

Elite Welfare Shocks and Diversionary Foreign Policy: Evidence from China

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ABSTRACT

This article presents a theory of diversionary foreign policy 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. 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, I find broad support for the theory.

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“A rising market eases contradictions; a falling market sharpens contradictions.”
—Chinese financial analyst, 2003¹

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 institutions may restrain autocrats and render their foreign policies more pacific.² However, these approaches overlook elite power struggles. These 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 develops 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 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 potential 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:

¹Quoted in Naughton (2003, 35).

²de 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).

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

⁴Carter (2015*a,b*); Kapuscinski (1989).

⁵See e.g. Svobik (2012).

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

To generate popular affection, I argue, autocrats may employ diversionary foreign policy. Diversion occurs when an unpopular leader initiates an international dispute to generate a rally around the flag effect that boosts his popularity.

Of course, executives enjoy a range of policy options to resolve political crises. For instance, autocrats might simply increase direct transfers to elites in response to negative economic shocks. However, this is expensive and risky because of public frustration with corruption. Alternatively, the autocrat might generate countervailing public support through public goods provision. However, public goods are expensive to construct and difficult to provide immediately. In contrast, diversionary foreign policy is relatively 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 will initiate newsworthy conflict rather than that which is unobservable. Because 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 potential adversary: the United States.⁷ China is an appealing case for three reasons. First, it offers a unique opportunity to measure elite transfers. In the early 1990s the autocrat transferred enormous equity to elites by privatizing state owned enterprises (SOEs). The stock market soon 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, where autocrats face

⁶Machiavelli (2012, Ch. XIX). Geddes (2009) captured this intuition when she suggested that an autocrat who faces coup threats may build countervailing political forces such as a mass civilian party.

⁷Diversionary theory suggests that rallies are most likely when the out-group is most threatening.

“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.

The empirics employ three original datasets that cover the 1990 to 2012 period. The first records elite transfers with the Shanghai Stock Exchange (SSE) composite index. The second measures Chinese propaganda on “party-mass relations” published in the *People’s Daily*. The third records over 2,000 bilateral interactions between China and the United States across a host of issue areas and severity levels. The evidence suggests that when elite transfers 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 links domestic politics with foreign policy 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 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 marshals evidence from policymaker memoirs and Wikileaks cables to demonstrate the causal mechanism at work during China’s 2010 stock market crash. In that case, 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 6 concludes.

2 THEORY

While the theory of diversionary foreign policy is well developed, the cross-national empirical evidence is “decidedly mixed.”¹¹ Findings on autocratic diversion are most relevant to this study. Because autocrats can contain domestic unrest with repression, some argue, they

⁸Shih (2008, 48). See also Fewsmith (2015); Li (2016); Nathan (1973).

⁹See e.g. Carter (2015*c*).

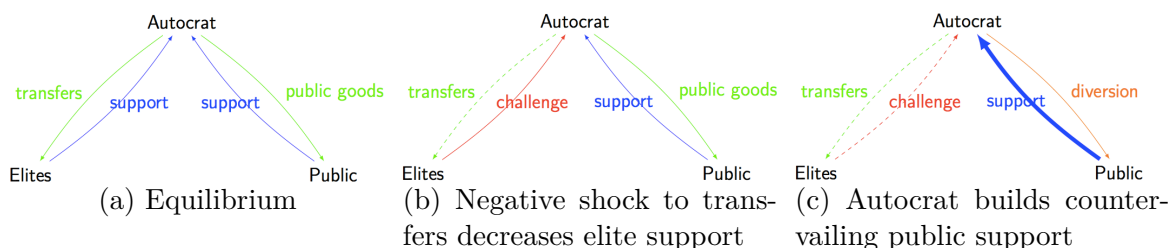
¹⁰For a recent review, see Bueno de Mesquita and Smith (2012).

¹¹Baum and Potter (2008, 48).

need not divert.¹² 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.

China scholars attribute some role for domestic politics in Chinese foreign policy. However, this is an ongoing debate, and they tend to focus on popular nationalism rather than elite dissatisfaction as a potential source of conflict initiation. Christensen (1996) attributes Mao’s decision to shell Quemoy in 1958 to his desire to promote agricultural collectivization – a policy unpopular among farmers – with a rally effect. 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 skeptical. Drawing on theories of omnibalancing, Fravel (2008) argues that domestic secessionist movements create incentives for China to compromise abroad. Weiss (2014) documents that Chinese leaders have managed nationalist protests to serve their goals, and that their foreign policies have not proven responsive to protesters’ demands.

Figure 1: Theory



Building on extant work, I develop a theory of why elite unrest may result in diversion in autocracies. The theory is illustrated in Figure 1. 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 with transfers and public goods provision, respectively.¹³ When transfers decline, elites are forced to consider the transfers they might receive under alternative leadership. Elites who expect to benefit more from alternative leadership 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. Pub-

¹²Gelpi (1997); Kisangani and Pickering (2011).

¹³In 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.

lic support discourages elites from challenging the autocrat because if elites were successful, they might face the threat of popular rebellion. This yields the first hypothesis:

H1: WHEN ELITE TRANSFERS DECLINE, THE AUTOCRAT INITIATES DIVERSIONARY CONFLICT WITH AN INTERNATIONAL RIVAL.

If, as the theory predicts, the autocrat diverts in order to discourage elite challenges, then we should expect him 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. 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 ranks.”¹⁴ Joseph Stalin used *Pravda* to threaten potential elite challengers with purges.¹⁵ 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.¹⁶

Propaganda provides a multiplier effect for diversionary foreign policy. By creating the impression of public support for the autocrat, it can reduce the expected utility of leadership challenges. When leadership challenges arise, the autocrat will employ propaganda to discourage them by emphasizing how widely the autocrat 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.¹⁷ 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 consequential and common in US-China relations. But because the goal of diversion is to increase popular support, it will be

¹⁴For a distillation of Goebbels’ 6,800 page diary into 19 core principles, see Doob (1950).

¹⁵Roxburgh (1987).

¹⁶Baggott and Carter (2015).

¹⁷See e.g. Truex (2014).

public. Diversion will take newsworthy forms that are likely to generate nationalism, 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. In the language of the theory, the autocrat balances the desire for a rally against the risk of international retaliation. Diversion risks teaching the target that the autocrat aims to upset the status quo. Therefore, the autocrat should placate his target after the domestic crisis passes. The most obvious way to do so is with cooperation: reassuring the target verbally and assisting it materially. After diverting, the autocrat will employ such charm offensives to recenter his target's prior about the autocrat's intentions. These 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 PRIVATELY COOPERATE WITH HIS TARGET IN ORDER TO RECENTER HER 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 the diplomatic dataset, which records bilateral interactions between China and the United States since 1990. 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 the measure of propaganda that I use to assess how the autocrat marshaled the state-run propaganda apparatus to discourage elite challenges.

3.1 DIPLOMATIC DATA

I constructed a dataset of over 2,000 bilateral interactions between 1990 and 2012 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 that follow Chinese politics, declassified primary source documents, and leaked American diplomatic cables provided by WikiLeaks.

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. In 2010, PRC State Councilor Dai Bingguo traveled to Pyongyang on behalf of the United States and warned North Korea not to respond to South Korean military exercises.

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, Treasury Secretary Hank Paulson requested that China appreciate the renminbi. Some, however, 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 overtures, whereas *cooperation* involves material, real-world 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*. 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 pink, and conflict in red. The top panel shows the

¹⁸The international relations literature considers verbal statements that generate audience costs to be costly (Fearon, 1994; Weeks, 2008). Therefore I consider official apologies – a fraught topic in US-China relations – a form of material cooperation. Because public threats by leaders generate audience costs, I consider these to be a form of material conflict. Because public threats by low-ranking officials do not generate audience costs, I consider these to be a form of criticism. Some studies suggest that autocrats are only able to generate audience costs by inciting domestic nationalist protests, and not by making public leader threats (Kinne and Marinov, 2013; Weiss, 2013, 2014). The results are robust to this modification.

¹⁹A 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 the other side’s assertiveness rather than to status quo patrols.

Table 1: Event Types. See online appendix for examples.

<p style="text-align: center;"><u><i>Diplomacy</i></u></p> <p>Positive statement</p> <p>Request</p> <p>Meet</p> <p>Negotiate</p> <p>Invite</p> <p>Visit</p> <p>Explain</p> <p>Reassure</p> <p>Offer</p> <p>Express regret</p> <p>Propose</p>	<p style="text-align: center;"><u><i>Criticism</i></u></p> <p>Negative statement</p> <p>Postpone</p> <p>Downgrade protocol</p> <p>Refuse</p> <p>Demand</p> <p>Warn</p> <p>Private threat</p> <p>Public low ranking threat</p>
<p style="text-align: center;"><u><i>Cooperation</i></u></p> <p>Apologize</p> <p>Release national</p> <p>Concede</p> <p>Aid</p> <p>Sign agreement</p> <p>Hold summit</p> <p>Yield militarily</p>	<p style="text-align: center;"><u><i>Conflict</i></u></p> <p>Public leader threat</p> <p>Obstruct</p> <p>Withdraw support</p> <p>Cancel exchange</p> <p>Punitive economic action</p> <p>Infringe on human rights</p> <p>Intervene for dissident</p> <p>Incite protest</p> <p>Arrest national</p> <p>Espionage</p> <p>Develop weapon system</p> <p>Assert territorial claim</p> <p>Proliferate</p> <p>Downgrade relationship</p> <p>Military exercise</p> <p>Military conflict</p>

number of events China initiated toward the United States each year. The bottom panel reports similar data for China. Both states engage in discussion – both positive and negative – approximately four times as often as they act. Diplomacy is more common than criticism, and cooperation is more common than conflict.

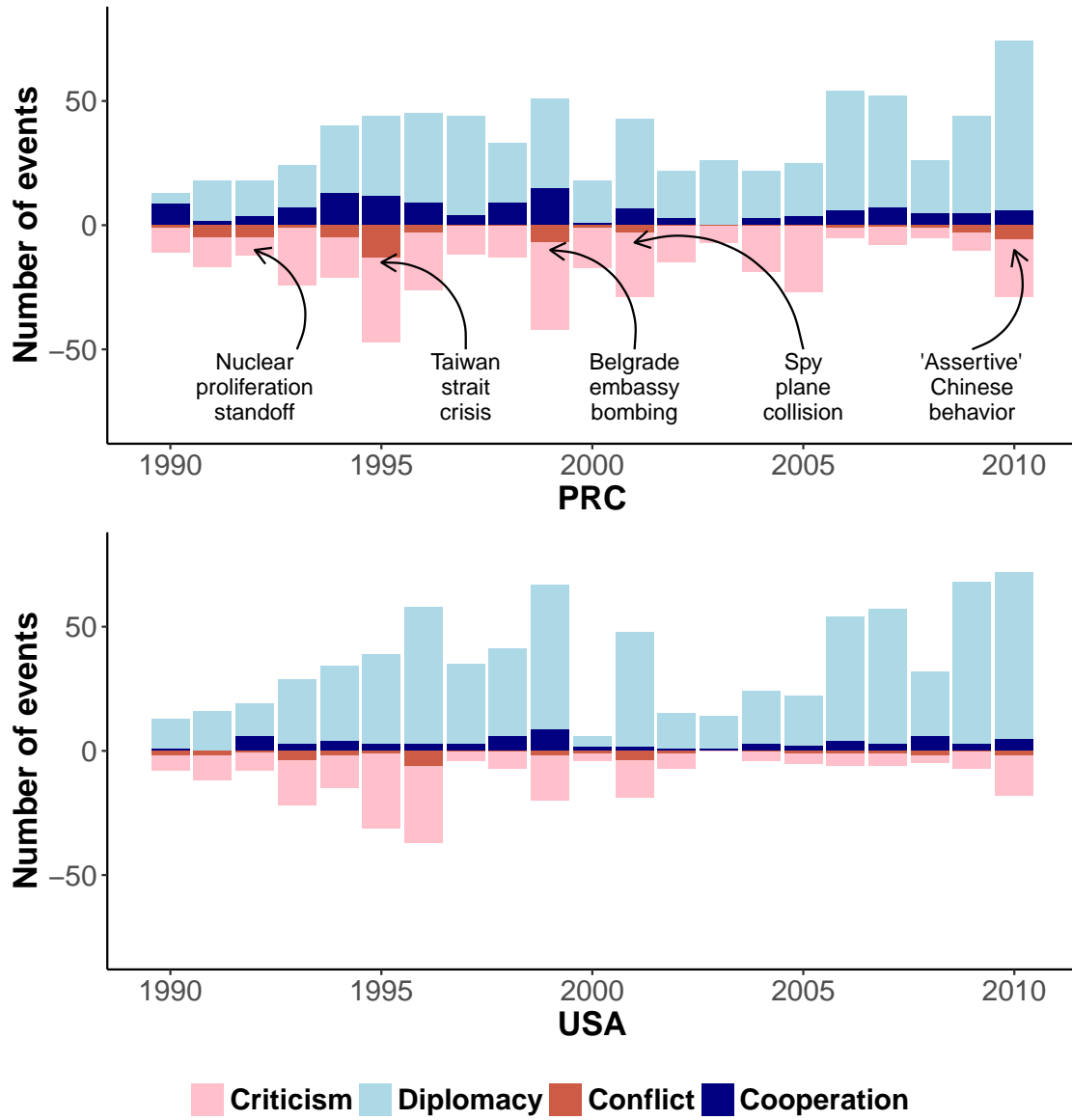
My dependent variable is *Chinese conflict initiation*. This variable records substantive bilateral conflict in military, diplomatic, economic, and human rights areas. The dataset records 171 episodes of conflict that occurred in 58 months. The measure has high construct validity, as shown with black arrows in Figure 2. China’s most conflictual years were characterized by major crises: the 1993 standoff at sea over nuclear proliferation, the 1995 Taiwan Strait crisis, the US bombing of China’s embassy in Belgrade in 1999, and the collision between a Chinese fighter jet and a US spy plane in 2001. 2010 – a year that many scholars deemed one of “assertive” Chinese behavior – was also a high-conflict year in the dataset.²⁰

I chose not to use existing event datasets because of data accuracy issues. 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. 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. By my estimation, 20-30% of these events are false positives or false negatives. The ontologies used to construct these datasets also 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.

And finally, much diplomacy takes place out of the public eye. For example, China allowed dissidents to quietly emigrate to the United States, agreed to the US request to not dump treasury bonds in the wake of the 2008 financial crisis, and occasionally employed aggressive aircraft tails and submarine dogfights to signal its discontent to US policymakers. These episodes are very important, but appear only in policymaker memoirs or declassified documents. By hand coding some 10,000 pages of historical documents, my dataset is the most complete account of the bilateral relationship since 1990.

²⁰While 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, 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.

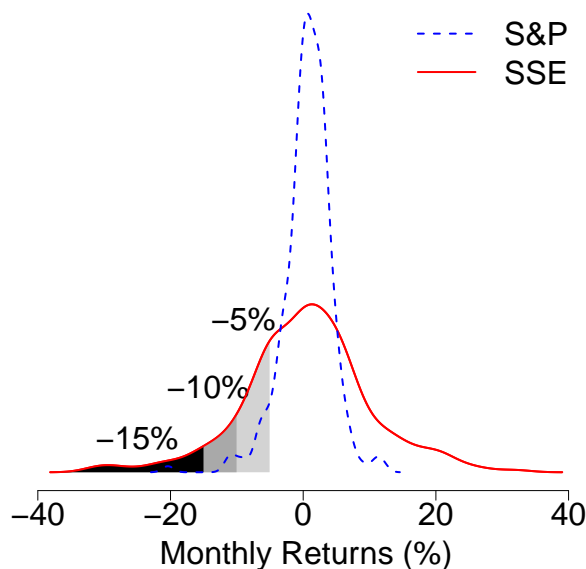
Figure 2: Bilateral Interactions



3.2 ELITE TRANSFER DATA

The distinguishing features of China’s stock markets are that they are dominated by SOEs and that they are extremely volatile. Today, SOEs account for 40% of China’s GDP but an even greater share of its equity market: 65% of firms and 89% of market capitalization.²¹ Figure 3 shows a kernel density plot of monthly SSE and S&P 500 returns since 1990. S&P 500 returns are normally distributed. In contrast, the distribution of SSE returns has fat tails, indicating an excess of very positive and very negative returns. Average SSE monthly were 2% with a standard deviation of 17 percentage points. Indeed, as shown by the shaded areas, the SSE lost 5% or more of its value in a *quarter* of months.

Figure 3: Kernel Density Plot of Stock Market Returns



In the 1990s, the autocrat used the privatization of state owned enterprises (SOEs) to transfer rents to political elites. Privatization created three streams of rent transfers. The first had to do with initial public offerings (IPOs). Through the nomenklatura system of personnel control, the autocrat appointed chosen elites to high-ranking positions at SOEs. He then set IPO share prices at artificially low values and offered management buyout provisions to the elites he had appointed. This allowed them to benefit from arbitrage. As a result, high-level officials and their families were “among the biggest beneficiaries” of privatization.²²

²¹Pei (2012, 34), Piotroski and Wong (2012, 219).

²²He Qinglian (2015). See also Rimmele (2012).

This process mirrored that in the post-Soviet states in the 1990s, where leaders sold state assets to people close to them for cents on the dollar.

The second stream of rent transfers from privatization was somewhat pedestrian: simply the dividends from shares retained by elites after IPOs. Given the rapid expansion of China's stock markets in the 1990s and 2000s, these dividends were considerable.

The third stream of rents resolved the problem of future transfers: how to deliver rent infusions to elites whose SOEs had already been privatized. For these, the autocrat turned to corporate financing arrangements. In the 2000s and 2010s, SOEs have provided 40% to 50% of the financing for the IPOs of *other SOEs*. That is, elites who previously benefitted from arbitrage have been offered opportunities to do so again. For example, China Unicom's IPO was financed by SOEs with few ties to the communications industry: Beijing Capital Airport Group, Shanghai Auto, Sinochem, and COFCO Foods. Crucially, the autocrat controls which SOEs are allowed to serve as "strategic investors" in subsequent IPOs, and thus maintains control over which elites receive rents.

Because of the autocrat's well documented precedent of propping up the stock market,²³ elites hold him responsible for returns. The state has provided an "implicit guarantee to prop up the market," according to economist Barry Naughton.²⁴ Wikileaks 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, he said, 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."²⁵ One Western analyst concluded that "There's an expectation of the government adjusting policy to suit the market, in a cheerleading fashion."²⁶ 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."²⁷

While China's stock markets have benefitted political elites, they 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 and 2 million active investors.²⁸ The estimate is conservative

²³Walter and Howie (2006, xvii-xi). More recently, after the SSE lost a third of its value in June 2015, Xi Jinping spent over a trillion US dollars trying to stabilize the market. His liquidity provision efforts were so vast that he was forced to devalue the renminbi in August 2015 for the first time in two decades.

²⁴Naughton (2007, 474).

²⁵US Embassy Beijing (2007).

²⁶Deng (2015).

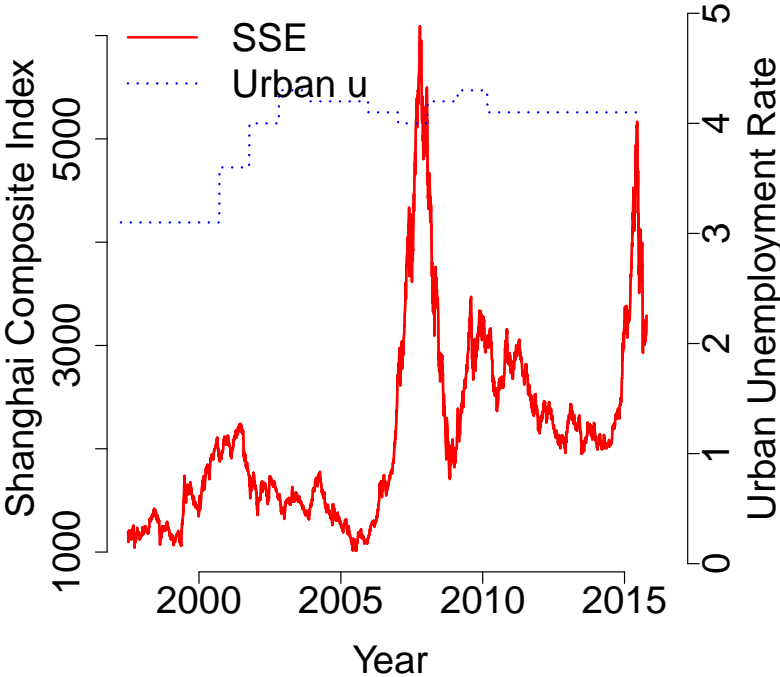
²⁷Walter and Howie (2006, 219).

²⁸See Walter and Howie (2006, p. 10 and Ch. 7) for a fascinating account. Green (2003) cites similar

because many brokers operate hundreds of illegal “ghost accounts” opened with 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 4 shows that there is virtually no relationship between stock returns and urban unemployment. In short, SSE returns are an appropriate measure of elite transfers unrelated to public welfare.

Figure 4: Stock Returns and Urban Unemployment



3.3 PROPAGANDA DATA

I gathered propaganda data from the *People’s Daily*, China’s main propaganda outlet. China’s paramount leaders have enjoyed direct control of the *People’s Daily* since its found-
statistics.

ing in 1946.²⁹ Indeed, Mao Zedong personally revised draft editorials. Domestic and foreign observers regard the *People’s Daily* as the authoritative statement on central policies. I downloaded all 783 articles published between 1990 and 2012 that contained the phrase “party-mass relations” (*dangqun guanxi*). This term emerged as a political buzzword in the early years of communism and remains salient today.³⁰

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.³¹ 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 on month t , and it is standardized to take values between 0 and 1:

$$Propaganda_t = \frac{(\text{Positive Coverage: PMR}_t) - (\text{Negative Coverage: PMR}_t)}{(\text{Positive Coverage: PMR}_t) + (\text{Negative Coverage: PMR}_t)}$$

The result is a time series that records how positively the *People’s Daily* covered party-mass relations each month between 1990 and 2012. Descriptive statistics for this variable appears in Table 6.

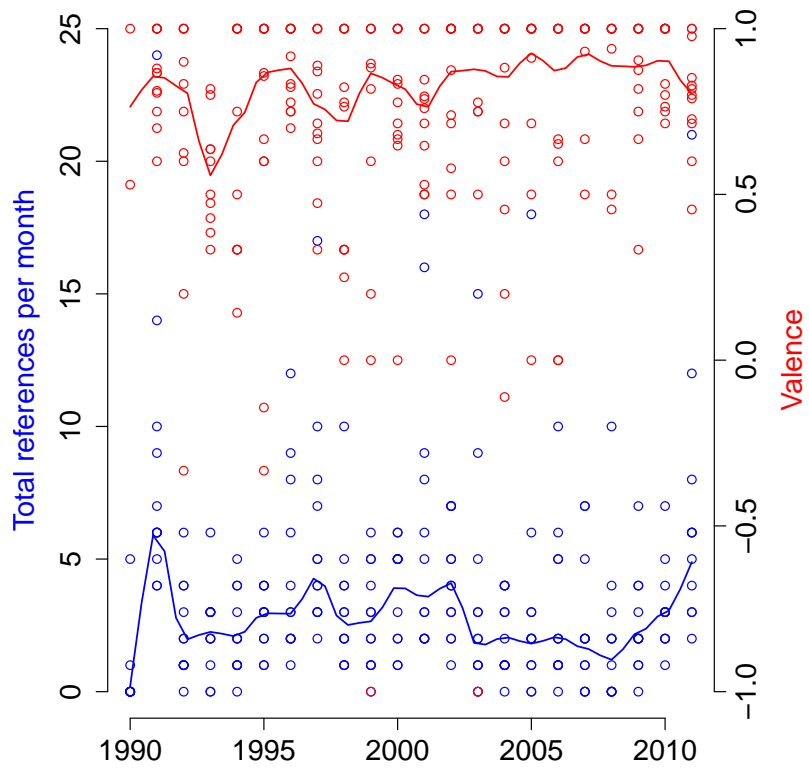
Figure 5 visualizes the propaganda data. The number of references to “party-mass relations” each month appears in blue with a loess smoother. On average, the *People’s Daily* discussed party-mass relations 3.3 times per month. My measure of $Propaganda_{it}$ appears in red, also with a loess smoother. Typically, party-mass relations were discussed quite favorably, with an average positive valence of 75.2%. Both series, while stationary, have exhibited some volatility.

²⁹Zhang Yong (2000).

³⁰Stern and O’Brien (2012).

³¹Dong and Dong (2014). 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) and Lowe et al. (2010).

Figure 5: Propaganda



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 index³² – and Chinese conflict initiation the following month. The estimating equation is:

$$\begin{aligned} \text{neg bin}(\text{Conflict}_t^{PRC}) &= \alpha + \beta (\Delta \text{SSE}_{t-1}) \\ &\quad + \kappa X_{t-1} + \psi W_s + \gamma_t + \lambda_s + \epsilon \end{aligned} \tag{1}$$

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 γ_t and λ_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 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 in 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 Chinese economic indicators that are measured but annually: unemployment and GDP per capita. Both proxy popular dissatisfaction. A description of all variables and the sources from which they are drawn appears in Table 6 in the appendix.

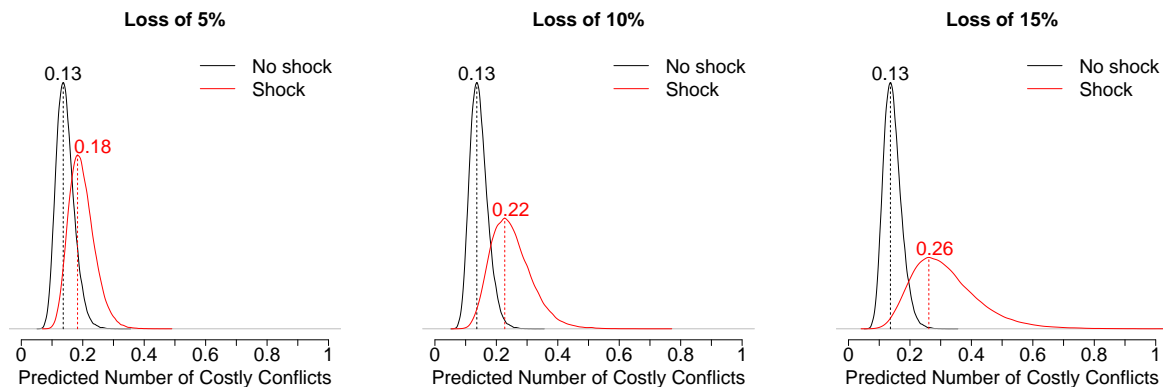
The results appear in Table 2. SSE returns are significantly inversely correlated with

³²The 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.

Chinese conflict initiation in a bivariate context. The relationship is robust to the introduction of recent 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 6. 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 Subsection 3.2, negative shocks this large are not atypical. In real world terms, 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.

Figure 6: SSE Shocks and Chinese Conflict Initiation



4.2 TESTING H2: ELITE TRANSFERS AND PROPAGANDA

Hypothesis 2 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:

$$\begin{aligned} \text{OLS}(\text{Propaganda}_t) &= \alpha + \beta (\Delta \text{SSE}_{t-1}) \\ &\quad + \kappa X_{t-1} + \psi W_s + \gamma_t + \lambda_s + \epsilon \end{aligned} \tag{2}$$

Table 2: Evidence for Diversion

	<i>Dependent variable:</i>					
	PRC conflict _t					
	(1)	(2)	(3)	(4)	(5)	(6)
Δ SSE _{t-1}	-3.933* (2.194)	-5.047** (2.254)	-5.579** (2.269)	-5.516** (2.275)	-4.566** (2.130)	-5.569** (2.197)
PRC conflict _{t-1}		0.353 (0.225)	0.138 (0.203)	0.129 (0.201)	-0.065 (0.188)	0.307 (0.187)
USA conflict _{t-1}		0.201 (0.377)	0.159 (0.313)	0.158 (0.310)	0.051 (0.302)	0.028 (0.302)
CPI _{t-1}			0.081** (0.038)	0.080** (0.038)	0.036 (0.097)	0.070** (0.034)
Unemployment _s			4.081*** (1.507)	3.790** (1.474)	-94.260 (21,106,291)	3.045** (1.357)
Log GDPpc _s			0.630 (0.434)	0.638 (0.431)	530.400 (18,865,445)	0.537 (0.398)
Party Congress _{t-1:t-6}			-1.996* (1.201)	-1.879 (1.180)	-1.258 (1.483)	-1.940 (1.193)
Δ S&P500 _{t-1}				0.066 (0.056)	0.037 (0.059)	0.063 (0.052)
Constant	-1.682*** (0.219)	-1.851*** (0.234)	-32.703*** (12.086)	-31.426*** (11.883)	-2,623.6 (167,846,335)	-61.161 (11,877,603)
Year fixed effects	No	No	No	No	Yes	No
Month fixed effects	No	No	No	No	No	Yes
Observations	288	288	240	240	240	240
Log Likelihood	-133.165	-131.545	-115.859	-115.328	-97.126	-106.439

*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.

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 path dependent 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 or product safety scandals, epidemics, 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 γ_t and λ_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 ???. In a bivariate setting, SSE returns are significantly 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 domestic instability in Model 3. The results are visualized in Figure 7. When transfers decline by 10%, the propaganda apparatus discusses party-mass relations 8% more positively. In short, elite dissatisfaction compels propaganda about mass support for the autocrat.

4.3 TESTING H3: DIVERSION IN THE PUBLIC EYE

Because the point of diversion is generating a rally, Hypothesis 3 suggests, the autocrat will employ policies that are observable to the public. They 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 will not occur in low politics. Economic negotiations are unlikely to arouse nationalist sentiment. Nor will diversion involve *human rights* issues. These cases are often negotiated privately, and moreover, Chinese citizens may not view punishing the United States on human rights issues as a compelling defense of national interests.

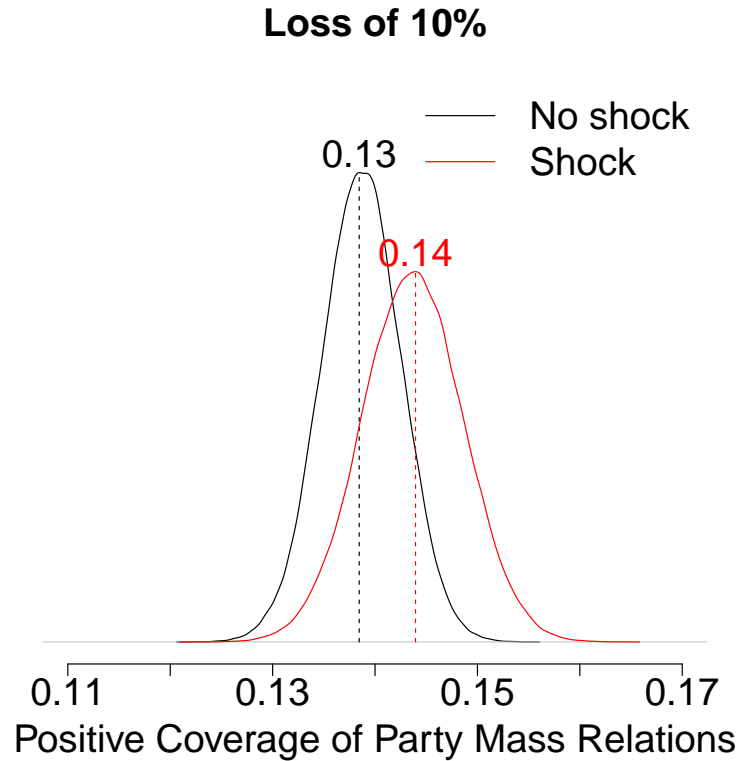
To test Hypothesis 3, Table 4 reproduces the analysis in Section 4.1 but disaggregates

Table 3: Diversionary Propaganda

	<i>Dependent variable:</i>		
	Propaganda _t		
	(1)	(2)	(3)
Δ SSE _{t-1}	-0.270* (0.156)	-0.526** (0.246)	-0.524** (0.243)
Propaganda _{t-1}		-0.165** (0.079)	-0.166** (0.078)
PRC conflict _{t-1}		-0.005 (0.043)	-0.007 (0.043)
USA conflict _{t-1}		-0.025 (0.059)	-0.022 (0.058)
CPI _{t-1}		-0.016 (0.014)	-0.017 (0.014)
Unemployment _s		-0.229 (0.598)	-0.215 (0.589)
Log GDP per capita _s		0.547 (1.305)	0.445 (1.286)
Party Congress _{t-1:t-6}		-0.379*** (0.100)	-0.390*** (0.099)
Instability _{t-1}			0.298** (0.124)
Constant	0.755*** (0.022)	0.677 (7.926)	1.338 (7.813)
Year fixed effects	No	Yes	Yes
Month fixed effects	No	Yes	Yes
Observations	228	195	195
R ²	0.013	0.253	0.280

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

Figure 7: SSE Shocks and Chinese Propaganda

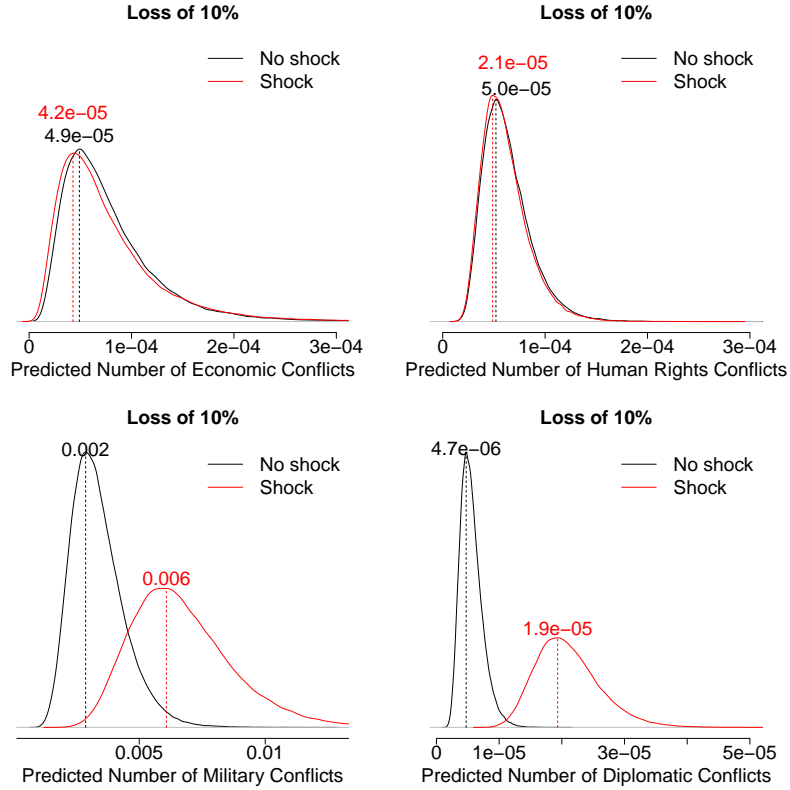


Chinese conflict initiation into military, diplomatic, economic, and human rights areas. Models 1-4 show that diversion occurs in military and diplomatic areas but not in economic or human rights areas. Figure 8 visualizes the results. A negative transfer shock of 10% results in three times as many military and diplomatic conflicts as usual. In contrast, a shock of this size does not affect the number of economic or human rights conflicts.

Another way to test Hypothesis 3 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 obstructing American policies, withdrawing support, canceling exchanges, punitive economic actions, hostile congressional resolutions, infringing upon human rights, inciting protests, and arresting the other country's nationals. *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 9 visualizes the results. A negative transfer shock of 10% makes severe

Figure 8: SSE Shocks and Chinese Conflict by Issue Area



conflict more than twice as likely as usual, with no change to 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.

4.4 TESTING H4: UNLEARNING DIVERSION

The final hypothesis contends that to avoid containment, the autocrat should help the United States unlearn the lessons of diversion. Chinese leaders are wary of provoking American containment. 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.”³³ In January 2007, China conducted a missile test that destroyed a weather satellite and

³³Suettinger (2003, 254).

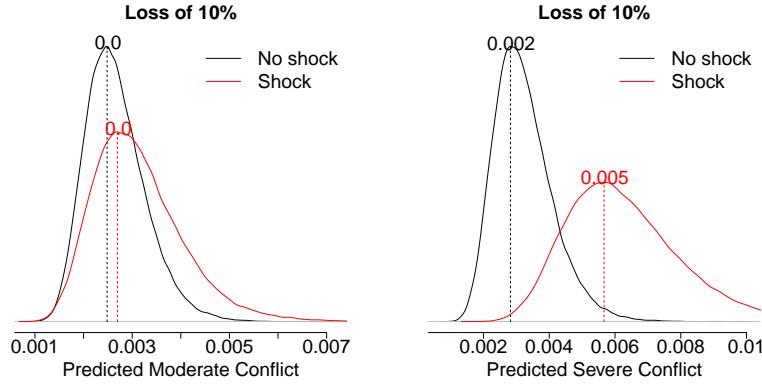
Table 4: Issue Area Model

	<i>Dependent variable: Type of PRC conflict</i>					
	Military _t (1)	Diplomatic _t (2)	Economic _t (3)	Human rights _t (4)	Moderate _t (5)	Severe _t (6)
ΔSSE_{t-1}	-5.895** (2.915)	-10.346** (4.365)	12.858 (12.422)	3.581 (4.028)	-0.241 (1.025)	-5.574** (2.836)
PRC conflict _{t-1}	-0.057 (0.426)	0.095 (0.517)	-0.866 (1.269)	-0.181 (0.354)	-0.506* (0.302)	-0.014 (0.400)
USA conflict _{t-1}	0.042 (0.568)	0.998 (1.271)	1.911 (1.543)	-0.179 (1.035)	0.732** (0.371)	-0.004 (0.565)
CPI _{t-1}	0.089 (0.137)	0.189 (0.165)	-0.678 (0.774)	-0.084 (0.132)	-0.036 (0.100)	0.083 (0.135)
Unemployment _{t-1}	-148.601 (13,284,618)	-42.482 (72,176,106)	68.415 (165,282)	15.032 (72,745,578)	10.554 (72,033,010)	-156.447 (15,344,324)
Log GDPp _{t-1}	305.202 (23,090,126)	276.693 (19,650,697)	147.789 (222,055)	289.406 (23,207,863)	516.336 (12,939,047)	296.604 (33,298,585)
Party congress _{t-1:t-6}	-0.452 (1.519)	-30.321 (2,353,075)	-17.076 (23,257)	1.452 (8,272,414)	-29.605 (1,902,552)	-0.467 (1.505)
$\Delta S\&P500_{t-1}$	-0.048 (0.098)	-0.034 (0.148)	0.482 (0.323)	-0.106 (0.123)	0.086 (0.066)	-0.069 (0.092)
Constant	-1,055.293 (161,260,378)	-1,455.473 (372,024,839)	-1,130.091 (1,696,441)	-1,748.389 (380,911,556)	-3,048.290 (360,841,895)	-966.301 (230,490,222)
Year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Observations	240	240	240	240	240	240
Log Likelihood	-40.882	-29.135	-9.530	-23.563	-89.913	-43.044

*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 9: SSE Shocks and Chinese Conflict by Severity Level



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 day after, the Ministry of Foreign Affairs added that the test did not create any debris.³⁴ These examples illustrate that China is sensitive to American perceptions. When the United States becomes suspicious of Chinese motives, Beijing often employs reassurance behavior.

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 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:

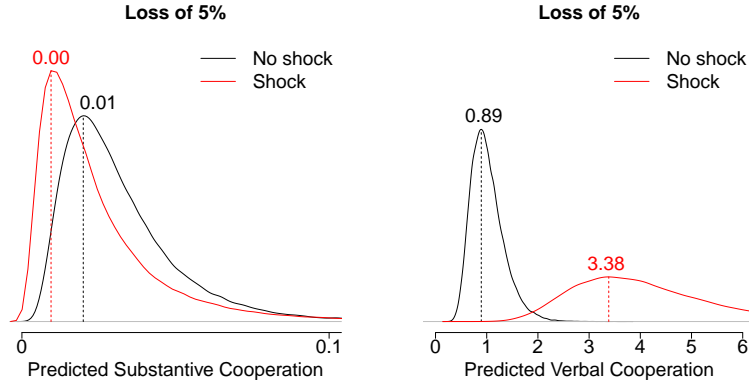
$$\frac{\partial \text{PRC Cooperation}_t}{\partial \text{PRC Conflict}_{t-1}} \Bigg|_{\Delta \text{SSE}_{t-2} \leq -0.05}$$

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

Table 5 presents the results and Figure 10 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 fol-

³⁴Mulvenon (2007, 2010).

Figure 10: 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 $t - 2$.

lowing 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

Results are robust to several different approaches presented in the online appendix. First I employ placebo tests. Above, elite transfers are operationalized as a continuous variable. 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 offers 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

Table 5: Unlearning Diversion

	<i>Dependent variable:</i>		
	PRC cooperation _t	PRC diplomacy _t	
	(1)	(2)	(3)
Δ SSE _{t-1}	3.908 (4.212)	0.048 (6.073)	-3.244 (4.648)
PRC conflict _{t-1}	-0.263 (0.196)	0.555** (0.229)	1.225*** (0.420)
USA 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)
Instability _{t-1}	-0.001 (1.147)	0.215 (0.607)	0.133 (0.694)
Party Congress _{t-1:t-6}	2.414** (0.973)	1.570** (0.634)	1.961*** (0.469)
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 conflict _{t-2}			-0.185 (0.166)
USA conflict _{t-2}			-0.484 (0.653)
Δ SSE _{t-2} × PRC conflict _{t-1}			8.646*** (1.653)
Constant	-11.982*** (2.986)	-3.693 (3.559)	-3.777 (4.285)
Observations	63	63	63
Log Likelihood	-35.031	-100.403	-96.403

Note: 26 *p<0.1; **p<0.05; ***p<0.01

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

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 $t - 1$.³⁵ 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. 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.

Fourth, 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

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

monthly changes in *new floorspace construction*.³⁶

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.

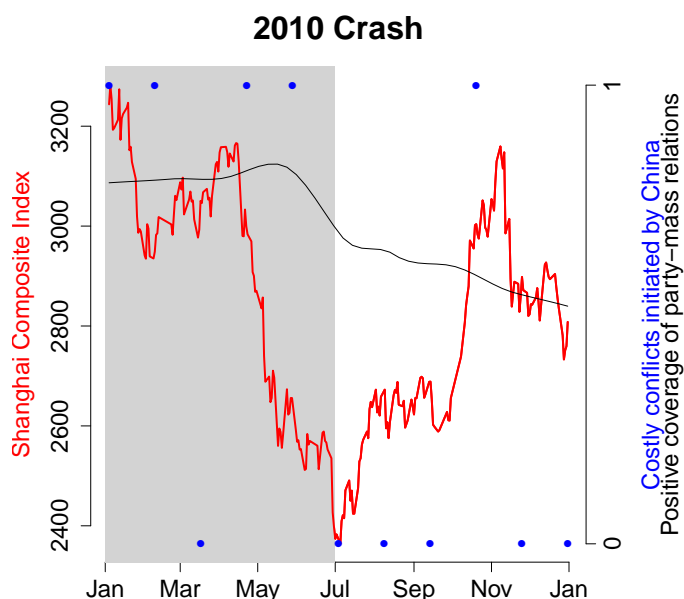
In the first months of 2010 the Shanghai Stock Exchange plummeted, as shown in Figure 11. Meanwhile, GDP growth increased and unemployment declined. As returns fell, China initiated high profile conflicts with the United States. However, China secretly warned the United States to expect aggression over 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 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. 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.

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 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

³⁶There are also theoretical reasons to exclude construction bribes from the main analysis. 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.

Figure 11: 2010 Crash and “Assertive China”



described as ‘defensive.’³⁷ The arms sale was unwelcome but expected by China. Ambassador Zhou Wenzhong “relayed Beijing’s anger over the sale” but also “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.”³⁸

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.³⁹ It publicly threatened unusually strong retaliatory measures, including a ban on Boeing, the largest US exporter to China. However, Bader “did not see a serious

³⁷Gates (2014, 415).

³⁸Bader (2012, 73-74).

³⁹In 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).

prospect of the Chinese carrying through on these threats.”⁴⁰

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” 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 emphasized 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.”⁴¹

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.”⁴² After the meetings, the Western press deemed Beijing “incensed.”⁴³ The Chinese press described bilateral relations as “strained” and “at a low point.”⁴⁴ Chinese policymakers told journalists that they believed that the United States was trying to contain

⁴⁰Bader (2012, 74).

⁴¹US Embassy Beijing (2010).

⁴²Bader (2012, 76-77).

⁴³Wall Street Journal (2010).

⁴⁴Cheng Guangjin and Tan Yingzi (2010); Yan Feng (2010).

China. Of course, the accusation made Asian headlines.⁴⁵ 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.”⁴⁶

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.⁴⁷ When Secretary of State Hillary Clinton traveled to Beijing later that month, Chinese leaders “warned they would not tolerate outside interference” in the South China Sea.⁴⁸ 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.”⁴⁹ 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?”⁵⁰ The Chinese press was effusive. In its view, China had demanded that Washington “respect its core interests and major concerns.”⁵¹

In June, China continued to block American efforts to censure North Korea in the United Nations. Some observers concluded that China “is becoming more assertive on many foreign policy issues.”⁵² Indeed, references to “assertive China” quintupled in US news articles in 2010.⁵³

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.⁵⁴

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

⁴⁵Huang (2010).

⁴⁶Batson, Poon and Oster (2010).

⁴⁷Clinton (2014, 56).

⁴⁸Clinton (2014, 76).

⁴⁹Clinton (2014, 76).

⁵⁰Pomfret (2010*b*).

⁵¹Xinhua News Agency (2010).

⁵²Swaine (2010, 8).

⁵³Johnston (2013, 12).

⁵⁴Bader (2012, 78).

Council statement condemning North Korea. In August, Chinese officials said that they “had not authoritatively called the South China Sea a ‘core interest.’”⁵⁵ 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.”⁵⁶

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.⁵⁷ Bader recalls,

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.⁵⁸

In an October meeting at the Asian defense ministers forum in Hanoi, Defense Minister Liang Guanglie quietly reinvited Secretary Gates to Beijing.⁵⁹ *Xinhua* published a brief note on the meeting that 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 Bingguo 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 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.”⁶⁰

⁵⁵Bader (2012, 106).

⁵⁶Bader (2012, 106).

⁵⁷Bader (2012, 116, 118).

⁵⁸Bader (2012, 118).

⁵⁹Gates (2014, 524).

⁶⁰Swaine (2011, 9).

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 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.

6 CONCLUSION

This study demonstrates that the economic interests of political elites condition the international behavior of autocrats. In China, these interests are responsible for an estimated 40% of conflict initiation toward the country's strongest adversary. When elite transfers through the Shanghai Stock Exchange decline by 5% to 15%, China initiates 1.5 to 2 times as much conflict with the United States as usual the following month. This conflict occurs in the high-profile areas most likely to generate a nationalist rally, and is accompanied by propaganda that emphasizes the autocrat's popularity. It is followed by private diplomatic initiatives designed to reassure the United States of China's peaceful aims. All this suggests that the autocrat employs both foreign policy and propaganda in order to inoculate himself against elite leadership challenges.

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 have diminished Vladimir Putin's ability to transfer rents to elites. In his view, this may explain Putin's

popular wars.⁶¹

Future research should proceed in three directions. First, scholars should further explore the subnational sources of autocratic foreign policy. How do 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, or the winning coalition larger?

Second, researchers should explain how autocrats choose between diversionary targets. Several Asian and European embassies complained to Ambassador Huntsman about Chinese aggression in 2010. After he was publicly excoriated by his Chinese counterpart Yang Jiechi, for instance, the Japanese foreign minister told Huntsman that Yang had “always been a peace lover. I guess the Chinese felt like yelling.”⁶² In China and elsewhere, do leaders prefer to scapegoat strong rivals or those with historical animosities? Do they cycle among them?

Finally, researchers should consider whether diversion may target domestic groups. Xi Jinping’s prosecution of elite corruption cases has been very popular among Chinese citizens. Both scholars and elites speaking off-the-record feel that the anti-corruption campaign has been politically motivated.⁶³ “Domestic diversion” has precedent elsewhere: Mexico’s single party presidents periodically attacked business elites to improve their popularity among ordinary people.⁶⁴ When do autocrats scapegoat foreign versus domestic foes?

This research agenda is pressing because if economic projections are correct, China may employ diversion more frequently in the future. If China’s economic rebalancing is successful, the relative economic position of Chinese elites will deteriorate. In the long run, the autocrat will run out of SOEs to privatize, diminishing the value of stock markets 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.⁶⁵ Chinese elites may become similarly discontented in an era of normal growth. The autocrat could respond 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.

⁶¹Robins-Early (2015).

⁶²Pomfret (2010*a*).

⁶³Anonymous interview with author, China.

⁶⁴See e.g. González (2008).

⁶⁵Murphy, Shleifer and Vishny (1992).

7 APPENDIX

Table 6: Variable Definitions

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

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