>
<td>(-0.007) (0.043)</td>
<td>(-0.025) (0.059)</td>
<td>(-0.022) (0.058)</td>
<td>(-0.016) (0.014)</td>
<td>(-0.017) (0.014)</td>
<td>(-0.229) (0.598)</td>
<td>(-0.215) (0.589)</td>
<td>(0.547) (1.305)</td>
<td>(0.445) (1.286)</td>
</tr>
<tr>
<td>Propaganda&lt;sub&gt;t-1&lt;/sub&gt;</td>
<td>(-0.165^{**}) (0.079)</td>
<td>(-0.166^{**}) (0.078)</td>
<td>(-0.005) (0.043)</td>
<td>(-0.007) (0.043)</td>
<td>(-0.025) (0.059)</td>
<td>(-0.022) (0.058)</td>
<td>(-0.016) (0.014)</td>
<td>(-0.017) (0.014)</td>
<td>(-0.229) (0.598)</td>
<td>(-0.215) (0.589)</td>
<td>(0.547) (1.305)</td>
<td>(0.445) (1.286)</td>
<td>(-0.379^{***}) (0.100)</td>
<td>(-0.390^{***}) (0.099)</td>
<td>(0.298^{**}) (0.124)</td>
</tr>
<tr>
<td>PRC conflict&lt;sub&gt;t-1&lt;/sub&gt;</td>
<td>-0.005 (0.043)</td>
<td>-0.007 (0.043)</td>
<td>0.547 (1.305)</td>
<td>0.445 (1.286)</td>
<td>(-0.379^{***}) (0.100)</td>
<td>(-0.390^{***}) (0.099)</td>
<td>(0.298^{**}) (0.124)</td>
<td>(0.755^{***}) (0.022)</td>
<td>(0.677) (7.926)</td>
<td>(1.338) (7.813)</td>
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<tr>
<td>USA conflict&lt;sub&gt;t-1&lt;/sub&gt;</td>
<td>-0.025 (0.059)</td>
<td>-0.022 (0.058)</td>
<td>(-0.379^{***}) (0.100)</td>
<td>(-0.390^{***}) (0.099)</td>
<td>(0.755^{***}) (0.022)</td>
<td>(0.677) (7.926)</td>
<td>(1.338) (7.813)</td>
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<td></td>
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<tr>
<td>CPI&lt;sub&gt;t-1&lt;/sub&gt;</td>
<td>-0.016 (0.014)</td>
<td>-0.017 (0.014)</td>
<td>(-0.379^{***}) (0.100)</td>
<td>(-0.390^{***}) (0.099)</td>
<td>(0.755^{***}) (0.022)</td>
<td>(0.677) (7.926)</td>
<td>(1.338) (7.813)</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unemployment&lt;sub&gt;s&lt;/sub&gt;</td>
<td>-0.229 (0.598)</td>
<td>-0.215 (0.589)</td>
<td>(-0.379^{***}) (0.100)</td>
<td>(-0.390^{***}) (0.099)</td>
<td>(0.755^{***}) (0.022)</td>
<td>(0.677) (7.926)</td>
<td>(1.338) (7.813)</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Log GDP per capita&lt;sub&gt;s&lt;/sub&gt;</td>
<td>0.547 (1.305)</td>
<td>0.445 (1.286)</td>
<td>(-0.379^{***}) (0.100)</td>
<td>(-0.390^{***}) (0.099)</td>
<td>(0.755^{***}) (0.022)</td>
<td>(0.677) (7.926)</td>
<td>(1.338) (7.813)</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Party Congress&lt;sub&gt;t-1:t-6&lt;/sub&gt;</td>
<td>(-0.379^{***}) (0.100)</td>
<td>(-0.390^{***}) (0.099)</td>
<td>(0.755^{***}) (0.022)</td>
<td>(0.677) (7.926)</td>
<td>(1.338) (7.813)</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Instability&lt;sub&gt;t-1&lt;/sub&gt;</td>
<td>(0.298^{**}) (0.124)</td>
<td>(0.755^{***}) (0.022)</td>
<td>(0.677) (7.926)</td>
<td>(1.338) (7.813)</td>
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*Note:* \( ^*p<0.1; \ ^{**}p<0.05; \ ^{***}p<0.01 \)

#### 4.4 Testing H4: Unlearning diversion

To avoid containment, the theory suggests, the autocrat should try to help the United States unlearn the lessons of diversion. As discussed above, Chinese leaders are wary of provoking American containment. To assess the hypothesis that China employs diplomacy to recenter American perceptions after a diversionary episode, I examine whether conflict in month \( t - 1 \) is associated with
Figure 9: Post-Diversion Cooperation

The data are subset to simulate the effect of conflict in $t - 1$ on cooperation in $t$ conditional on a negative transfer shock occurring in $t - 2$.

cooperation in month $t$, conditional on a negative transfer shock occurring in month $t - 2$. That is, I subset the dataset to observations with a 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 cooperate in the next period:

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

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

Table 6 presents the results and Figure 9 visualizes them. Conditional on a negative transfer shock of 5%, conflict is associated with nearly four times as much diplomacy as usual the following month. It is not associated with more 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 more substantive forms of cooperation that might be observed—and penalized—by his domestic audience.

4.5 Robustness Checks in the Online Appendix

These results are robust to several different approaches presented in the appendix. First I employ placebo tests. Above, elite transfers are operationalized as a continuous variable. In the 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
Table 6: Unlearning Diversion

<table>
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<th></th>
<th>PRC cooperation&lt;sub&gt;t&lt;/sub&gt;</th>
<th>PRC diplomacy&lt;sub&gt;t&lt;/sub&gt;</th>
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<td>(2)</td>
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<tr>
<td>Δ SSE&lt;sub&gt;t−1&lt;/sub&gt;</td>
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<td>0.048</td>
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<tr>
<td></td>
<td>(4.212)</td>
<td>(6.073)</td>
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<tr>
<td>PRC conflict&lt;sub&gt;t−1&lt;/sub&gt;</td>
<td>−0.263</td>
<td>0.555**</td>
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<tr>
<td></td>
<td>(0.196)</td>
<td>(0.229)</td>
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<td>−0.233</td>
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<td></td>
<td>(0.466)</td>
<td>(0.435)</td>
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<td>CPI&lt;sub&gt;t−1&lt;/sub&gt;</td>
<td>0.097***</td>
<td>0.036</td>
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<td></td>
<td>(0.026)</td>
<td>(0.036)</td>
</tr>
<tr>
<td>Instability&lt;sub&gt;t−1&lt;/sub&gt;</td>
<td>−0.001</td>
<td>0.215</td>
</tr>
<tr>
<td></td>
<td>(1.147)</td>
<td>(0.607)</td>
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<tr>
<td>Party Congress&lt;sub&gt;t−1:t−6&lt;/sub&gt;</td>
<td>2.414**</td>
<td>1.570**</td>
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<tr>
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<td>(0.973)</td>
<td>(0.634)</td>
</tr>
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<td>Δ S&amp;P500&lt;sub&gt;t−1&lt;/sub&gt;</td>
<td>0.108</td>
<td>−0.036</td>
</tr>
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<td></td>
<td>(0.118)</td>
<td>(0.065)</td>
</tr>
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<td>(2.072)</td>
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<td>(0.166)</td>
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<td>(0.653)</td>
</tr>
<tr>
<td>Δ SSE&lt;sub&gt;t−2&lt;/sub&gt; × PRC conflict&lt;sub&gt;t−1&lt;/sub&gt;</td>
<td>8.646***</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(1.653)</td>
</tr>
<tr>
<td>Constant</td>
<td>−11.982***</td>
<td>−3.693</td>
</tr>
<tr>
<td></td>
<td>(2.986)</td>
<td>(3.559)</td>
</tr>
</tbody>
</table>

Observations 63 63 63
Log Likelihood −35.031 −100.403 −96.403

Note: *p<0.1; **p<0.05; ***p<0.01
* Analysis restricted to observations with decline of ≥ 5% in SSE in \( t - 2 \).
outcome. Indeed, this is what one should expect: the theory describes how declining transfers lead the autocrat to employ diversionary foreign policy, but offers no reasons why ample transfers would make the autocrat pursue a more cooperative foreign policy with the United States.

I use a second placebo test to probe for reverse causality. One might object that controlling for lagged conflict is not a strong design, since conflict is inevitable a noisy measure of latent hostility. Therefore, instead of modeling PRC Costly Conflict as a function of $\Delta SSE_{t-1}$, I model PRC Costly Conflict as a function of $\Delta SSE_t$. That is, rather than controlling for lagged conflict, I see if my controls are sufficient to ensure there is no “reverse” correlation. The results confirm that $\Delta SSE_t$ is not significantly correlated with PRC Costly Conflict in any specification.

Third, results are also 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 occurred 24 times (publicly or privately) between 1990 and 2010. The result is robust to dropping observations in which either side threatened the other in $t-1$. 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 omitted informational variable which enables investors to anticipate bilateral conflict and sell stocks before it occurs.

Fourth, results are robust to operationalizing the outcome variable differently. Readers may be concerned that 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:

$$\text{(Net conflict)}_t = \frac{(\text{conflict} + \text{criticism})_t}{(\text{conflict} + \text{criticism} + \text{cooperation} + \text{diplomacy})_t} \quad (3)$$

While this measure may capture the overall tenor of the bilateral relationship better than a simple count of conflict, it yields fewer observations because months with zero events prompt division by zero and fall out of the model. Nonetheless, the result is robust: When elite transfers
decline, the overall relationship becomes more conflictual.

Fifth, results are robust to more extensive economic controls. I give unemployment, logged GDP per capita, and inflation more flexibility by including three lags rather than one. The results are substantively unchanged. Finally, results are robust to two additional control variables. First is 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. I also control for elites’ other sources 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*.

5 Case Study

5.1 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 SSE 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 coming months and that its bellicosity would be temporary. It continued to cooperate with the United States on issues that could be kept private. Propaganda about party-mass relations grew most effusive in the spring, as the market sustained its greatest losses. After the stock market stabilized in July, China reassured the United States privately. In short, through diversion and reassurance, and by carefully separating public and private interactions, China was able to navigate its domestic crisis without damaging bilateral relations.

5.2 The crash

The SSE faltered in late 2009, but recovered toward the end of the year. In January 2010, Defense Secretary Robert Gates visited Beijing and President Hu Jintao visited Washington. Both meetings were 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’.” The arms sale was unwelcome in China but expected. Ambassador Zhou Wenzhong “relayed Beijing’s anger over the sale” but “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” and proposed steps to improve bilateral relations. National Security Council senior director for East Asian affairs Jeffrey Bader concluded that the two sides “could restore positive momentum to the relationship, and that the damage would be relatively short lived.”

Shortly thereafter the SSE began to plummet. Abruptly, Beijing’s rhetoric over the sale “sharpened considerably.” In February, China made headlines by canceling Secretary Gates’ upcoming visit. In public, it threatened unusually strong retaliatory measures, 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.”

As these events were unfolding, the editor of China’s most nationalist state-run newspaper, the *Global Times*, met with US embassy officials in Beijing. He told them “not to be concerned”

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51 Bader (2012, 73-74).
52 In mid-February, President Obama met with the Dalai Lama. Obama had previously declined to meet with him and met in the presidential residence rather than the Oval Office; signals “considered by many observers to be a sign of Washington’s acknowledgement of Beijing’s political sensitivities” (CNN, 2010).
53 Bader (2012, 74).
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 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.”

China reiterated this message through other private channels 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.” Huntsman advised Washington that over the coming months, China would “stomp around and carry a small stick.” “This attitude,” he counseled, “has more form than substance and is designed to play to Chinese public opinion.”

After sending private assurances, China initiated public conflict. In March, US policymakers were subjected to 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.” After the meetings, the Western press deemed Beijing “incensed.” The Chinese press described bilateral relations as “strained” and “at a low point.” Chinese policymakers told journalists that they believed that the United States was trying to contain China. Of course, the accusation made Asian headlines. In response, a senior US official told reporters that “With these issues, such as arms sales to Taiwan and meetings with Dalai Lama, there are things said for domestic consumption.”

The claim, however, was largely lost on observers. In May, China scuttled a US initiative in the United Nations to blame North Korea for the sinking of a South Korean vessel. When Secretary of State Hillary Clinton traveled to Beijing later that month, Chinese leaders “warned they would

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54 US Embassy Beijing (2010).
55 Bader (2012, 76-77).
57 Cheng Guangjin and Tan Yingzi (2010); Yan Feng (2010).
58 Huang (2010).
59 Batson, Poon and Oster (2010).
60 Clinton (2014, 56).
not tolerate outside interference” in the South China Sea.\textsuperscript{61} 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.”\textsuperscript{62} Subsequently, a senior Chinese official told reporters that “It may not have been politically correct, but it wasn’t an accident. ...The army follows the Party. Do you really think that Guan did this unilaterally?”\textsuperscript{63} The Chinese press was effusive. In its view, China had demanded that Washington “respect its core interests and major concerns.”\textsuperscript{64}

In June, China continued to block American efforts to penalize North Korea in the United Nations. Observers concluded that China “is becoming more assertive on many foreign policy issues.”\textsuperscript{65} Indeed, references to “assertive China” quintupled in US news articles in 2010.\textsuperscript{66} 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.\textsuperscript{67}

### 5.3 The Recovery

In July, the stock market reversed course. So too did China’s foreign policy. Conflict subsided. Diplomacy, then cooperation, rose. Beijing agreed to support a UN Security Council statement condemning North Korea. In August, Chinese officials said that they “had not authoritatively called the South China Sea a ‘core interest.’”\textsuperscript{68} 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.”\textsuperscript{69}

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.\textsuperscript{70} Bader recalls,

The Chinese reaction in all the meetings was a steady drumbeat of references to their

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\textsuperscript{61}Clinton (2014, 76).
\textsuperscript{62}Clinton (2014, 76).
\textsuperscript{63}Pomfret (2010b).
\textsuperscript{64}Xinhua News Agency (2010).
\textsuperscript{65}Swaine (2010, 8).
\textsuperscript{66}Johnston (2013, 12).
\textsuperscript{67}Bader (2012, 78).
\textsuperscript{68}Bader (2012, 106).
\textsuperscript{69}Bader (2012, 106).
\textsuperscript{70}Bader (2012, 116, 118).
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.71

In an October meeting at the Asian defense ministers forum in Hanoi, Defense Minister Liang
Guanglie quietly reinvited Secretary Gates to Beijing.72 Xinhua published a brief note on the
meeting but did not mention the invitation. Secretary 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 took place in in January and was successful. Observers noticed
the improvement in bilateral relations. In February, the China Leadership Monitor noted that “In
recent weeks, Beijing seems to have stepped back from the most strident and activist words and
actions of winter 2009-2010.”73

5.4 Taking stock

This case demonstrates 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 as when they
were rising. Propaganda on party-mass relations became most effusive when the market suffered its
steepest declines. While US embassy cables that year attributed China’s aggressive foreign policy
to domestic problems, they failed to distinguish between mass and elite interests. 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.” Similarly, 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.

More, differences in public versus private policies suggest that China’s behavior was strategic
rather than simply regression to the mean. As elite transfers fell, China warned American officials
to expect diversionary foreign policy. It then employed diversion and propaganda publicly, while
continuing to cooperate with the United States privately. Thereafter, it privately reassured US
policymakers once the domestic crisis had passed.

71 Bader (2012, 118).
73 Swaine (2011, 9).
CONCLUSION

This study demonstrates that the economic interests of political elites condition the international behavior of autocrats. In China, elite interests were responsible for an estimated 40% of conflict initiation toward the country’s strongest rival between 1990 and 2010. When elite transfers through the Shanghai Stock Exchange declined by 5% to 15%, China initiated 1.5 to 2 times as much conflict with the United States as usual the following month. Conflict occurred in observable issue areas most likely to generate a nationalist rally, and was accompanied by propaganda that emphasized the autocrat’s popularity. It was followed by private diplomatic initiatives designed to reassure the United States of China’s peaceful aims. This evidence supports the theory that declining elite transfers pose extraordinary challenges to autocratic rule. Elite politics in autocracies are fiercely competitive, and they influence autocratic foreign policy in ways that go beyond fixed institutional configurations. The theory may explain the foreign policy of other autocracies as well. Michael McFaul, the former US Ambassador to Russia, has argued that financial sanctions diminished Vladimir Putin’s ability to transfer rents to elites. In his view, this may explain Putin’s aggression abroad.\textsuperscript{74}

Future research should proceed in two directions. First, scholars should further explore the subnational sources of autocratic foreign policy. Chinese foreign policy responds strongly to elite interests, but is the public sometimes more influential—for example, in autocracies with less urban bias or larger winning coalitions? How do the opinions and living standards of a broader segment of the population condition foreign policy in other autocracies?

Second, scholars should examine how autocrats choose among potential diversionary targets. Several Asian and European embassies complained to Ambassador Huntsman about Chinese aggression in 2010. For instance, after he was publicly excoriated by his Chinese counterpart, Yang Jiechi, the Japanese foreign minister told Huntsman that Yang had “always been a peace lover. I guess the Chinese felt like yelling.”\textsuperscript{75} Do leaders prefer to scapegoat strong rivals, those with whom they share historical animosities, or those who are unlikely to retaliate? Do they cycle among them? A theory of diversion conditional on multiple potential targets would further illuminate autocratic foreign policy.

\textsuperscript{74}Robins-Early (2015).
\textsuperscript{75}Pomfret (2010a).
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