

CHINA

The Emergence from, and Potential Return to Isolation

ALONE

Anne Stevenson-Yang



**Cátedra
México-China**



**CENTRO DE ESTUDIOS
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Preface

This book comes principally from a series of lectures that I delivered at the University of Mexico in February 2013 as the first Cátedra Extraordinaria México-China. This program, graciously sponsored by the CECHIMEX Center in UNAM's Department of Economics, is designed to promote a better understanding of China in Latin America and the Caribbean, especially in Mexico. The faculty and students at UNAM were extraordinarily thoughtful and contributory, adding a new dimension of understanding to how China affects the rest of the world. I am particularly grateful for having been selected for this program and most particularly to Professor Enrique Dussel Peters, among the most able as well as gracious of economists now writing on China.

Anne Stevenson-Yang
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Abbreviations

AMC	Asset Management Company
CASS	Chinese Academy of Social Sciences
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CDB	China Development Bank
CITIC	China International Trust and Investment Corporation
CCP	Chinese Communist Party
CPPCC	Chinese People's Political Consultative Congress
FDI	Foreign Direct Investment
FEC	Foreign Exchange Certificate
GITIC	Guangdong International Trust and Investment Corporation
MOF	Ministry of Finance
MOFCOM	Ministry of Commerce
NPL	Non-Performing Loan
ODI	Overseas Direct Investment
OEM	Original Equipment Manufacturer
PBOC	People's Bank of China
PDB	Pudong Development Bank
PE	Private Equity
PLA	People's Liberation Army
PRC	People's Republic of China
SOE	State Owned Enterprise
TSF	Total Social Financing
WMP	Wealth Management Product

Introduction

This book represents an attempt to make sense of the financial and political change that is starting to wash across China, change that represents a turning point in the most recent cycle of glorious expansion, wealth creation, and hope over the last thirty years. Those years followed thirty of crabbed contraction, mistrust, and isolationism. The intensity of these cycles in China's state of affairs demonstrates how those who manage to command this enormous, diverse, yet unified nation exercise control of a scale inconceivable elsewhere, and find themselves able, intentionally or not, to create both economic miracles and tragedies of unrivaled scale. I argue that the current, utopian overbuild of cities measures against the Great Leap Forward as one of the great follies of history, and one that will have unfortunate consequences for China as an economy and for its people.

The five generations of Party leaders who have ruled China since the founding of the People's Republic in 1949 have managed both to build the fastest-growing economy at scale the world has ever seen and to incite chaos, from the teenagers who riotously tormented their own parents and mentors and burned to the ground the monuments of their own historical legacies, to the pitched battles of the Cultural Revolution that brought the economy to a standstill. Such is the power concentrated at the top of the world's largest single-party polity that the leaders have managed to de-motivate their people as they lumbered through decades of economic stagnation and then to motivate them to create astonishing wealth.

In reliable thirty-year cycles, China decided to become a republic in 1919, established the People's Republic in 1949, then did an about-face in its most basic policies and economic practices in 1979. Within those large spans, this study sees a critical turn in the demonstrations at Tiananmen in 1989. Those events, however one writes their history, forced a deep reflection and recalculation on the part of the leaders about how to weave the complex political, social, and economic threads in hand into the modern, industrialized China they sought to build. About this goal there was no doubt, after over two generations of humiliation at the hands of foreigners, and over two more at their own.

Our analysis sees in this very effort to modernize China since 1989 both great ingenuity and also the roots of the current, precarious state. The economic and political restructuring of the 1990s was intended to save China from fracturing under the pressure of unplanned, unanticipated, and explosive pluralism, diversity, and distribution of resources that blossomed in the first decade of Deng Xiaoping's economic reform. Tiananmen in 1989 had persuaded China's top leadership that, if they did not themselves restructure China's economy, then others would, and anarchy might be loosed upon the world as they knew it.

So the reformer Zhu Rongji's group set out to create a new, robust economic architecture that would support and enable growth while maintaining the un-assailed political dominance of the Chinese Communist Party.

The dichotomy between economic and political control turned out to be a false one, and the Zhu reforms ultimately reversed the very retreat of the state that they were designed to enable.

Prior to the inflection point under Zhu's hands, Deng's reforms in the industrial economy were deployed in various decentralization initiatives, which at their edges also marketized, or privatized, some significant economic activity. Zhu's restructuring entailed a masterful buyoff of state interests, often deploying the private capital that had been earned in the previous decade. As a result, in barely over one decade, China rebuilt both the institutional and the physical infrastructure of government, dramatically recentralizing fiscal authority and putting the management of finances, technologies, and labor into new bodies under the direct management of government rather than of government-owned companies that had always been the agents of the urban state. And of course, both atop and alongside the government, itself a public and administrative system, was the Party, in whose enclaves the major decisions were made.

Slightly over three years of reflection and slow growth came to an end when Deng made his famous southern tour of Shenzhen and reignited reform momentum in 1992. Indeed, the reforms of 1993-98 were breathtaking in scope and drew an almost giddy global optimism about China's future. In order to create new systems, including social security, public healthcare, national tax collection, and private housing, to name just a few, China threw open its doors to academics, corporations, and governments that could offer models and advice. Chinese officials traveled the globe to bring back examples of systems that seemed to work. The nation that had been isolated for three decades and sought nothing from the world outside its tight borders seemed to become an enormous graduate school for open-minded government officials and a magnet for the best practices from every corner of the globe.

The pace of change along with the seeming eagerness to learn from foreign businesses, governments, NGOs, and research institutes and universities won China the most concentrated influx of foreign capital, foreign technology, and foreign practices the world has yet seen, and old investment begat new. The opportunity to capture and direct these rich flows of capital was not lost upon the Communist Party and its leadership, which perhaps understandably conflated personal with public benefit, positioning themselves resolutely as arbiters and abettors of capital flows as well as protectors of the domestic industries designated to receive them. In the era of explosive growth, there was a happy mutuality of personal and private benefits. In fact, as the decades rolled by, the outside world was fascinated by the way in China that wealth brought political positioning, but even more impressed by how political positioning brought wealth.

The reforms were steered forward through a series of trade-offs, designed to ease the state out of direct management of the economy by providing governments at all levels with the benefits of capitalist ownership and control rather than the rewards and burdens of socialist managers. This was not deeply discontinuous with Deng's initial reform concept, what he called the Contract Responsibility System. But in this latter

implementation, the reformers concentrated economic privilege, without symmetrical responsibilities or consequences for failure. Softening the constraints of responsibility and de-risking bold investment were the obvious moves to accelerate China's growth to unprecedented levels. The incentives for a new, privileged class drove growth hard with the twin interests of career advance paralleled with opportunity to wring generous measures of family wealth from the bank of public assets. These interests coexisted within the local elites who managed public assets with essentially unchecked authority.

China's astonishing ability to create change, whether by eradicating poverty for a billion people or by creating world-historical tragedies like the great famine, flows from the unity of its central political institutions and the elasticity in all below it. A government that can capture the unitary center of power in such a huge nation has leverage to create change with astonishing speed and command resources concentrated from the value creation of a massive population. The elasticity that characterizes all below enables a powerful form of local entrepreneurship that fuels growth with the resources channeled to it.

Emerging from the Cultural Revolution, China's leaders successfully deployed this central machinery to aggregate capital and deploy it on badly needed infrastructure. But the recapture of the economy that followed from the reforms of the 1990s put discretion over the ever-larger capital flows into the hands of non-commercial organizations, governments, and state-owned enterprises. This structure not only reduced the share of wealth that went to ordinary citizens to grow household consumption, it dramatically reduced the efficiency of capital in the system. Capital intensity in China marched steadily upward, requiring ever-greater investment to achieve a slowly diminishing rate of growth. As capital requirements roared past what inbound investment and productivity gains could provide, the state's ownership of the banks came into play, and the great credit boom was under way.

The accumulation of debt is a familiar story among more developed nations. China's increasing reliance on debt was not in and of itself a bad thing. But what China lacks is a control mechanism, a connection between the power to deploy debt and responsibility to deploy it in a productive way. This lack of a control mechanism has meant that, even as debt became visibly out of control, there was also no corrective mechanism. Instead, all players in the system shared incentive to deploy more debt, increasing amounts to evergreen existing debt as well as to fuel more investment.

In a few short years, from 2006 and accelerating in 2009, this syndrome brought China to the point where the country finds itself today: an apocalyptic landscape of empty towers, many unfinished, in every city and town and resort, on farmland, hillsides, and in mountains. The scope of this bizarre overinvestment is hard to grasp and impossible to measure with any precision. But there is no major city in China where it is not starkly visible in the ride from the airport to the city center. The empty towers built in living urban locations are unaffordable to new urbanized populations, and the empty towers built outside living urban locations are uninhabitable; there are no jobs, no services, no way to live in them. There is no possible future for the empty cities across China other than to decay, for the cement and steel to revert to rust and rocks and gravel. But that will not be an easy process. Nor will the toll on the economy be low.

In 1979, no one predicted China's current prosperity or had any inkling of the effect its manufacturing industries, resource consumption, and outbound investment would have on the world. But like the celebrated acrobatic act of spinning plates atop a stick, when there are too many to keep spinning, they begin to fall and shatter. China's prosperity and levered-up standard of living have reduced its manufacturing competitiveness; its resource demands have unsettled its trade balance, and its massive debt has boxed-in investment options. Now, what kind of China will emerge on the other side of these challenges, whether they become crises or not, is as impossible to predict as was the nation's miraculous growth.

Chapter 1:

The Historical Prism

Analysts of China's economy all have access to the same, abundant data, and yet they are as deeply divided on what conclusions to draw as if they were interpreting faint signals from a distant planet. No country since perhaps Japan has attracted such sharp disagreement among people so well informed about whether it will become a powerful new world model and the largest world economy or, instead, fail to survive the current decade as a single nation or a functioning stable economy at all. One side points to surging property values and seething demand for steel and iron ore, and the resilience of the Chinese model over the last three decades of state-economy reform, a banking crisis, and external shocks. The other side points out that ghost cities are smothering the economy, employment is declining, and consumer demand tumbling, while the people of China are deeply dissatisfied and increasingly restless. We could dismiss this diversity of opinions with a "feeling the elephant metaphor." But more simply, China presents a constellation of unprecedented historical features, political and social traits, economic structures and processes, scale, reach, and on and on. Obviously lack of precedent precludes modeling a future based on precedent. But this is also not an excuse to beg off the critical task of undertaking an informed and balanced study of where China is likely headed.

In a few short years since 2011, largely unadulterated admiration for the Chinese model has modulated into an uncertain skepticism. The international press is beginning to explore the cracks in the growth model: reporters are roaming from Inner Mongolia to Liaoning and Shanxi to understand why the stunningly obvious visual of empty buildings in every single Chinese city seems not to resolve itself into a flagrant economic disaster. Believers, meanwhile, looking up at those same empty towers, say that China's current growth is tracking 7.5%, and, regardless of flaws, the model is the most robust in the world.

These two counterpoised observations on the economy seem to diverge more and more. If China's growth rate indeed remains the highest of any large economy, by a factor, as the government and most international investment banks aver, why should there be any doubt at all around China's continued strength?

There are complex answers, having to do with how statistics are collected, organized, analyzed, and reported: China's system is one of goal seeking to reach a political target rather than deduction from data collected, and the fact that growth numbers are targets is enough to question them. The discussion about the reliability of China's data is a well-practiced one. The discussion has merit, but its heuristic value is limited. There is little alternative data. You can take it, or leave it.

However, the real resolution to the conundrum between stated growth, whatever the number, and visible malaise lies in what the leadership's measures of success and the concept of growth imply. For two decades now, China's has been an investment

market for all able players. Entrepreneurs, companies, investment funds, and the nation as a whole have embraced the idea of a China that will grow into the world's dominant economy, where future dividends will pay handsomely on the investment made to capture share today. That prospect is made persuasively visible in the impressive towers of Pudong, Beijing, and Shenzhen, where two decades of rapidly accumulated prosperity are proudly displayed, and where almost all foreign business visitors spend all of their time.

In fact, China very smartly focused early investment on international airports, the expressways that linked them to the city centers, and fine hotels and office buildings. The success of this is clear. What were once the new airport, new hotel, and new city center have now matured to be the world's largest airport, one after another, the tallest tower in Asia, the biggest building in the world and the most gilded hotel. China's building zeal has reached a point where the nature around it no longer contains the buildings; the buildings contain nature. Recently completed or under construction are an indoor beach and an indoor ski slope.

Wealth creation has come with this same display. Profits taken and wealth created have been from capital gains in land use value and property development, IPOs, share appreciation, and M&A deals. It has not been, by and large, from the operating returns earned by companies. The many billionaires and millionaires China has produced in just a handful of years may have started making things or providing services, but the material ramp up in their wealth has always been from real estate capital gains or capital market gains. As an aside, that is why in a system where land use is allocated by an impenetrable state monopoly and access to capital markets is micromanaged by the central government, political power and financial success are closely mated.

Likewise, the success of the massive new infrastructure and property investments is measured not by cash flows from the projects, but by more investment enabled by the new credit the projects are able to extract from increasingly diverse credit sources. The players in this market focus on the channels and financial products needed to expand their asset base and monetize a portion of it to keep their loan payments current. The rapid escalation of prices and the collateral value rise it gives all existing assets in the economy make it possible to keep loan payments current without real cash flow generated from the investments. The balance sheet of the economy as a whole is buoyant with capital gains fueled by ballooning credit and escalating property values. The property values themselves are set in land use transactions from one government pocket to another, transactions where both parties benefit from inflating prices. There is no real market demand for the final project, no market transaction along the entire development path.

The incentives for China's political leaders have created a culture in which the nation's economic health and the personal gain of elite clans have comingled, ironic given the Party's roots. As this investment culture thoroughly penetrated companies throughout China, it has evolved into both the justification and the engine of political success. In China's growth dynamic of asset appreciation, almost any fixed-asset investment, regardless of return, entrained new investment credit, creating link by link an unprecedented chain of appreciating assets and debt. When, starting around 2008, international and domestic markets curtailed their appetite for new investment,

China's central government assumed the role itself, force-feeding the economy with an unprecedented flow of newly printed money, a process that has brought M2 supply of money to nearly 200% of GDP. The money supply of even free-spending, QE'ing America stands at about 70% of GDP. That paper was brought to market via soaring land-transfer costs, an expansion of asset values that cities were only too happy to drive and share with builders and developers, also city or elite owned.

In these latter years of reform, especially since 2000, imagine China as a sort of virtual Silicon Valley in 1995, but one in which the political equivalents of the federal reserve chair and the president are free of institutional constraints on their ability to direct public capital flows. They are also major owners of pre-IPO shares in the hottest of hot Internet companies, telecom companies, and financial service companies, and also embedded in the most valuable land transactions the world has ever seen! For example, they can corner land use rights where the world's largest airports will be built, or where new subway lines will launch land value skyward.

This is the position in which the political leadership finds itself, by virtue of having maintained government ownership of the most lucrative companies, direct control of the biggest banks, and extremely granular regulatory control of business licenses and resource access. There is no perceived conflict of interest in a typical elite family, which would include a political leader and one or more major asset investors, all motivated to grow state monopolies in land allocation, financial services, commodities, industry, and commerce.

Until most recently, this structure has worked well and encouraged optimism that the day would be at hand, as Deng Xiaoping put it, when everyone would be rich. The dream of perpetual growth then befits the nation, its political stewards, and the Party itself. The payback has been abundant for families positioned, as Deng put, to get rich first, to benefit from capital gains on almost any kind of asset, from Internet to real estate to banking and insurance.

It takes a long time to break the spell of a good salesman's pitch, and people everywhere want badly to believe in miracles for others, as they may foreshadow miracles for themselves. Under the circumstances that actually exist in China—the close alignment of the interests of business and political leaders, as well as regulators and statisticians—it seems not only possible but unavoidable that the government will focus all resources on the optics of China's markets rather than on the wobbly reality. Mao's fabled message to writers and artists in Yan'an, to hold fast to proletariat optimism, has evolved into a silent guideline in late reform China, hold fast to investor optimism, and make the best effort to make everyone an investor, at one level or another.

A reliable and enduring comment made by Chinese leaders in international events is that every nation must develop in accordance with its unique internal culture and characteristics. The confluence of political power and personal family wealth forms the real fabric of the Chinese economy and strategically informs economic reports to the outside world. The confluence of political power and personal family wealth is not necessarily about corruption, especially in a system where well-accounted reciprocity governs relations that are woven into the political and commercial systems, China's unique internal culture. After all, in the historical roots of this system, the emperor owned ev-

everything, every piece of land, every domestic animal, every cultural artifact. The ministerial class shared in this wealth, under the emperor's patronage.

The actual risk of corruption charges is rooted in two things: the accumulation of wealth that is disproportionate to one's influence, and the vicissitudes of political power in a system where tensions are not visible between two or more sustained political parties but subtle and shifting among rival factions within a single party.

The new president's fight against corruption and strengthening of his support base also incur costs and create opportunity. Tagging and handling top leaders accused of corruption, the kind of undertaking brought to the forefront with the trial of former top leader Bo Xilai in summer 2013, costs money. The cost is in building consensus that is adequate to dismantle a massive patronage network. Since 2012, each economic upturn seems to have gotten some stimulus generated by spurts of spending related to network realignment.

The multiple purposes of the leadership require capital: the system must deliver special benefits to sensitive regions, provide foreign investors with the outside returns that justify the risk associated with investing in China, provide political leaders with the personal gain to which they have become accustomed, and provide the general public with a sense of momentum and hope. The Chinese miracle was in achieving all of these for the better part of two decades.

Now, in the maturing economy, such growth to the benefit of so many parties can no longer occur with the simplicity and certainty it did at earlier growth stages. Indeed, the interests of the parties will inevitably evolve toward competition and even conflict, a consensus observation among experts in economic development. Ideally, institutions will evolve to moderate and mediate competing claims. Absent that, and less ideally, either accelerated real growth must be generated, or, in its absence, at least the appearance and hope must be sustained.

China has generated one or the other by driving up to 70% of its growth with fixed-asset investment, funded by very loose credit. As is well known, to achieve this level of investment, the government has taken every measure to restrain family income growth and keep people from spending their money. One measure of this is the bleakness of life in China's cities, where residents have few cultural opportunities, virtually no public entertainment or sports, and dreary, regimented schools. An under-valued currency for years imposed a tax on consumption of any critical import, such as fertilizer and crude oil. In lieu of such consumption, the government has opted for ever-larger investment projects, most prominently, unneeded housing.

1.1. The lost promise of reform

Deng Xiaoping and the successor government of Jiang Zemin and Zhu Rongji are credited with engineering a peaceful transition from Maoism to an authoritarian brand of capitalism that continues to soften and pluralize and may soon allow the Communist Party to melt away, leaving the world's largest economy and a new social model to emulate.

Indeed, China has transformed economically since the era of Deng Xiaoping, but not as much as it may seem: the concentration of wealth and power has now become the principal threats to the government's continuing peaceful rule. Through more than three decades of the reform era, which was supposed to mark a radical break with the Maoist past, deep, historical China has reasserted itself, and the nation's wealth and social harmony are being sacrificed to the self-enrichment of the political elite.

This comes about because there is no brake on economic power in China, whether in the Ming, the Qing, the Republic, or the People's Republic. In cycles, sometimes quite brief, the economic juggernaut enabled by central power over such a huge nation creates such a groaning imbalance in wealth that the incumbent powers are ousted and a new ruling house installed. It is a great irony of history that the Reformers of the 1980s and 1990s fostered a repeat of this epochal cycle.

1.1.1. The socialist-market economy

1.1.1.1. Multiverses

Embedded in China's autocratic political system is the ability to maintain different sets of rules for different populations or regions, and this framework has been overlaid on the society that Deng and his successors built. China has drawn critical distinctions between what is inside and outside the Great Wall, between the Han and the Barbarian territories, the Foreign Concessions, the Treaty Ports, Autonomous Regions, Open Cities and Special Economic Zones, Friendship Stores (where imported goods could be purchased), designated areas where foreigners were permitted to live/travel/work, and so on, distinctions designed to inject flexibility and discretion into a system whose detailed set of top-down controls would otherwise make simple transactions infeasible. Flexibility is a hallmark of Chinese governance throughout history, because flexibility is the quality that enables complete bureaucratic discretion.

The greatest of all China's modern dualities is Deng Xiaoping's "socialist market economy," a system that provides a wide range of economic tools to achieve desired outcomes: socialist tools for the majority of the population, whose needs are deemed to extend only to adequate food, shelter, and clothing, and capitalist tools for the elite, who are designated procurers of wealth for the nation as well as charmed beneficiaries of the market's largesse. The "market" in the Chinese system represents a carve-out much like the Special Zones or Friendship Stores, a stage on which the best Chinese talent performs for the international markets and captures investment capital.

The stage props are well tended. An analyst once observed that the roads from the airports to the downtown in capital cities are straight in dictatorships, circuitous in democracies. Among the earliest initiatives in China's campaign for investment capital was to build a ramrod-straight expressway from the Beijing Capital Airport direct to downtown, so that visiting dignitaries could be carried in a whisper of speed direct from embarkation to the cool marbled hotels that sit on islands of cynical separation from the Chinese cities around them. Chaoyang, Beijing's embassy district and the

area chosen as the bedroom to visiting Western investors, has been built out with the ostentatious grandeur of a Las Vegas, and foreign visitors always used to remark on how unexpected all the tall buildings were.

1.1.1.2. Vision and reality

The very success of Deng Xiaoping's socialist-market duality in the 1980s created pressure to extend the economic freedoms contained in the zones outside to a few privileged companies, a few more regions, sectors in need of stimulus, until the economic and social growth thus generated outpaced the ability of the existing regulatory apparatus to keep tabs. By the time of the 1989 cataclysm, the party leadership feared that they would ultimately be forced out of power and China could, like the Soviet Union, crack apart. The culmination of this centrifugal force came in the Tiananmen protests and subsequent massacre. In the following years, a shocked leadership believed that the economic experiments could no longer be feasibly contained within the ad hoc structures set up for the purpose, nor could the nation's political system withstand the pressure building from undirected growth.

To save themselves, they began to draft an ambitious restructuring plan that would radically alter the relationship between central and local governments, change the way China finances itself, create a private housing market, dismantle the government bureaucracy, and radically alter the size, scope, profitability, and accountability of the state sector.

1.1.1.3. A brief historical review

After the death of Mao Zedong, it would have taken another god-like leader to galvanize the bureaucracy. The other way to grasp and hold power was to aggregate resources quickly and deliver benefits to a new set of supporters.

To do that, Deng Xiaoping set out to accomplish three things: bring in hard currency to enable imports, create a test-tube commercial economy that would generate wealth more efficiently than the socialist economy but whose freer ways would be segregated from the rest of China, and accelerate investment by devolving a portion of decision-making control.

In *Red Capitalist*, Walter and Howie (2011) recount the story that, when Deng Xiaoping decided to visit the United States, he ordered an inventory of hard currency among all of China's banks and came up with. . . \$38,000. This was very constraining: government officials could not import needed products or travel overseas without more U.S. dollars. Hard currency was a particular prize, because, under the closed capital account, currency earned through exports was the property of the government, not of the companies that earned it, which had to exchange incoming dollars for Renminbi. Therefore, exports for the government were tantamount to building savings that could be used for all sorts of national missions.

The second leg of Deng's tripod was a new set of zones that could more freely engage in trade. He made this non-controversial via the carve-out of physical locations, laws, institutions, and staff who would be dedicated to the new commercial economy, keeping the zones, the people, and the legal system hermetically sealed so as not to disturb the political system. This quarantine expressed itself in the Open Coastal Cities program, the Special Economic Zones, the establishment of foreign staff employment companies to be the employers of record for any Chinese working in foreign-invested companies, and the writing of new laws to govern foreign-invested companies, starting with the Joint Venture Law of 1979.

The third leg was devolution of control over investment decisions to lower levels of government in order to allow money to flow more readily. This entailed improving the incentive system, or allowing managers to benefit from performance, a process that provided tacit approval of corrupt gains from the system. By mid-1980, there were thousands of enterprises enrolled in the "profit retention" plan (Tidrick and Jiyuan, 1987), allowing them to keep 70% of profit and distribute it as bonuses and creating powerful new incentives to increase sales.

These strategies initially worked like a charm. Desultory peasants required to grow rice in unsuited soil turned their land to cash crops like tea and fruit and built themselves houses from the proceeds. Dusty electronics factories sold "shares" to the public to raise expansion capital, unused factories restarted, functionally bankrupt facilities were taken over by their managers and turned into export powerhouses.

The entrepreneurial energy created a burst of growth that benefited just about everyone in China. After decades of a winter diet consisting of cabbage and rice, Beijingers found that exotic southern fruits were appearing in private stalls. Markets appeared where shoppers could pick their own items instead of begging a stolid counter clerk to fetch something they wanted, and no longer was there a single color and single sizes, one for men and one for women. Clothing became abundant and more various. Amazingly, a few birthday cakes appeared, though many days old and with white frosting that tasted like shaving cream. In Beijing, a supermarket opened; local people would put on their best clothes to visit but not buy, as everything was much more expensive than it was in street markets. A few lucky households managed to install telephones. Life improved, in both little ways and big.

What is under-appreciated in this story is the extent to which this wealth spurt was a political necessity as well as a bold leadership choice. Deng Xiaoping, after all, was a capitalist roader, rehabilitated and brought back to Beijing on forbearance. (MacFarquhar, 2011) Among his earliest moves was to visit the United States, that incarnation of bourgeois self-indulgence. When Deng came to Beijing, with him came such figures as Ye Jianying and Li Xiannian, whose relative moderation in the late Maoist era had pitched them against the ruling Gang of Four. This "moderate" faction provided Deng's support, but he also needed support from the highly placed political and military figures who had been pushed aside and even persecuted in more radical times.

The best tool Deng had for securing this support was the economy, and the limited rights doled out in the early years directly benefited these people whom the new Deng government needed. There was a short list of companies, for example, entitled to keep

a portion of their profit for their own reinvestment. Franchises could be handed to military allies in certain special economic zones, and there was more investment capital to be spent at the discretion provincial officials who supported Deng.

The critical tool to enable these benefits was capital, and the principal tool for accumulating capital was exports. Accordingly, the new regulatory regime emerging in the early 1980s focused on creating exports and keeping the resulting hard currency earnings at home.

1.2. Morphing

1.2.1. Amassing capital

China's reform period opened with a policy of export-led growth, with efforts to make exporters more competitive. The system of government monopoly over international trade was relaxed. Companies were allowed to exchange export earnings at an exchange rate more advantageous than the official rate (Prime and Park, 1997). According to the U.S. Department of State Bureau of Economic and Business Affairs (1994), direct subsidies for exports were notionally abolished in 1991, but policy support for exports continued to be aggressive, with reduced taxes and easy approvals, subsidized facilities and utilities, and cheap loans all readily available. Strenuous encouragement of foreign investment gradually turned China into the largest destination for foreign direct investment (FDI) in the world, with US\$61 bln in FDI in 2004. The great majority of those capital inflows have come from Asia, mostly Hong Kong, Taiwan, and Macao, although FDI has grown more diversified—and more focused on China's domestic economy—since 2002 (Whalley and Xin, 2006).

As a result of these preferential policies, FDI for many years has been largely focused on the export economy. By 2005, foreign-invested enterprises employed only 24 million workers out of a total workforce of 752 million, but they accounted for 58% of exports in 2005¹ and 60% of imports as well as 30% of industrial output (Stevenson-Yang, 2007). Much of the export growth was accomplished by displacing export facilities from other countries in Asia. According to UN Comtrade statistics, between 1993 and 2005, China's share of Asia's global trade went from 11% to 35%. Meanwhile, Japan's share declined from 42% to 25% and Taiwan's from 12% to 8%.²

Taiwan and Hong Kong have played a critical role, particularly in higher value-added exports. Cultural and geographic proximity made it easy for these smaller, flexible investors—many of them actually subsidiaries of mainland companies seeking to invest under more favorable rules—to establish businesses in China that meet an emerging market standard distinct from the standards that prevail either in domestic Chinese or Western markets. China's current electronics sector represents a displacement of Taiwanese capital and know-how: by 2002, 70% of China's electronics were being made by Taiwanese-invested factories, while Taiwan's own IT industry had been largely “hol-

1. OECD: “China: Open Policies towards Mergers and Acquisitions,” Paris, 2006, Annex, Table 9.

2. Daniel Rosen: “Geographic Composition of Asia's Trade”

lowed out" (Chase, Pollpeter and Mulvenon, 2004). As early as 2001, Jiangsu Province in the Yangtze River Delta area, the focus of China's IT industry, had displaced Guangdong as the principal destination for Taiwanese investment, which has increasingly focused on the electronics sector (Chase, Pollpeter and Mulvenon, 2004, p. 58).

Over the last 15 years, China has also been gaining in its share of exports of higher-value goods to Europe and the United States. Between 1990 and 2003, China's gain in exports of electronics to the U.S. market went from 3% to 18% of U.S. electronics imports (Dussel Peters, 2005). China in the late 1990s assumed its current role as "factory to the world." By 2004, China manufactured 40% of the world's notebook computers, 50% of the world's displays, 30% of the air-conditioners, 50% of the cameras, and a staggering 90% of the DVD players in the world. Exports continued to grow on the strength of radically low prices. Chinese-made DVD players can be had for as little as \$20. Exported automobiles can cost \$6,000. There are \$15 microwave ovens, \$25 inkjet printers, and \$300 laptop computers.

1.2.2. Special zones

In order to expand investment and exports as rapidly as possible without undergoing the uniform regulatory change that would otherwise have been necessary, starting in 1980, China began establishing special zones to which accrued various policy benefits, usually including reduced income taxes, reduced tariffs or product taxes, improved infrastructure, cheap land, and streamlined bureaucratic approvals. In most cases, the special zones are operated by newly incorporated entities that act as local government agencies under delegated authority. The zone managers, who hold civil service ranks, are advanced or rewarded on the basis of meeting short-term bureaucratic targets, and those targets to date have focused on the scale of capital investment and gross tax revenues. No government agency has made an accounting of, or created accountability for, the profitability of the zones by looking at total spending versus total revenues. The author's work points to huge public expenditures on capital infrastructure and tax breaks that are of doubtful value to the Chinese public..

1.2.3. Limited privatization

At the start of the reform period in 1979, Chinese business was directly owned, financed, and managed by government agencies. The following twenty years saw the government devise a series of mechanisms to shift business to independent management and private participation, while government agencies retained the levers of ultimate control: they stepped back in order to realize higher benefits and in the process, handed out limited franchise rights to private parties to participate in the wealth they would create.

Diverse mechanisms were deployed: in one common strategy, ministries contracted out ("chengbao") the operation and financing of state companies to private parties, who undertook to pay all operating expenses in return for the right to keep profit. Starting in

the late 1980s, government-owned investment funds were established to finance companies and receive the rights to cash flows without directly managing. The “limited by shares” corporate structure permitted mixed public and private ownership. Bureaucratically imposed mergers enabled losing companies to benefit from cross-subsidization by profitable ones. Under all these diverse formats, political leaders and government institutions retained a high degree of control over an economy that ostensibly was privatizing.

1.2.4. Repressing consumption

In order to ensure that the new export earnings would be available to the government to spend, China had to repress consumption. This was done in three ways: by control of the currency, control of residence rights, and disallowing private capital in the non-tradable goods and services sectors, such as health care and education, which make up a large portion of private spending in liberal economies.

Among the most powerful mechanisms of spending repression is the household registration or “hukou” system, which has been instrumental in keeping capital earned in the export economy from seeping into the development of education, the health system, environmental preservation, and generally a service economy that would have attracted more spending by individuals.

Hukou has two parts, one designating a person’s classification and the other his or her location. The classification divides citizens into rural and urban, with the rural population enjoying inferior access to all sorts of services, from pension, schooling, and health care to eligibility for a bus pass or ease of getting a passport. The system is a holdover from the old system and implicitly assumes that people in rural areas are self-sufficient while the state must provide housing, food, and services for the urban population. (Chan and Buckingham, 2007).

To this day, the system has not fundamentally changed; only its enforcement has become more lax, while many of the benefits of urban life are now available for purchase on the open market. But any brush with the bureaucracy—getting a job, licensing a car, getting a telephone, opening a bank account—requires a hukou. Hukou has been critical in ensuring that the coastal factories built during the first twenty years of reform were staffed by seasonal workers who did not move permanently to cities. The exporting cities and the factories they contained were built around ports, and the workers they hired came from the inland. In some cases, the exporting zones, like Shenzhen, were chosen specifically because they were empty, with very small native populations. By the late 1990s, China had a “floating population” of about 250 million, who move to the exporting cities, live in dormitories, eat in company facilities, and save their money to send home. Many factories do not permit the workers to leave factory premises during the workweek, which is generally six days.

The government has been unwilling, to this day, to enable these people to take up permanent residence in the cities where they work. Permanent residence would have meant spending on housing, schools, medical care, and financial services, but such spending would have undermined the key political goal, which was the accumulation of capital by governments.

While there has been spillover wealth in the inland villages that sent workers to the coast, overall, the seasonal workers in the export facilities have realized a meager portion of the proceeds of their labor; workers have realized in wage growth only about half of the productivity gains that sped GDP. (Pettis, 2013) In the 1990s, the labor share in GDP declined. As output grew, the benefits reaped by the Chinese people shrank as a proportion of the growth.

And so the export explosion meant an unprecedented accumulation of capital for the central government. On one hand, this accumulation has enabled China to invest in a phenomenal capital infrastructure. On the other, the lack of spending options has meant that a higher and higher proportion of people's savings have been salted away in the banks, which erode them through non-remunerative government investment programs.

1.2.5. Proliferating businesses

Key to the economic development that took off in the 1980s was the devolution of decision-making to lower levels of government, with less oversight. This had two effects: it accelerated the economy and it also created windfall earnings for the new government's allies. In the meantime, the growth of government agencies lagged the proliferation of commercial entities, such that regulators had to move back from direct, micro management of companies and find principles of governance that would allow a smaller number of people to regulate more companies.

In the mid-1980s, the government experimentally relaxed rules that specified the crops that had to be grown in specific regions and permitted the growing of cash crops, which could be sold through emergent "free markets." Entrepreneurial businesses started in the coastal provinces, without clear property rights, but with sufficient support that they virtually exploded: the output of rural industries increased by 26% every year between 1979 and 1987, and rural incomes grew by nearly 12% annually in real terms (Tsai, 2007). People who had been doing subsistence farming were able to raise capital and start or take over existing small businesses to make garbage bags, bras, snack foods.

Some provinces adopted the new, more entrepreneurial systems with lightning speed. According to Huang Yasheng (2008), by the end of 1981, 98% of the households in Guizhou Province had adopted agricultural contracting, meaning they signed a contract to farm a particular plot of land (rather than join in a team farming collective land) and guaranteed delivery to state procurement offices of a fixed amount of grain, while they could sell the surplus for cash. Contract farming had become nearly universal by the end of 1983, causing grain production to surge. (Naughton, 1993). Farmers started to use their free time to work at small businesses.

This was mostly a coastal phenomenon, and regions varied: in some, the new entrepreneurial businesses were allowed to grow unimpeded. In others, there was a good deal of bureaucratic interference and control.

Disorderly growth: the print media

By the early 1980s, the economy was running on a dual-track system: many commodities and companies continued to operate within the government's plan; the prices of a few commodities were permitted to rise, and private businesses could sometimes sell them. "Free markets" popped up, outdoors stalls that offered goods unavailable through the state stores, at higher prices.

Because this de-control process was spreading to a wider range of categories, there was ambiguity around what was and was not permissible. Many companies continued to enjoy the security of being "in plan" but could also augment incomes through the "free market." Naturally, everyone wanted to try a hand at creating a cottage industry within the confines of a state company or a secure government job. There was inexorable pressure for the free market experiments to expand in scope.

The planning system could not always keep up with this growth. Raw materials could not be appropriately allocated, staff were in short supply, and money came up short, as the government had to shift from expropriation of all company proceeds to a tax system. In many industries, the bureaucracy simply could not keep up. If a company wanted to open a higher-price dining hall for employees, for example, it might be permitted to do that as long as it did not demand in-plan supplies of food and cooks assigned to work the kitchens.

As funding weakened, so did regulatory oversight; the ministries had no choice but to step back, and this retreat in itself enabled businesses to grow. The computer company Lenovo, for example, started around the loosening of restrictions on distributing and maintaining computers, a service the original Legend team performed for IBM computers. The print media provide another example of how small new incentives led to wild growth that challenged the system.

Media today have come a long way from the 1980s, when daily newspapers were posted in glass cases on the avenues to be read by passers-by, since the post office could not deliver them on time. Official newspapers, bought by mandatory subscription by all government companies and organizations, were generally brief and contained didactic editorials about issues distant from the average person's life, like the visit of an African state leader or the agricultural achievements of a certain locality. Protocol was obsessively observed: the first 500 words of a report on a national celebration would list all the officials who attended in order of rank, attaching all their titles, and would contain hints about the current political standing of the leaders so subtle that combing the grammar and usage for such hidden comment became a national pastime. Newspapers formed the syllabus for Saturday "study groups" at all domestic organizations but were not considered recreational reading.

Today, portions of media content are delivered from the Party's Propaganda Bureau and retain this character, but not all.

The first phase of media growth came in the early 1980s, as subsidies were being gradually withdrawn. At the period of highest growth in about 1984, a new

newspaper appeared roughly every four days. Over the decade of the 1980s, the number of China's newspapers grew from 186 to nearly 2,000, magazines from a few hundred to more than 7,000, TV stations from about 700 to around 9,000, including more than 5,000 cable networks, many of them run by state-owned companies or housing compounds.³

The easiest way in the early 1980s to go into business was to do it under the wing of the government. The period from 1980-84 saw huge growth in the publications sponsored by government ministries, a class of publications that enjoyed relatively little ideological and Party oversight and that were supposedly limited to "internal" circulation within the ministry--although in fact they circulated like any conventional magazine or newspaper. Ultimately, the central government grew displeased and commissioned a survey of publications by People's University in 1986, concluding that most new publications should not be on the government tab, and cut off subsidies.

The withdrawal of funding unleashed an era of intense media competition. Publications grew in size and variety and began to seek more muscular distribution strategies. Quasi-legal distribution organizations grew up on the city and provincial level to compete with the Xinhua chain and the postal system. Star journalists, like Liu Binyan, emerged on the staffs of prominent dailies. A commercial advertising market was emerging, but circulation was the most important driver of revenue. Competing for circulation, newspapers and magazines began to write about divorce, shoddy products, and the plight of the average Chinese faced with job competition and government layoffs.

The liberalized content was a challenge to the Party, which was concerned that it maintain control over the flow of information. Even more challenging was the weakening of the state's distribution monopoly. Door-to-door delivery was a channel for political communication that made the government extremely nervous.

The post office has always had a monopoly on delivering periodicals, and it collected between 35-40% of the cover price of a magazine or newspaper from the publisher as its distribution fee. But the post office grew less and less efficient in the new publication world: publications got heavier, rural distribution more onerous, and the cover-price proposition grew less attractive.

Gradually, urban-based publications began establishing their own networks, by poaching postal employees while simultaneously shoring up support from competing bureaucracies. In 1996, Beijing Youth Daily established its own distribution company, Little Red Cap by hiring members of the Post Office Publication Distribution division at high salaries and having them set up a network. Red Cap reached agreement with the Bank of Industry and Commerce to have subscription fees accepted at any bank branch, which solved the problem of consumer trust and took the financing stream out of the hands of the Post Office. The model was replicated around the country.

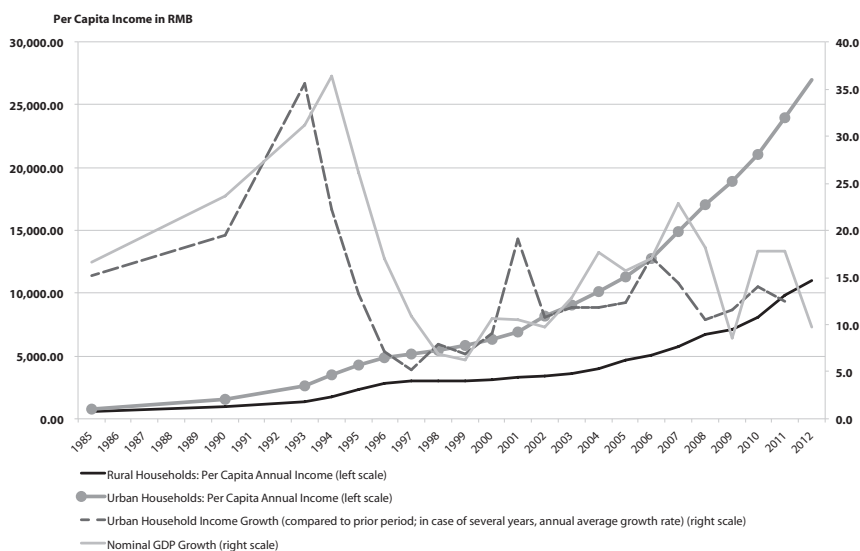
3. Universal McCann

By the end of the 1980s, then, economic reforms had engendered a regulatory shift, from direct, pre-publication content control to after-the-fact penalties for offensive content. Instead of having all periodicals delivered by one, reliable bureaucracy, newspapers had their own delivery crews. Some of these delivery teams had started delivering advertising, commercial samples, and even surveys. This sort of direct access to individuals, without the mediation of a party organ, was new in the system and very challenging.

This disorderly growth of businesses and opportunities is what made life in China in the 1980s exciting. People who had been drivers or repairmen suddenly made more money than anyone had ever imagined possible. People who would otherwise need to spend decades working to gain authority in state industry were being offered responsible jobs at high salaries. It seemed that anything was possible. At the same time, the hybrid economy created arbitrage opportunities, corruption, a sharp divergence of opportunity for people with connections to the state versus those without, and bursts of rapid inflation.

For a time, household income grew much faster than GDP, and consumption also grew as a proportion of GDP (Chart 1).

Chart 1.
Household Income and GDP Growth per Year



(1990-1998)

Source: Wind Data, NBS

Before 1980, companies had virtually no discretionary financial resources. The profit-retention system instantly altered the incentives in industry but also dropped government revenue sharply, as there was no change to controlled prices. As companies kept more of the proceeds of their effort and gave less to government, property rights remained vague and shifting, creating more incentive to exploit state property for private gain.

Meanwhile, as government revenue fell, the economy became more firmly tethered to capital investment as an engine of growth, relying more on the banking system as its key utility, to drive investment capital to the industries and regions it deemed most advantageous.

1.3. Tiananmen's challenge to stability

The story of the Tiananmen rebellion has been well told. Less understood are the profound and lasting effects that this failed revolution had on the country's political economy over the next decade.

The economic expansion starting from 1980 had engendered a series of crisis points, each of which represented a threat to the progress of the reforms. In a brief few years, Chinese urban society had developed the tools and communication channels for political protest. The breakdown of state planning belied the hope that the Party could contain the capitalist portion of the economy separated from most of Chinese society, like uranium inside a lead box. Instead, the private economy was growing tendrils, spreading outside its designed limits, creating the basic circuitry of a civil society.

First was the reaction within the Party against the new ideas being disseminated by virtue of increased contact with other nations. The autumn 1983 Campaign Against Spiritual Pollution, revived in 1988, was designed to demonstrate the Party's disapproval of the capitalist system as a whole and show that capitalist instrumentalities were mere tools to be deployed for socialist ends.

One of the stranger signs of social ferment was the qigong movement that reached a peak of frenzied adherence in 1987. Masters of this loose collection of Buddhism-descended meditation techniques filled stadiums and healed the sick, won converts, or drove people into trances or bouts of paroxysmal joy much as the revival meetings of evangelical churches do now. Work organizations organized classes in qigong. Schools sprang up and sold home-instruction tapes.

Few movements could have been more unnerving for the ruling party, aware, as it was, of how many dynasties of the past were overthrown by rebel groups led by mystical religious sects. In 1988, the qigong masters were repressed.

Around the same time, the arts were flourishing. There was a new "wound" literature, expressing the hurts of the Cultural Revolution. Independent painters, formerly limited to propagandistic murals, showed abstract art. Dance parties were held on college campuses. Poets of the new "misty" (Menglongshi) style traveled to give readings. College students held marches; social unrest emerged.

Even more politically combustible than the mass rallies around qigong masters was the inflation generated by the investment surges in the 1980s, because this inflation ex-

acerbated the economic inequalities that had already become so glaring. Each time the government attacked the inflation by pulling back on investment, the austerity measures inevitably hurt some bureaucratic interests.

Two days before the military attack on civilians in and around Tiananmen Square, according to *The Tiananmen Papers* (Zhang et al., 2002), Deng Xiaoping's inner circle, in deciding to use deadly force against the students, told each other that "capitalists" were plotting to undermine China's progress. The documents record Li Xiannian, the chairman of the CPPCC and one of the staunchest allies of Deng Xiaoping, declaring:

Western capitalism really does want to see turmoil in China. And not only that, they'd also like to see turmoil in the Soviet Union and all the socialist countries of Eastern Europe . . . China will lose all hope if we let turmoil have its way or open the door to capitalism. The nature of this turmoil is extremely clear: Its bottom line is death to our Party and state.

Deng Xiaoping agreed with all and added:

When the West stirs up turmoil in other countries, in fact it is playing power politics—hegemonism—and is only trying to control those other countries, to pull into its power sphere countries that were previously beyond its control . . . This turmoil has taught us a lesson the hard way, but at least we now understand better than before that the sovereignty and security of the state must always be the top priority.

Peng Zhen, the retired mayor of Beijing and revolutionary war hero, added a note that would be echoed over and over and remains a frequently stated justification for party rule today:

This month or more of turmoil lets us see how important stability is. Stability is the crucial issue if China's going to shake off poverty and get to the Four Modernizations . . . We had no real choice about martial law.

These views would shape the policy that emerged in the aftermath of Tiananmen.

Chapter 2:

China's Gilded Age

2.1. The 1990s

Tiananmen demonstrated the flaws in the political leadership's belief that they could quarantine foreign trade, foreign investment, and private business from the majority of Chinese society, reaping benefits in income growth without having to change internally. The commercial experiments had made incursions on Chinese society, generating destabilizing levels of inflation, rapidly altering the social status of men and women, young and old, encouraging crime and conspicuous corruption. The political leadership was loath, however, to give up benefits that the pre-Tiananmen economy had made possible.

Understanding that the economic reforms were impelling social and legal changes, the leadership determined that the Party itself should be the architect of social change. This would ensure that the Party maintained its control and reaped the benefits of economic gain. Party elder Chen Yun had said that China could tolerate a free economy within the "birdcage" of the socialist structure; the post-Tiananmen government, led by Jiang Zemin and Zhu Rongji, then set about designing the cage.

Premier Zhu almost single handedly cut through bureaucratic resistance. Between the reforms of 1993 and 1998, he managed to cut the government bureaucracy in half, privatize housing, sell off about two-thirds of the companies in the state sector, unify the currency, impose a new, nationwide tax system, bring most banks directly under central government control, get visibility into Customs tariff collections nationwide, and capture authority over all major provincial-level appointments, while also smashing the biggest smuggling ring in history.

The step-by-step dismantling of the Chinese socialist system was thrilling. It was also key to capturing surging FDI flows and the initial public offerings that fueled the Chinese economy's phenomenal growth in the early part of this century.

The alterations took place within the context of a living political system and adhered to its shape. Government bureaucrats could not simply be laid off: they were moved into business associations that had been hived off the ministries. Local governments were not going to give up their revenue and authority: compromises had to be made. SOEs would not simply be hacked apart and sold for their assets: they often bore responsibility for their employees' health care, housing, education, and pension, but commercial buyers did not want to fund these liabilities.

Overall this was a chaotic period, and reform detractors, who were gaining support, started pushing to retract them and return to a more Maoist way of governing. Only Deng Xiaoping's endorsement was able to legitimize and consolidate China's reform path.

2.1.2. Deng's tour

In the spring of 1992, Deng made a "tour of the south," bestowing his support and approval on the private-economy experiments in the special zones his own policy had established.

Perhaps the most important signal Deng sent on his southern tour was to the military. Deng had used his personal capital and his position as chairman of the Chinese Military Commission to extend deep reforms into the military, professionalizing the corps, improving access to new technologies, and demobilizing a million men and women in uniform. At its height in the 1980s, China's People's Liberation Army (PLA) operated 20,000 enterprises (Mulvenon, 2000). The Deng government had a stated intention to reduce the number of armed forces and hive off some of the businesses that were sapping the attention and resources of the PLA.

In 1985, the government announced its intention to demobilize one million members of the armed forces; already, about half a million had been demobilized since 1982. The program was accompanied by a large military-to-civilian conversion program for people, companies, technologies.

As the economy restructured by half measures, and the military started spinning off businesses, many soldiers lived in a gray zone between military and commercial employment, holding on to the security and status of the military, earning an income in related businesses that had been spun off but depended on the military for contracts and resources.

Shenzhen, a city created by Deng Xiaoping and managed by his close allies, was a listening post for Hong Kong, then independent and just steps away. As such, the city held communications stations and R&D labs, which easily spun off to become technology companies with reliable military procurement contracts coupled with the exciting growth prospects of the private economy. This was the environment in which, in 1985 and 1988 respectively, ZTE Corp. and Huawei were established.

After Tiananmen, the future of companies like these came into doubt: was it legitimate for armed forces personnel to be involved in these commercial businesses? Would the military reclaim them? Cut them off?

The visit of Deng Xiaoping, a genuine war hero, to Shenzhen and other southern cities was designed to send a signal to the military: the experiments could continue. Hybrid was okay, windfall profits were okay, as long as it worked economically.

With this trip, Deng coalesced a consensus around the continuing bifurcation of the economy into "strategic" portions that should continue being managed by the state and "commercial" companies, which, like plots of land, individuals could manage under contract. He managed to strike a balance between those who would have retracted the economic experiments of the 1980s in favor of recapturing firmer control and those who would have democratized the system.

Deng's trip to the south strengthened the "reform" faction. It also affirmed to the ruling elite that using capitalist tools within the socialist economy could be extremely lucrative. By 1993, China started allowing state-owned enterprises to list in Hong Kong, bringing in new windfalls of cash at notional valuations that included the value of state-

owned shares that could not be traded. The experiment with venture capital, started in 1987, had expanded the commercial horizons of government officials. The tentative separation of bureaucratic from financial authority in the 1980s, when the State Planning Commission tentatively began to fund companies that it did not directly own and manage, held out a path to ownership for bureaucrats who managed funding decisions.

The Tiananmen protests occurred during a visit of Mikhail Gorbachev to Beijing, and the subsequent disintegration of the Soviet Union served as a palpable reminder of what might be in store for China. The reform coalition around Deng had been tentative and fractious enough; the threat posed by Tiananmen dramatically undermined the loose and experimental nature of his reforms, yet the profits that the new economy promised to deliver directly to individuals were key to maintaining a consensus around economic restructuring. The political consensus was built on the promise of gain, and this set the stage for the emergence of China's current elite.

2.2. Rise of the blooded elites

The reforms that began in 1979 had always been intended as transitional, a necessary historical stage on the road to communism. The endpoint being undefined, representing as it does an indefinite ideal future, the measures to be taken to promote this transition must be discretionary and ad hoc. Experimental intervention in the economy, portrayed as a test or pilot, is actually standard operating procedure, allowing the political leadership ultimate discretion over what economic measures are taken and when they might be reversed. In the 1990s, Chinese bureaucrats often described the legal system as "incomplete" and commented that China had not yet had time to write enough laws. This was true enough, because China's was and is a discretionary system, critically dependent on the judgment of a political elite.

China's government has always been unitary, with no sharing out of power among landed nobles, the church, or other estates. In order to govern such a large territory, emperors granted monopoly concessions to loyal retainers but also withdrew the concessions when the retainers became politically threatening. State monopolies on salt and iron some 2,000 years ago form the most-discussed examples; rights to iron and salt were constantly being handed out, rescinded, or redefined. Granting a commercial fief to a trusted associate was an efficient way to receive tax income and control the use of technologies as well as access to resources by enemies. The emperors, however, did not permit the emergence of power centers that would compete. So it is in modern China. Contingent rights over business suit the Chinese economic system and indeed Chinese culture. As the economy has grown, limited monopolies have been granted to the elite, trusted because they are insiders but not actually government officials with the patronage requirements and the obligations that would go along with government office.

The hot, molten core of the political elite circulates through the most influential positions in both politics and business. They grow up in the same neighborhoods, go to the same schools, send their children to the same foreign boarding schools and universities, are cared for in the same hospitals. In a system where the government owns or wields

decisive influence over all large businesses, political and economic powers are inextricable. China's millionaires enjoy a level of conspicuous consumption matched only by the most decadent of dynasties of the past.

It makes sense, then, that economic transition has been guided not by laws but by provisional and tentative policies susceptible to revocation, requiring a high level of trust in the individuals who carry out the policies. The economic players whose interests align most perfectly with those of the political leadership are the sons and daughters of the revolutionary generation. They became investment bankers and corporate leaders, with the personal connections to provide an implicit guarantee of gain for stakeholders in the absence of property rights.

2.2.1. Neither State nor private

The children of the Long March generation were instrumental in sewing sprawling local offices of state-owned entities, as fundamentally noncommercial as post offices or public parks, into conglomerates that could IPO, and the process of corporatizing China has largely been one of transferring State assets to trusted individuals in order to devolve without surrendering State control. This made the economy not State not private, but an indeterminate "transitional economy," which in itself would make no sense outside the context of personal political control by the nation's rulers.

The power of China's millennia-old taboo against making light of the imperial family is so strong that colleagues are loath even to say the names of the "princelings" out loud. The power of the super elite relies on implicit, unstated influence, whose power rests on its indeterminate nature. That is because lateral communication in Chinese bureaucracies is weak and relatively minor decisions must go very high in the political system before two different government organizations can agree. The role of elite figures is to break down barriers among institutions. Now that the country has moved from total government control of industry to a hybrid system of state-private ownership and management, government agencies' control over companies is more diffuse. Bureaucrats are even more preoccupied with their need for trusted ambassadors who can pull back the corporate veil and assure them that their interests are being protected.

2.2.2. Breaking monopolies

By virtue of being trusted by the system but external to it, the red elite has played a pivotal role in effecting systemic change by breaking bureaucratic monopolies, a task that could have been accomplished peacefully only through the intercession of these trusted elites. In defense industries, for example, the children of Deng Xiaoping oversaw the formation of an independent military-industrial complex that creates better technologies and makes more profit than the armaments factories captive to the Ministry of Defense ever did. Diversified conglomerates like China Poly Group Corp., long chaired by Deng's son-in-law He Ping, are an example.

In finance, the “red capitalist” Rong Yiren, a close friend of Deng’s, was given the charter to break Bank of China’s monopoly on hard-currency banking and formed the China International Trust and Investment Corp. CITIC, progenitor of many financial institutions today, has enriched three generations of the Rong family as well as many in Deng’s own family and that of one of his strongest supporters, Long Marcher Wang Zhen. Wang Zhen’s son Wang Jun, China’s “father of golf,” was longtime chairman of CITIC.

The son of former Premier Zhu, Levin Zhu, sat at the head of China’s first investment bank as China systematically listed its state-owned companies overseas. Deng Nan, Deng’s second daughter, together with the daughter of Long March veteran Chen Yun created China’s first venture capital fund, Venturetech.

In electric power, the children of former Premier Li Peng helped drive a new breed of independent power producers. In telecom and high tech, former President Jiang Zemin’s older son, Jiang Mianheng, established companies that broke the duopoly held by China Mobile and China Telecom, and he also seeded and supported a sprawling empire of companies in software and semiconductors.

In a sense, Deng’s moderate group of allies became the new “old money” class in China. Deng ally Marshall Ye Jianying, though he died in 1986, lived long enough to ensure that the ultra-wealthy Ye family to this day dominates a sprawling empire in banking and finance, travel, property, and weapons.

In using influence to create special concessions in the state-run economy, this red elite also spurred innovation and competition for the sclerotic national leviathans that had been created to monopolize banking, trade, telecommunications, and manufacturing. Each fissure in the top-down, command-control system ultimately created *entrée* for others, and, as the economic system cracked and started to drift free, enormous social change ensued. By pursuing their self-interest, China’s super-elites have become tools for growth, innovation, competition, and massive privatization of the Chinese economy. The children of the Communist revolution dismantled Communism.

Shanghai Industrial Investment (Holdings) Co. Ltd. (SIHL) exemplifies the increasingly complex nature of public ownership in China. The company was incorporated in Hong Kong in 1981 by the Shanghai municipal government and subsequently listed four subsidiaries on the Hong Kong exchange. SIHL’s subsidiaries sprawl across logistics, information technologies, real estate, food processing, agriculture, auto parts, retailing, and semiconductors. The company has three investment funds and numerous joint ventures with foreign partners. The company’s executives and share owners are all former political appointees to the Shanghai government.

Certain well-connected individuals enjoy wide-ranging beneficial attachments to business in China, even when they do not have formal ownership positions. Nepotism is functional in the Chinese system of unsecured and poorly defined property rights; the involvement in a business organization of the son or daughter of a political leader can reduce political risk by staking the political leader in securing the business’ property rights. Moreover, the ambiguity of the nepotistic connection can be positive, because the connected person is not positively associated with any one bureaucratic organization and its objectives and personnel. Such an ambiguous elite figure can be a dark-horse negotiator, outside the usual bureaucratic turf battles and yet with the burnish of power.

The superfluity, and the political risk, of overt equity stakes for the politically connected is illustrated by the frequently used tactic of using a proxy to hold shares or position, a tactic that has been well documented among the families of political leaders.

2.2.3. Sharing out ownership

The political and corporate elite had begun to emerge in the early 1980s, as more independent corporate structures were created to enable growth. Perhaps the earliest experiment was masterminded by the Chinese Academy of Sciences (CAS), the government's basic-research arm. CAS secured provisional funding from the State Planning Commission so that it could realize commercial benefits from its technologies by spinning off companies. The corporate strategy birthed Legend Holdings, the parent of Lenovo, as well as Kejian, Hope Computers, and a dozen other companies.

Not long afterwards, the Science and Technology Commission, predecessor of the current Ministry of Science and Technology, formed the VC fund Venturetech, which then uniquely provided funding for companies unfettered by the controls of the parent ministries. Venturetech helped break the link between industrial planning and financing, permitting far more flexibility in business and opening the door to new forms of ownership, and led in a direct line to the establishment all over the country of venture funds directly owned and managed by local governments. These funds, which derived their capital from direct fiscal allocations plus bank borrowings, led to a decade-long spending spree interrupted briefly by the Tiananmen rebellion but resumed following Deng Xiaoping's tour of the south in 1992.

At the same time, China was developing its first stock market and was also packaging its greatest state monopolies to raise money on public markets. The stock markets promised access to capital without the strings foreign direct investors attached, and they promised capital gains of a scope not previously imagined.

2.3. Dismantling State industry

Two very different personalities managed China's government in an uneasy truce through the 1990s. Although contemporaries, born in the mid-1920s and with similar educations, Li Peng and Zhu Rongji temperamentally and intellectually belonged to different eras. Li Peng was philosophically and politically an autocrat but in management style, an easygoing leader happy to support the free spending of provincial leaders. A true child of the revolutionary era, he was orphaned as a small child and adopted by Zhou Enlai, growing up in the halls of power. Li is a hydraulic engineer by background.

Zhu Rongji, abrasive, forthright, loved by the public and disliked within the bureaucracy, served under Li as vice premier in charge of the financial system, overseeing banking, currency, and taxes, and took over as premier when Li Peng reached retirement in 1998. Indeed, Zhu's most stunning reform of the old industrial companies came in 1998, as Li retired, and it was in 2001 that he managed to engineer China's entry into

the WTO, a watershed for the perceived openness of the Chinese economy. The equally bracing reforms of 1993 focused on the areas of finance, monetary policy, and taxation in which Li had little understanding or interest.

The new for-profit companies competed on an uneven playing field with state industry. For the portion of China's workforce who worked off the land, employers provided pension, healthcare, housing, children's education, even funeral benefits and haircuts. There was no system for transferring benefits, and consequently, employees were not free to leave their employers. At any rate, work organizations had responsibility for political education and generally for the moral formation of their staff. They were empowered to send their employees to prison camps called "reform through labor" for up to four years. This system made labor mobility impossible and burdened the state with high legacy costs.

Under the new contract system, managers naturally left the costs with the state and found ways to move the profits into the "responsibility" system. Asset stripping, in other words, became the logical course of action for anyone in the hybrid system. Meanwhile, subsidies expenditures had ballooned, as the government tried to cushion the transition to a market economy.

In the early 1990s, the government began addressing these growing imbalances by framing a social security system. Its first leg was the 1995 Labor Law, which required local governments to create pooling funds for pension, health, unemployment, maternity, and disability, with the idea of gradually moving factory welfare funds to city-supported pools that would enable companies to go bankrupt without leaving current and former employees with no income.

The driving goal was to unburden the government of subsidies to industries and to allow the state to separate itself from money-losing companies. Once an independent safety net had been established, the State was able to keep the profitable and sell the money-losing companies, in a policy dubbed "grasp the large, release the small." Brokers set up shop to help state enterprises spin off non-productive assets like hair shops and canteens and closed-circuit TV systems into separate companies that would be left behind in the purchase. Cities established exchanges and held auctions, and cashed-up private companies from the southern coastal areas, who had amassed cash in the exporting industries, flocked to the auctions.

With this foundation established, the Zhu government embarked on an ambitious sell-off of rust-belt companies, resulting in the 1998 lay-offs of around 50 million people from state industry. The buyers of the old state companies had to pay compensation fees set by the local governments that were designed to fund pensions for the workers, most of whom receive significant pensions to this day. Retraining centers were established, and many of the laid-off workers remained technically employed, drawing a basic salary and social security benefits, while still free to find jobs on the private economy, driving taxis, selling things in markets, working at night schools and as guards at warehouses. The late 1990s showed significant dissatisfaction, including protests, but the economy was growing fast and the political culture was resilient, and China got through it successfully.

Two enormous initiatives framed the restructuring of government and industry into a more centrally coordinated apparatus. The first, in 1993-94, restructured the financial,

taxation, currency, and banking system and came with associated “informatization” programs designed to provide the central government with better oversight. The second, from 1995-98, was designed to create a new economic structure; it sold off the money-losing companies, created new legal structures that would arrogate far more power to corporations, and established a private housing market.

2.3.1. 1993-1994: Reforming the financial system

Two key problems had urgently to be addressed in the early 1990s. Government revenue had tumbled, from about 31% to about 11% of GDP between 1978 and 1996 (Wang, 1997), and showed no clear path to a return. Meanwhile, many of the privileged could arbitrage the porous barriers between the two halves of the dual economy: production in plan versus “surplus” production, Chinese versus foreign currency, companies that could retain profit versus those that could not, “open” cities, with the right to engage in foreign trade, versus the rest of China.

Among the great dualities of the Chinese system was the dual-currency system, Renminbi, which means “the People’s Coin,” for the masses, and Foreign Exchange Certificates, or FEC, for foreigners. By 1993, one dollar could buy about 8.7 RMB in China’s informal “swap markets,” while one FEC bought only 3, even though the RMB and FEC were theoretically interchangeable for purchases in China, the difference being that FEC were required for the purchase of imported goods. Foreign nationals were not permitted to use RMB. Fortunes were made in arbitrage between the currencies; those associated with the few companies that had the legal right to engage in international trade could profit massively from earning dollars and trading them in the swap markets for RMB.

Then there was the tariff system, designed to protect the Chinese market and hoard hard currency, encouraging massive arbitrage. Tariffs were prohibitive: 300% on the import of an automobile, 230% on soybean oil, and 100% on garments.

In a single stroke, on January 1, 1994, Zhu unified the currency at the lower, RMB rate and redesigned the tax system, also setting a precedent of tariff reductions that would be implemented at the start of each new year. Tightening the central grip on banks would not come until 1998.

2.3.2. Tax reform

The least dramatic of all the policy shifts was ultimately to have the deepest impact, the tax reform. This recalibrated how the central and local governments divided taxes. Previously, the sharing had been negotiated annually, but after 1994, the central government established its own offices to collect taxes directly, while local governments collected theirs, with shared taxes collected by the center and remitted back to localities. Additionally, the central government imposed a Value Added Tax on all purchases, with a 75% cut of receipts going to the central and 25% to the local governments. Over time, this VAT grew into by far the largest source of government revenue, dwarfing the income tax.

Initially, the central returned to local governments significant payments, such that their revenues would not change much, but, over time, the system beggared the local governments. The central portion of revenues grew while the local portion stagnated. This was exacerbated by shrinking corporate income tax revenues: once companies no longer had to turn over all their cash to their supervising government agencies, there were many methods and plenty of incentive to show little profit. Meanwhile, the central authorities restricted the ability of local governments to offer tax discounts for big projects.

The system designated 75% of taxes for the central and 25% for local governments, but “local” was not defined: China has five levels of government, and, as taxes trickled down through the levels, the last two or three were left with very little. Yet these were the governments tasked with paying for everything of importance, from schools to hospitals, water systems, roads, power plants, and welfare programs. The lowest-level governments were also least equipped to handle these tasks in terms of the educational level of the officials, their experience in managing budgets, and the resources they could command. By the mid-1990s, schools generally received only half their budgets from government payments and had to find income for the rest. (see Du and Sun, 2009 for elaboration)

In the early years, local governments simply borrowed the money they needed. But in 1994, the Budget Law barred local governments from borrowing or from running deficits. Local governments were not permitted to raise tax rates or impose new taxes. They imposed a blinding array of “fees,” but these were not enough to patch in for the missing tax revenues. Gradually, the local share of tax revenue fell from 78% in 1993 to 45% in 2002.

In the early years, the simplest work-around to raise money was to establish a “special zone,” an area generally in the suburbs of the city that could win higher-level approval to levy lower taxes and permit a wider business scope for certain industries the city wanted to attract. The locality that established the zone would set up a company to attract investment, build out infrastructure, and get the zone running effectively. For a given period, usually five years, the zone-management companies would be permitted to keep all zone revenues in return for having invested in the area’s infrastructure.

Different zone plans would come in and out of fashion. One year, every zone wanted semiconductor fabrication plants and software companies. Another year, the privileged zones offered rights to “domestic trade,” permitting business structures that would enable companies to sell imported products and service them within China.

2.3.3. The supporting infrastructure

As part of the effort to capture better central control over the fiscal apparatus, China embarked on a series of efforts to build out its IT infrastructure, with an emphasis on connecting local governments to the center in order to gain better control of Customs and Tax Office receipts and a clearer view of banking transactions. Articulated and initially funded in 1993, these telecommunication and information infrastructure initiatives were called the Golden Projects.

Phase One comprised four projects to bring information technologies to Customs and tariff collection, intra-government communications systems, and banking. Government communication then consisted of an internal courier system that carried documents to each government department, controlling copies by stamping them with legally privileged stamps and numbering the documents, making it illegal, under pain of imprisonment, to share the documents outside of the agency. "Golden Sea" aimed to change this into an electronic system linking China's top government leaders and providing them with live access to data they might need on the economy and political situation of the country.

Phase Two was designed to strengthen tax collections and audits. Phase Three had to do with applying the new IT program to the specific needs of ministries: Golden Health, for example, an information exchange system for hospitals, and Golden Shield, to create criminal detection and surveillance databases.

These programs greatly enhanced the ability of the center to peer into local economies and capture control

2.3.4. Banking

In 1998-99, Zhu pushed through a series of measures to centralize banking regulation. Critically, he brought appointments for the Big Four banks plus the banking regulatory institutions under his direct control, rapidly changing the pattern of political interference in the banks. The central Communist Party apparatus came to control the Big Four banks and their investment decisions, while the local commercial banks remained very much the enablers of local-government political agendas. (Yang, 2004)

As the most important of all government utilities, the banks are the critical funding mechanisms for government industry. Their money is made from repressed financial income, as they absorb deposits at a rate that has been fixed below the rate of inflation. Although lending rates, also fixed, are ostensibly profitable, the banks have regularly racked up enormous amounts of non-performing loans and have required large government bailouts roughly once a decade.

With many modifications in the system since about 2006, banks make an annual credit plan that is approved by the Ministry of Finance. The credit plan sets lending quotas and targets by industry and region and, within those quota levels, interest rates designed to encourage some industries and discourage others from taking loans. The annual plans sometimes name specific companies as targets of lending.

The banks serve the industrial targets of governments at whichever level they report to, and these targets are carried out by state-owned enterprises, so these enterprises receive the lion's share of lending capital. The banks, then, are a system designed to convey money from individual depositors to state-owned companies, whose capital is, for all intents and purposes, free. If SOEs take loans and make money, they pay interest and principal. But if they take loans and do not make money, the banks, meaning ultimately their depositors, pay the damages.

2.3.5. Corporate structures

Under the old socialist system, industry had been atomized, each function occurring in a separate location and separate entity: offices, factories, schools, and hospitals were each independent entities reporting up to a Party Committee; there was no such thing as a company that operated factories to make a line of products, warehoused those products, and trucked them to retailers; a separate, specifically licensed company carried out each of those functions. The management of capital always resided at the top, in the government bureaucracy. Companies could not even provide warranty and service for the machines they manufactured.

As China focused on growth and attracting capital, it had to create new economic structures with greater autonomy to manage capital. Although the proportion of government ownership of industry dropped each year, public ownership did not so much retreat as regroup into new structures designed to preserve the value of government equity by increasing managerial autonomy.

The “group corporation” structure came in the late 1990s for entities that owned multiple subsidiaries and met certain scale and investment targets. This structure gives profitable state-owned companies a higher degree of control over investment decisions and inter-company financing and was all the rage among State corporations in the 1990s, providing them with far more flexibility to retain and deploy their capital on new, attractive targets.

The “limited by shares” entity was formalized with the Corporations Law in 2006 and made it easy to own parts of companies rather than a whole, undifferentiated entity. This enabled state-owned companies to bring in private or employee investment capital.

Since the advent of government-sponsored investment funds in China, financial investment by government organizations has engendered a new form of State ownership, one expressly designed to convey less policy direction into enterprises but that has, as a byproduct, the conjoining of interests between individual government bureaucrats and companies with State ownership. The advent of investment funds encouraged the gradual separation of bureaucratic control over enterprises into the power to appoint managers and empower/disempower them, managed to some extent, by new boards of directors, and into the power to allocate capital, managed, also imperfectly, by funds and banks.

Thus, the bigger state-owned companies ceased to be organized as individual factories reporting to an industrial bureau and developed more complex organizational structures, which led to more appropriate legal structures—holding companies, finance companies, leasing companies, branch offices, and so on. As this happened, bureaucrats transferred by government authorities into companies’ managerial positions were given new authority to re-invest earnings, start new lines of business, form overseas shells, and, in the process, enrich themselves, through both legitimate and illegitimate means.

The nation’s need for capital to build the fragmented, Maoist industrial infrastructure into integrated and modern companies was commingled and confused with the personal fortunes of the political leadership who were taxed with guiding the transforma-

tion, finding investors and partners for state industry, and ensuring that the capitalist experiment, which would have unpredictable outcomes, did not sprawl out of control. As part of their work of stewardship, these political leaders had to review and approve the companies' expansion plans. They needed, once the capital was raised, to sit on the boards of directors and supervise to ensure that the money, coming in to augment the people's assets, was well spent.

In 1995, China established its own investment bank, CICC, originally a joint venture with Morgan Stanley, chaired by Premier Zhu's son, Levin Zhu, and the banks spun off underwriting divisions in 1996. Private equity investors, investment bankers, and underwriters either directly owned by the government or affiliated with the leading red dynasties all took part on the new IPO process, and in doing so, greatly enriched the families of China's top leaders and secured their support for China's corporatization.

By the end of the decade of the 1990s, China's government had created an alternative economy, in which "share limited" companies operated alongside socialist production units; investment banks, not just government ministries, deployed capital; State monopolies accessed public markets through listed subsidiaries, and corporate executives reported both to Party secretaries and to shareholders. In many ways it was ideal: without disturbing the structure of the economy, a subset of institutions could create more value, and a subset of China's people could live within this more modern political and economic system. The problem was, the new economy could not exist in hermetic isolation; the rest of China began to change as well, and not always for the better.

Chapter 3:

Unintended Consequences

3.1. Local versus central

The government and economic restructuring of the 1990s created the preconditions as well as the need for increasing national debt, largely via private fundraising by local governments. The sell-off of State assets and privatization of housing created a flood of cash in the economy that led directly to the first big banking crisis, of 1998-2002. Meanwhile, the tax and fiscal reforms ultimately beggared local governments, pushing 75% of tax revenue to the central authorities and leaving four other levels of government to fight it out for the balance. It happened gradually, as central authorities took care to make up the losses to localities with various subsidies, but the subsidies morphed over time and skewed toward the big cities that are able to come up with matching funds to obtain earmarked monies.

3.1.1. A private housing market

A critical portion of the reform to state-owned companies was to detach housing from them; the housing managed by employers had to be sold off and a private housing market was created. In the 1980s, urban employees, assigned to work in organizations after graduating from school, waited for years to be assigned an apartment and spent endless efforts currying favor with the officials who allocated housing in order to get a better unit; a popular pun was supposed to be the expected answer if you asked about your housing allocation: “we’re considering,” a near homophone for “cigarettes and liquor!” which were the bribes of choice back in the innocent 1980s.

Between 1998 and 2003, the urban housing that all work organizations rented to their employees for a pittance was sold to them at low prices, with various strings attached: the buyers could not resell for fairly lengthy periods of time. Once the end of the lock-up periods was in sight, housing prices began rising. Housing had been short until the late 1990s. In 1950, the National Statistics Bureau counted 400 mm square meters of housing in China’s urban areas. There were 602 urban residents, so each one had an average of 5.5 m² in living space. In 1950-1955, the government limited rent to 4.2% of salary, and the subsequent unwillingness to rent out housing led to a 1955 forced sale/confiscation of private housing. In 1964, the government declared success, saying that China no longer had privately rented housing. Some 100 million m² of housing had been made public.

Because of low returns, investment in housing in the period 1955-1976 was around 0.7% of GDP or about 100 mm RMB per year, according to NBS analysts. In 1976, there was 1.4 billion m² of living space in cities, but the urban population had grown 250%, so the average living space in cities had actually dropped. Various policy adjustments at-

tempted to address this issue, yet, by 1985, there were 596.6 million m² of urban housing, for an average living space of 6.1 m² per person.

In 1998, Premier Zhu undertook a massive privatization of housing. Work units were required to give their employees cash instead of in-kind housing. Employees bought the apartments that had been allocated to them by their work organizations, and the money created a huge pool of capital for new construction. Privatization generated enormous demand for housing, as, after a holding period, the new owners could sell at a mark-up and upgrade housing. Then, in 2001, the State Council restricted the sale of land, creating a constriction of supply amid the swelling of demand. Prices rose, and so did construction. By 2008, the supply of commercial residential housing had swelled to 760 million m². The housing sell-off, and the SOE sell-off before it, were key drivers of the cashing up of the economy so aptly symbolized by investment institutions like Venturetech. Cash in the economy flooded into the newly unrestricted channels, going into real estate, grandiose industrial plans, new types of financial institutions, and, of course, golf courses. By the time the bubble burst the scale of the failures was breathtaking, the scale of the failures was breathtaking. (Walter and Howie, 2011) The bailout, which cost China somewhere around 20% of its 2002 GDP, was more of a rollover than a bailout, and the immediate economic pain was fairly light. Instead of writing off all the bad assets, China's government segregated them into new institutions, the Asset Management Companies (AMCs), and printed new money to replace the unpaid debt, flooding the nation with cash at a rate far exceeding the actual gain in economic efficiency.

3.2. New financing mechanisms

Finance is China's arterial system, and, as valves are to the heart, so are the banks to the copious flow of money through society; they serve as gatekeepers, monitors, and choke points at which regulatory authorities can stop practices that they deem threatening to bank stability by fostering bank runs or losses for individual depositors.

China in the 1990s committed to rapid growth as a means of promising a future to locally owned state companies and government employees whose livelihoods were threatened by the Zhu restructuring. The capital expansion of the late 1990s and the bank restructuring rolled over all the bad debt from that episode, required economic expansion, and every additional point of nominal GDP required about 1.6 in new capital; the period 2003-2012, during which nominal GDP growth averaged 16%, saw an average input of new capital per year of 26%. As time has gone on, the efficiency of capital has fallen and the need for funding to maintain growth has become more acute. To generate the growth, and to ensure the support of the portfolio investors who are so vital to keeping the Chinese system well lubricated with cash, regulators in China made the deliberate decision to maintain pristine listed banks and to push the riskier financing out to non-banking channels. As gatekeepers for the system, the banks have been both facilitators and beneficiaries of the process and have of course been deeply impacted by it.

The financial bailout led to a period of accelerated state investment post 2002, as the government leaned on the most reliable mechanism at its disposal for driving top-

line economic growth. The drive was accompanied by a national slogan, “Guo Jin Min Tui,” or “The state advances, the private sector retreats,” which represented the process of rolling back some of the privatization experiments of the 1990s, not because they had failed but because they had succeeded in modernizing a wide range of industries, and so private capital was no longer required. Only direct State ownership enabled the government to rapidly deploy capital for industrial growth as well as to control prices by directly controlling each joint in key value chains.

China’s coal industry represents a vivid example of this policy. Private capital was invited into the mines in the late 1990s to improve safety standards and create bigger, more productive mines. (Fubing Su, “The Political Economy of Industrial Restructuring in China’s Coal Industry, 1992-1999, in Naughton and Yang, 2004) Coal pricing was adjusted to enable this investment, and private fortunes were made in the mines. But in the early 2000s, the central government determined that the mines had attracted enough capital, and government should again own them in order to ensure pricing control over the full value chain in energy. Certain SOEs were designated to buy out the private owners. When a price could not be agreed upon, strong-arm tactics often became necessary: greedy local mine owners would find their operations halted for lack of environmental permits or themselves arrested when a fatality at the mine was reported.

3.2.1. The Olympics

The 2008 Olympics created a fulcrum for a more complete advance of the state. Preparations occurred on a scale that would be unimaginable in any other country and cost much more than the Olympics in Los Angeles or London. A flawless Olympics became China’s highest political priority; in preparation, cities were required to move polluting industries out to distant suburbs, and they used the funding they could easily obtain to build brand-new facilities with added capacity for the steel mills and chemical plants that were moved, then cleared the old urban sites and in their place built malls and amphitheaters. To support the Olympics, trucks were given special fast lanes on highways and at tollbooths. The transport of dirty industrial substances like coal was temporarily banned. Food supplies were commandeered for visiting athletes. Beijing even induced rainstorms prior to the Olympic Committee visits in order to clear the air of smog.

The centralized bureaucratic machinery that this effort entailed and the speed with which money was deployed created networks that were firmly in place by the autumn following the Olympics, when the financial crisis struck. Serendipitously, the central government channels of control made more robust over the period of Olympic planning period could be rapidly actualized to generate trillions of RMB worth of stimulus proposals from local governments over a scant two-week period. The response to the financial crisis of 2008, the massive financial stimulus, dramatically increased the central government’s participation in the economy, such that, even if the program had not sharply increased China’s debt, it still so undermined the commercial activity of industry that the underlying economy would have weakened even without being engorged on cash.

China had been pouring money into capital works and abruptly seizing more central control and ownership both through the Olympics and through the following year's celebration of the sixtieth anniversary of the founding of the People's Republic. The most obscure and unrelated events throughout the country were colored by the Olympics preparations and measured by whether they met the national standards for the image the government intended to project. There were new control systems put in place on Internet and telephone communications. Spending on domestic security was massively increased. When a large milk company found that its aggressive addition of melamine to infant formula, designed to increase the measured protein content, had led to babies' deaths around the nation, the company and the government together agreed to suppress the information lest the Games be marred. Factories were closed and steel mills commanded to suspend production in order to clean the air for the month. Hotels, which had invested massively in new facilities in preparation for the influx of foreign visitors, at the last minutes were informed that visas would be strictly controlled. Residents of the city were encouraged to stay at home, and new driving restrictions were put in place. It was said that China spent \$1 bln on the opening ceremony, which was choreographed by China's own version of Leni Riefenstahl, director Zhang Yimou. The government preferred that the Games be played to an empty city, all the better to maintain complete control over the images projected from within.

When the Games ended, cities competed to capture more capital and more political authority with their own games, in the process, coming close to bankrupting themselves. In 2009, the Party organized a celebration of the nation's 60th anniversary on a scale of delusional grandeur that would have made the Egyptian pharaohs blush. In 2010, Shanghai hosted its Expo, in 2010, Guangzhou its Asian Games, and in 2011, Shenzhen had a Universiade, each city competing to offer a spectacle even grander than the last and, when money ran out, commanding companies to purchase land or to buy tickets to the events and bus students in from neighboring provinces to swell the audiences.

The capital spending on the Games obscured the economic erosion quietly under way since the start of 2007, largely because the new spending and associated increase in domestic rates for capital led to an influx of capital that increased the value of the Renminbi. The appreciation masked the degree to which exports were weakening, starting with electronics and machinery.

3.3. Credit, credit, credit: The impact of the 2008 financial crisis

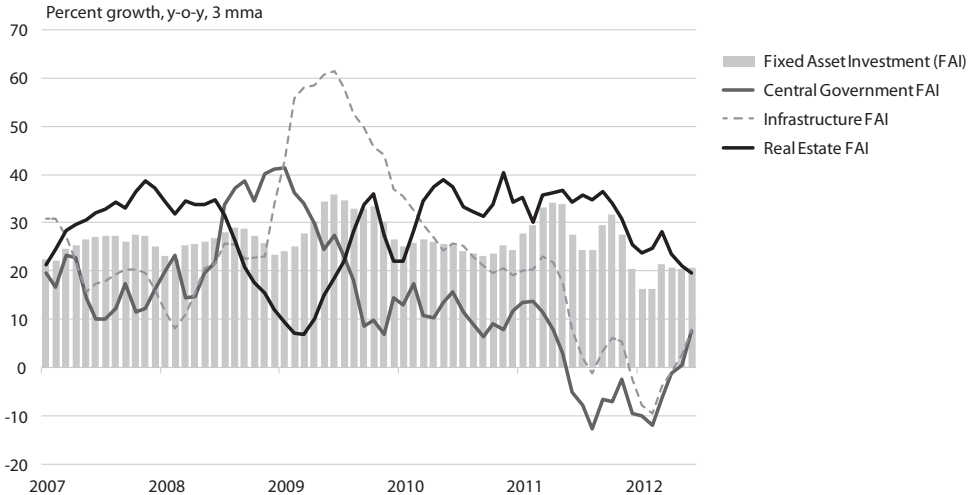
October 2008 was a terrifying moment in the economic life of most nations, not least China. Foreign trade froze. GDP turned sharply down, and the government reacted as if under attack, with new government spending plans, interest rate cuts, tax incentive plans, and corporate behavioral shifts designed to muffle the economic shocks cascading through the economy. The central government announced a massive railway construction project and a general infrastructure-spending plan to which it assigned a RMB 4 tln price tag. Central government authorities then sent a call to local governments to

gather up their spending wish lists and submit them within a month's time for fast-track approval and funding.

The stimulus plan thus assembled in early November that year gave local governments a political mandate to spend money. Immediately, China's counties, cities, and provinces went searching for any plausible capital-construction plan that could be sent to the central government. The most ambitious plans came from Sichuan, which proposed 3 tln in spending on new housing and infrastructure, of which 1.2 tln was to be spent in 2009; Shaanxi, with 1.7 tln in spending planned on new rail and pipeline projects; Yunnan, with a plan for 3 tln over five years and 70 bln for 2009, including an oil and gas pipeline to Myanmar; and Liaoning, which proposed RMB 1.3 tln for new highways and other infrastructure.

The plan strongly favored capital construction projects, especially rail and subway construction, as well as gas pipelines, highways, and power plants, many of whose plans had been sitting in planning offices seeking approval as part of the Five Year Plan process, so they were able to get under way rapidly. One goal of the stimulus was to rekindle a market for the politically favored steel industry, viewed as a sort of economic main artery carrying cash from mines through mills to a wide range of industries.

Chart 2.
Driving Growth with Fixed Asset Investment



Sources: NBS, CEIC, The Conference Board

Two weeks after the initial stimulus plan, a second package was being drafted to promote individual consumption by raising income tax deductibles, increasing welfare

payments and subsidizing housing more aggressively. The government also promised up to RMB 400 bln to support the stock market—roughly 10% of the then-value of China's two exchanges. Later, the government lowered benchmark interest rates by 108 basis points, hoping to promote spending on housing.

Price subsidies grew, and various types of consumer stimulus focused not so much on consumption but on moving subsidies to manufacturers of consumer goods provided they sold them at discounted prices in rural markets. The program, which poured billions each month into the subsidies, soon extended to automobiles, driving sedan prices to world-beating lows and prompting huge increases in purchasing of small vehicles by indigenous automakers like BYD and Geely and Chery.

Initially, the funding pushed China into a significant current-account deficit. To diminish risk, the central government turned immediately to the banking system. The banks instantly doubled their lending in 2009 compared with 2008, and further funding came from bond issues, local government spending, direct investment by state-owned companies and the private sector, as well as direct treasury allocations. The Railways Ministry, for example, planned to issue RMB 20 bln in bonds to fund railway construction.

The more lending was done, the more localities spent on compensating displaced residents of land parcels that they wanted to sell. Families receiving these windfalls then began funding thousands of small lending companies that sprouted all over the country, seeking higher returns than they would get in banks.

Credit flows in any financial system to the politically empowered, and in China, that is state-owned industry. In spite of already impressive overcapacity in industry, SOEs borrowed heavily, but they soon began directing the new funds toward the most high-yield portions of the economy: real estate, whose value was soaring. Those with the most access to borrowings became financial intermediaries, lending on capital at the higher rates that the market would bear and paying back the banks at the preferential rates provided to system insiders, via new finance subsidiaries of all sorts.

The stimulus of 2008 took over from the Beijing Olympics in the process of rapid aggrandization of the state. Direct ownership increased, as the central government targeted specific areas, especially in mining and resources, for direct involvement. Renationalization of once-privatized assets occurred in coal mining, iron and steel, and other materials, while high levels of government procurement to counteract falling consumption by industry increased the level of dependency of the state, on nominally private companies throughout solar and electronics industries.

The state became the prestige employer and the career path leading to the highest compensation; no longer did every bright graduate want to work for McKinsey; those chosen by Bank of Agriculture or, even better, by one of the Asset Management Companies established to clean up the banks in 2002 were instead the golden boys and girls who attracted their classmates' admiration and jealousy.

The stimulus plan was launched in November of 2008 and relied upon massive new injections of credit to bring forward capital construction projects that had been planned for five years from that time. The estimated value of total spending under the plan was RMB 20 tln over five years.

3.4. The local government-financing platform

Without taxation or budget authority, county and district governments over the last fifteen years have migrated toward entrepreneurial exploitation of the resources they can control. In the early days, they all formed “development zones” to arbitrage land prices and tax rates. Once the preferential tax rates for the zones were taken away, localities started relying directly on selling land for their income. They often collude with developers to seize it from residents then make extravagant investment announcements to buck up the price.

The key solution to the problem of how to fund local governments has been dubbed the “local government financing vehicle” (LGFV). (Shih, 2007) Although the mechanism has been used since the late 1990, local financing companies owned by governments became critical actors in the build-out of China’s infrastructure and housing only post 2006 or so. Governments were not eligible for borrowing, but companies were, and governments had access to all sorts of assets to use as collateral, land chief among them. The solution was for governments to form companies, which then would become just as creditworthy, because not only did they have assets, but they were quasi-sovereign, and governments had tax revenues. Unlike companies, governments could be relied upon not to disappear.

In 1998, the State Development Bank received quiet political support to create the “Wuhu model” of lending: the Anhui city of Wuhu hocked its land resources in return for loans. With the loans, it built infrastructure. Wuhu created “financing platform companies” to hold the debt. Classified as small and medium enterprises in the Chinese data system, these companies slipped under the surveillance system and became the enablers of the current debt crisis. (Sanderson and Forsythe, 2012)

Local governments have no interest in providing clear data on the LGFVs to the central authorities or to the general public, and definitional issues make it debatable what should be reported as government and what as private debt. Many of the LGFVs were formed to build local infrastructure, but many are building commercial malls and pedestrian streets and housing complexes that, in principle, should earn their own keep and pay back loans from cash flow.

The LGFV model was the principal one used for the 2008-2010 build-out of infrastructure under the stimulus plan. By 2009, local governments were financing roughly 50% of their budgets by selling land. In some regions, the ratio ran to 70%. Then, in addition to selling land, governments collateralize land for loans; the outstanding loans in 2011 were estimated at RMB 17.5 tln, or about 37% of that year’s GDP, based on data from the National Audit Office. As of 2013, according to press reports on the as-yet undisclosed National Audit Office report on LGFV debt, the number was roughly RMB 20 tln.

3.5. Subsidies

Like any socialist economy, China’s grew out of a wartime apparatus that worked well for purposes of deploying capital rapidly to rebuild the nation’s infrastructure. As in war,

the Chinese economy mobilizes around campaigns. Chief among these are the national GDP growth targets. The target has been a function of investment that the Party could deploy by virtue of its central control and administrative reach directly into the top business management of some 40% of the economy. The chief goal of the private economy since its inception in 1979 has been to attract the investment that enables the growth, feeds some innovation into the otherwise finance-driven state sectors, and extracts wealth from the state sector into the hands of elites.

A key tool to drive consumption during the stimulus program was subsidies for consumer goods, initially home electronics and eventually extending to white goods and automobiles. At the height of the consumer electronics program, subsidies funds equaled roughly RMB 2 bln per month to underwrite purchases of cheap electronics such as television sets and cellular phones. Mostly, the money goes to the producers of the cheaper products—which has generally encouraged overproduction, which to some extent balances inflationary pressures in the economy at the expense of producer margins derived from sales. In this perspective on household consumption, it is clear that the subsidy regimen enhances reportable data on inflation and producer performance.

Overall, investment-driven growth has meant that a smaller and smaller proportion of China's wealth is available to its people to spend on consumption, including education, health care, and public goods such as parks and libraries and clean environments. The need to commandeer capital for investment has driven consumption down from its already low level in 2000 to only about 35% of GDP now. Pushing investment capital to the state actors who will deploy it has two important effects, among others: to convey outsized profit to companies owned by the government and to subsidize exports by making them cheaper to produce as well as by controlling the value of the Renminbi. The parts of the economy that have not enjoyed the same level of subsidies include property, schools, hospitals, and logistics and distribution companies, sectors critical to the economy that now offer the same products and services as 15 years ago at far higher prices, prices that are underweighted in the CPI. The real level of rents, for example, is almost entirely not reflected within the CPI, nor do health and education costs include the large unofficial payments that need to be made for access to services.

All this indicates that the persistent funding of losses in the state sector has blown up the money supply in China, made non-subsidized products and services far more expensive, and depressed the quality of life by repressing consumption. Given a strong political commitment to keep non-performing loans at the banks below 3% of total loans, to maintain high GDP growth targets, and to guarantee investment products, the government has implicitly committed to continuing capital infusions. But a mutuality of interest extends from the State Council through the Ministry of Finance and People's Bank into the State banks, the Asset Management Companies, and finally into the SOEs. The many players in this constellation of top-tier State-owned and directed financial institutions are not obligated to report to the public in any transparent way, and through the use of parent-subsidiary structures, can spawn public companies and even undertake compliant IPOs while revealing very little of the parent company's financial state.

These huge flows are garbed in market-like instruments that are bought, sold, or otherwise traded among the State-owned and directed institutions. What is missing operationally is the strong motivation of independent and self-interested financial institutions that hold their borrowers and lenders to a precise standard of performance on their “external” obligations. Instead, self-interest and the innovation it fuels focus on maximizing cash flows inward from within the State-owned system and accumulating an ever-expanding portfolio of assets.

The ease with which all players downstream from the Ministry of Finance and PBOC, sort of sovereign and sort of not, access capital supports the view that at the core of China’s era of reform is an enduring State-corporate fusion that can mix and match every manner of financial, fiscal, and fiduciary tool to meet the consensus goal of producing world-pacing growth figures.

Core companies in the system are essentially government utilities. They are accorded high protection in lucrative sectors and enabled with capital that is essentially free. As long as they have pricing leverage, they support themselves in the market, but when they run into difficulties, national and local governments step in. Tools for intervention are many: debt forbearance, reorganization of assets, gifts of land and services, subsidized utilities, or direct subsidies.

In 2012, more than 98% of the companies listed on China’s A-share markets received subsidies, with total subsidies reaching RMB 54.91 bln, according to news reports. On average, each company received RMB 41.8 mln. This was on average profit of RMB 2.6 bln per company, so the subsidies averaged 15% of profit. The 2012 subsidies represented a big jump over 2011. The top subsidy recipients on the Chinese A share exchanges were nominally powerful SOEs with high levels of profit:

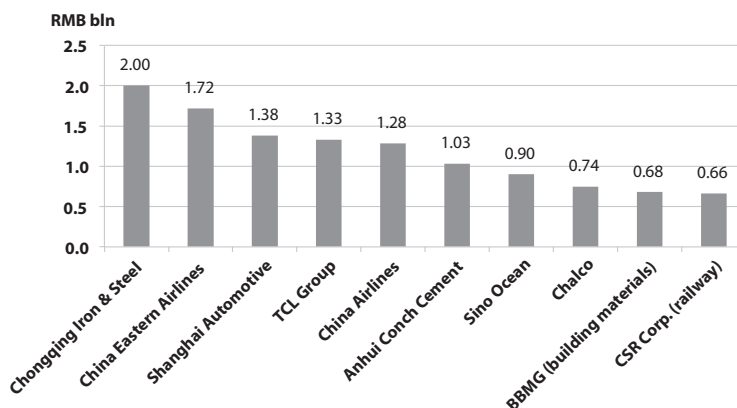
- **Chongqing Iron & Steel: 2 bln** In addition to this 2 bln, the company received a RMB 306 mln investment gain from “transferring” its 41% equity interest in the Sanfeng Jingjiang Logistics Company to the Chongqing government.
- **China Eastern Airlines -1.72 bln** China Eastern does not count subsidies received by its parent holding company for essentially the same business as China Eastern. Across the entities, China Eastern received RMB 4 bln in subsidies, a 69% increase over the 2.73 bln in 2011 subsidies. Meanwhile, China Eastern’s 2012 revenue rose only 1% over 2011.
- **Shanghai Automotive 1.38 bln** Shanghai Automotive received 37% more in subsidies than in 2011, on 10% more revenue.
- **TCL Group 1.33 bln** TCL’s RMB 1.33 bln in subsidy income was up from 829 million in 2011. TCL at the start of 2012 absorbed 30% of the parent company of Huaxing Optical. Of this company’s 7.24 bln RMB in 2012 revenue, 1.34 bln came from government subsidies.

The detail on TCL Group’s subsidies demonstrates this national champion’s role in supporting government-sponsored tech programs. TCL’s holding company received 776 mln in subsidies for its Gen 8.5 LCD plant construction, 62 million for building energy-saving devices, 54 mln for the trade-in program for old appliances, 80 mln from a special fund for “late-generation LCD technology,” 188 mln for “building an

industrial value chain in LED," 133 mln in power subsidies for the factory. Overall, the company's "other income" rose 54% due to the subsidies increase.

- **Air China 1.28 bln** In addition to the subsidies received by the listed company, the China National Aviation Holding Company, Air China's parent, announced a plan to inject 1.05 bln RMB into the listed company via a private placement. That money is to be used to pay back loans. The company reports that its subsidies were to support its less economic routes.
- **Anhui Conch Cement 1.049 bln**, up from 649 mln in 2011.
- **Cosco 900 mln** Cosco's subsidies were worth nearly double the 2011 amount. The company lost nearly 10 bln RMB in 2012 after losing a bit more than 10 bln in 2011.
- **Chalco 740 mln** Chalco lost 8.2 bln in 2012. One of the uses of the Chalco subsidies in 2012 was—wait for it—to acquire 35% of a solar power plant in Ningxia, for 2 bln RMB.
- **BBMG 680 mln** This building material company saw the slowest growth in subsidies: from 535 mln RMB in 2011 to 680 in 2012.
- **CSR Corp. 664 mln** The 664 mln in subsidies to CSR were up by 185 mln or 38% over 2011.

Chart 3.
Top 10 Listed Recipients of Subsidies 2012



Source: iFeng Finance (<http://finance.ifeng.com/stock/special/nb2012/20130424/7956349.shtml>)

Where SOE parent company records are available, usually through bond prospectuses, they usually show much higher levels of subsidies than to their listed subsidiaries. The parents then may selectively inject cash in order to maintain positive results at the sub level, which is visible to investors. The 900 mln provided in direct subsidies to Cosco's A-share company, for example, do not begin to reflect the myriad subsidies to Cosco Shipping's 20-odd subsidiaries or the asset injections that have enabled the listed

company to sustain losses of about RMB 10 bln for two years running. Analysts estimate that Cosco the parent owes around US\$14 bln in un-payable debt.

Autos companies have been favored recipients of subsidies. Subsidies in 2012 grew fast in most cases, as shown in table 1. The 1% drop for Geely is deceptive, as its parent company, also engaged in auto production, receives very high subsidies.

Table 1.
Subsidy Income 2011-2012 (RMB)

Company	2011	2012	Growth
BYD	301,221,000	550,387,000	83%
Great Wall	62,322,811	122,351,085	96%
Geely	877,437,000	870,119,000	-1%
JAC	166,763,058	251,480,857	51%
Haima	73,640,301	(not reported yet)	

Source: Company reports

The range of subsidies provided to the auto industry provides a hint as to why sales of consumer sedans continue to rise even as sales of commercial vehicles have fallen sharply in 2012 and 2013. A subsidy to promote energy efficiency, with 16 levels, starts at 3,000 RMB per auto. The subsidy for trade-ins of cars ("cash for clunkers") ended in 2010 and was RMB 15.6 bln that year across categories (the biggest portion, at 4.7 bln, was for sedans). Localities also have their own subsidy programs. Shanghai's is the most ambitious, targeting local production of 50-80,000 hybrids by 2015. Many localities subsidize the production of electric vehicles.

In 2012-13, the subsidies focused more on heavy industry. Local governments use direct subsidies to prop up steel mills in order to maintain local growth and avoid local unemployment. J Capital Research tracked the recent subsidies provided to Lingyuan Iron and Steel, in Liaoning Province, for example: in the first half of 2013, Lingyuan was given a RMB 382 mln subsidy by local governments, a 52% increase over 2012. Lingyuan's total liabilities are now RMB 18.4 bln and debt has risen 40%. Interest expenses in the first half of 2013 were RMB 340 mln, an increase of 48%.

The steel industry, the very core of the socialist industrial system, attracts the greatest subsidies in the economy. The China Iron and Steel Association has estimated that aggregate debt and outstanding liabilities in its 87 member companies, which are the largest steel manufacturers in China, may amount to as much as RMB 3 tln, or 344 bln per company, USD 56 bln each at today's exchange rate. This is a staggering figure and probably roughly equals the total historical revenue for these companies. This suggests that debt provided to industry in reality is simply a new name assigned to subsidies, and it brings into question whether the economy has really changed very much since the days of command-control of production and distribution.

In 2013, subsidies to the listed steel companies have increased to around 50%. Still, they are reporting losses. The 22 listed steel companies reported 2012 losses of RMB 8.4 bln compared with a profit for the same group of RMB 10.5 bln in 2011. Government subsidies to those companies totaled RMB 3.7 bln, so losses would have been 50% higher without the subsidies.

Chongqing Iron and Steel had its entire loss of RMB 2 bln covered by subsidies. Lingyuan Iron and Steel's loss of RMB 500 mln was also covered entirely by government subsidy. Hunan Valin's 2011 loss of RMB 1 bln was covered by subsidy but it had to use its cash reserves for a similar loss in 2012.

Table 2.
Subsidies To Steel Producers

RMB Millions	2011	2012
Bao Steel		
Revenue	174672	129732
Operating Profit	8838	3596
Subsidy	646	698
Subsidy as % of Operating Profit	0.07	0.19
Operating Margin	0.05	0.03
Hebei Steel		
Revenue	133343	116632
Operating Profit	17350	200
Subsidy	120	50
Subsidy as % of Operating Profit	0.01	0.25
Hunan Valin		
Revenue	78859	59320
Operating Profit	-1008	-3380
Subsidy	1165	10
Subsidy as % of Operating Profit	-1.16	0
Shanxi Taigang		
Revenue	96220	103515
Operating Profit	1805	956
Subsidy	48	64
Subsidy as % of Operating Profit	0.03	0.07
Chongqing		
Revenue	23532	18458
Operating Profit	-1895	-2024
Subsidy	4	2001
Subsidy as % of Operating Profit	0	-0.99
Lingyuan		
Revenue	14308	13136
Operating Profit	204	-461
Subsidy	24	507
Subsidy as % of Operating Profit	0.12	-1.1
Maanshan		
Revenue	86854	74404
Operating Profit	55	-4000
Subsidy	85	48
Subsidy as % of Operating Profit	1.55	-0.01

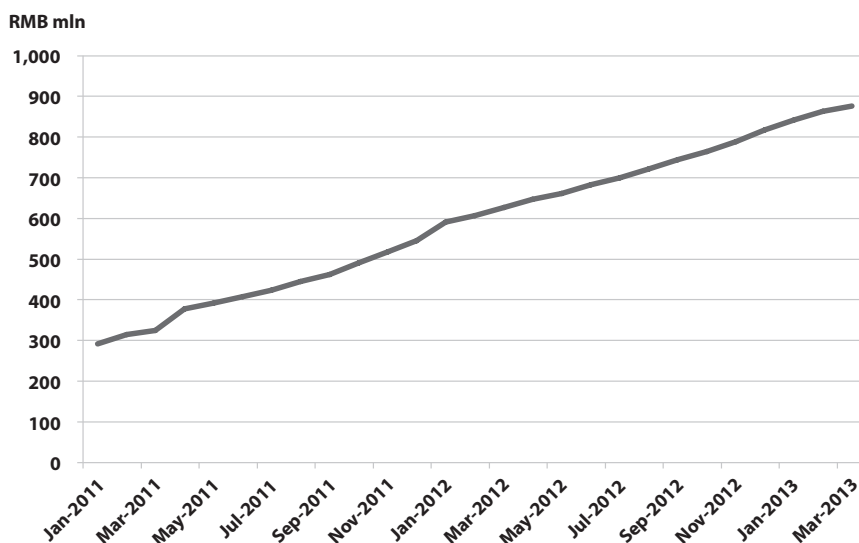
Source: J Capital, company reports

The capital provided to these State players takes two principal forms: loan capital and direct cash or tax subsidies. These direct subsidies were a key component of the

2008 stimulus plan but seem to have become an enduring portion of economic management.

The best documented of the post-2008 subsidies is “Home Appliances to the Countryside,” a key component of the plan to “balance” the economy by encouraging consumer spending. Funded at more than RMB 20 bln per year, this subsidy tends to be directed preferentially toward provinces that host consumer-products manufacturers: Henan, Anhui, and Shandong. Probably the biggest single subsidy in electronics is the annual 26.5 bln, for “promoting the use of LEDs.” Recipients are large, State-sponsored companies like TCL, Skyworth, and Konka.

Chart 4.
Subsidies in the electronics sector



Source: NBS

Early in 2013, local governments provided large new loans to a cohort of functionally bankrupt solar-power companies.

3.6. Other means of support

Economic subsidies in China represent a range of strategies available to government to promote the interests of businesses. Close relationships between government and companies provide strong incentive for government to assist businesses; the form of the relationship runs the gamut from equity ownership to transfer-pricing arrange-

ments that lower costs for business and enable governments to meet bureaucratic targets. Some of the subsidy mechanisms:

- **Special zones:** Each level of government in China authorizes “special zones” in which investors receive various benefits for encouraged activities. The richest benefits used to be aimed at exports or import-substitution, but now that land is the chief currency of local governments, “zoning” is used to attract businesses and investment of every type.
- **R&D Funding:** Government funding for R&D has grown at around twice the rate of GDP growth since 1999. Much of this funding is for research, but there is a portion as well that represents essentially the re-labeling of industrial funds that had originally been explicitly earmarked to support exports. In addition to direct R&D funding, the science parks and “industrial bases” provide seed capital to new businesses, tax and land price benefits, and government services.
- **The “Going Out” Program:** “Going Out” is a set of policy measures to assist Chinese companies in developing overseas investment programs and exports under their own brand names. The majority of funding is for low- or no-interest loans for exports or overseas activities by a short list of Chinese companies.
- **M&A:** The most common bailout strategy in China is for the government to instruct SOEs to acquire their distressed competitors. This happens in banking all the time: sometimes, bank deposits are quietly assumed by another bank. In recent years, various state-controlled investment companies have been making equity investments in the banks. There have been state-directed roll-ups in autos, mining, construction materials, telecom—too many sectors to name. Each program comes with low-interest loans to assist the acquirer.

Subsidies are used as instruments of greater national-government control, to achieve production volume and price targets, avoid layoffs, and, above all, support the government’s ability to report successful targets. China remains perhaps the only major economy that publishes and promotes an annual GDP growth target, and then, unerringly, is able to report success every year. The political importance of that target itself drives much of the subsidy behavior described here, and, in that sense, the annual GDP target is anathema to actual reform. Subsidies impact the market directly, and they impact the “context” in which published data should be read.

The illusion of sustained robust growth is required in order to amass the capital resources that the Party urgently needs to create growth, appease its many vested constituencies, and support its reputation as capable stewards of the economy and the People’s assets.

3.6.1. Using statistics to recruit capital

As the ever-grander stimulus programs have poured cash into the economy, government policy has sought to recruit foreign and private capital in order to relieve the burden on China’s banks. To do that, the nation must post attractive returns on capital invested. Despite protestations of objectivity and de-politicization, the statistical

system has been deployed as one tool in this effort. Li Keqiang referred to China's economic statistics as information "for reference only," and, as the real economy has worsened through 2012 and 2013, so have the statistics issued by the National Bureau of Statistics (NBS).

A few examples should suffice. In electric power statistics, overall power demand was reported up 4.3% in the first quarter of 2013, and yet thermal power utilization declined 7.2%. Hydropower utilization was reported to have risen by 16.1%, which has become a usual pattern: when thermal power demand falls, hydropower always manages to rise dramatically, sometimes 35% or more (chart 5). While inputs to thermal power plants—coal—can be counted, water flow cannot, and is presumably a tempting target for overstatement; the government knows, after all, the analysts watch power consumption carefully, believing that it is a key indicator of the economy's true health.

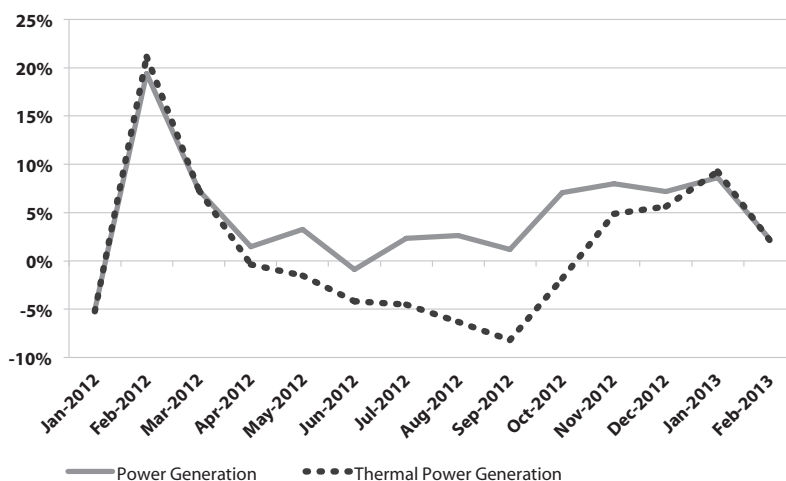
Table 3.
Hydropower growth (YoY)

Month	Hydropower
Jan-12	-12%
Feb-12	3%
Mar-12	0%
Apr-12	4%
May-12	30%
Jun-12	13%
Jul-12	31%
Aug-12	44%
Sep-12	48%
Oct-12	48%
Nov-12	15%
Dec-12	13%
Jan-13	17%
Feb-13	22%

Source: NBS

Presumably the reason for the difference is that NBS applied a seasonal smoothing strategy. The 48% YoY growth for hydropower in late summer 2012 is just barely plausible, as the base months were during a very severe drought, but the growth in Q1 2013 is not plausible. The effect of the high sporadic growth in hydropower generation is to smooth the power-generation line, avoiding any sharp downturns.

Chart 5.
Thermal and Overall Power Generation
(YoY growth)



Source: NBS

The biggest user of hydropower is the aluminum industry, and output there was reported up by over 17% at the start of 2013, although many portions of the statistics were only selectively released in 2013. But industry experts say that the numbers were simply wrong, and that, with closures in the winter of about 700 kilotons annualized and net new starts at about 600 kilotons, net production was about flat. Cement output data in the first quarter of 2013 simply disappeared. Steel production, which has been reported at record highs, does not reflect demand.

The China Logistics Association compiles the Producers' Manufacturing Index (PMI), a critical indicator of economic trends within China. But this group has changed its sample and methodology at least three times in 2012 and 2013 without disclosing precisely what the changes were or explaining how the new data set should compare with the old. In Q1 2012, the association changed the way it calculated seasonality, applying a new algorithm to smooth out the data. In Q1 this year, they changed the companies that are interviewed.

A common way to manipulate statistics is to withhold data that are trending negative. Retail sales are often reported in this manner because of the political sensitivity of the number, which is always among the most rapidly growing numbers in China's economy. As of December 2012, monthly figures disappeared for grain and oil, meat, poultry and eggs, beverages, tobacco and liquor, garments, books, newspapers and magazines, and "other." Many more categories had been discontinued from January 2010: coal, raw chemicals, agricultural machinery, metal materials, fertilizers, etc. The remaining categories all show growth over 10% for Q4 2012, with three categories showing growth over 30%.

The critical role played by capital investment since the economic reforms of the 1990s has created a promotional economic culture, in which hiding the weaknesses of the economy becomes a critical tool for maintaining the sense of momentum needed to capture yet more capital.

The investment acceleration, so necessary to the economy that China built, nevertheless led to the instabilities that plague the country today.

Chapter 4:

Housing: The New Asset Class

4.1. The second Great Leap: China's property market

Perhaps the most potent symbol of American excess, and the morality tale best representing the follies of the housing bubble in the United States is “Versailles,” the 30-bedroom house built by time-share baron David Siegel and his wife in Florida, which was the subject of a documentary in 2012 called *The Queen of Versailles*. The Siegels’ Versailles, with 11 kitchens, yoga rooms, and “man caves,” is designed to meet the Siegels’ every dream, no expense spared.

The Chinese version of the dream is an aspiration, a vision not of how the buyers hope to live but of how they imagine that wealthy people must want to live. In Ordos, the city at the epicenter of China’s bubble, before property values crashed, the emptiness of the new district, Kangbashi, contrasted with the overheated imagination of its design. Villas stood next to a lake, dug into the desert, on which yachts floated, waiting to be purchased by the people who would buy the homes. There were “magnet schools” with squash courts, a concert hall modeled after Beijing’s National Center for the Performing Arts, which cost \$500 mln to build and was designed by French architect Paul Andreu. There is a six-story library, with very few books, and a large exhibition center.

At one end of the new city square, which is larger than Tiananmen, stands a luxury complex called “Royal Ascot View,” selling in May 2011 for RMB 12,000 per square meter. Had to put cloth over their shoes to see the model apartment, which like an ad in *Playboy* ca 1975, all except the electronics: long-haired shag rugs, a faux fireplace, chandeliers, gold-and-black damask wallpaper setting off an elaborately upholstered sofa and Queen Victoria chairs. Two bottles of champagne were positioned on a side table with some festive streamers, as if the wealthy young couple who lived there had just gotten back from a new year’s celebration in Times Square, and to be certain, the developer had placed a photo of a handsome newlywed couple on a side table. In the kitchen was a large glass jar of dried pasta, something a Chinese family may never have seen, much less enjoy eating. Likewise the champagne and the soaking tub: these are the imagined accouterments of a Western lifestyle, not reflections of what any herdsman in Ordos would choose to do with new millions.

The Royal Ascot had been almost entirely sold out, said a salesman. One year later, the complex was boarded up and surrounded with a wall of blue construction fence.

In many markets, buyers speculate on rising prices for housing, betting that population and earnings trends will carry with them appreciation of these assets. But housing, fundamentally, almost anywhere is lodging, places where buyers ultimately expect to live. In China, on the contrary, commercial housing has become a new class of asset, a means of storing value, like large jewelry. Whether corporations buying blocks of apartment units or individuals buying for their children, Chinese over the past decade have been accumulating housing units while occupancy levels plummet. This is because rent

yields are low: statistics are very hard to come by, but sampling in various commercial and high-end residential markets generally points to yields of about 2%. The cost of renovation following a tenant's departure, meanwhile, has skyrocketed. There is no cost, on the other hand, associated with carrying an empty property.

4.1.1. What the data tell us

Until 2008, the NBS collected, and sometimes published, vacancy rates for housing. A property was designated as vacant if it had not been sold after the one-year anniversary of being offered for sale. But the rate did not include empty properties that had been sold.

In 2003, the vacancy rate for residential property was recorded as 61% in the eastern part of the country, with a low of 18% in the west. In 2008, there were 90.7 million square meters of housing empty for more than one year. From 2009, the statistic was no longer made available. Residential occupancy rates generally are low. In 2008, the last year that NBS made the statistic available, there were 90.7 million square meters of housing empty for more than one year. That would have represented about 16% of the housing built the previous year. After 2008, construction accelerated dramatically and, anecdotally, so did vacancy rates.

The quality of China's housing stock may be fairly low, but the quantity is more than adequate. According to the Household Finance Survey undertaken in 2012 by the Southwestern Finance University at the behest of the PBOC, 85% of urban and an amazing 93% of rural families own at least one dwelling, far higher than the average U.S. ownership level, which is 65% despite strong government supports for ownership. Furthermore, the survey found that 15% of households own more than one unit. Some cities have been reported to have average home ownership per family of more than five units.

Rural housing, like everything else in China, comes under a separate statistical system than urban housing. In 2006, the NBS counted 22.59 billion square meters of housing in rural areas, translating to 35 square meters per person or about 140 square meters per rural family. Assuming no rural population growth—rural people are supposed to be moving to cities—urban housing growth should accommodate population growth along with upgrades.

Urban commercial housing construction has been running at around 7 million new units a year since 2001. Here is the table:

True demand is hard to gauge, but several numbers suggest that housing is well supplied. First, there are the low occupancy rates. Then, the average space per person has risen dramatically in 20 years, from 6 square meters per urban resident in 1985 to 17.8 in 1998. In 2005, the average was up to 26 square meters, and that number will have grown considerably by now. But the most reliable measure for new demand ought to be new household formation. In 2013, China had roughly 78 million units under construction.

Taking the population growth estimate provided by the NBS and projecting a continuing decrease in the number of people living together, China might form as many as 7.8 million new households a year for the next 10 years, an optimistic assumption, giving the

aging of the population. That suggests that the level of construction in 2006 was reasonable for absorption, and yet in 2011, China completed 46% more units than in 2006.

Below is a chart showing new construction starts for residential housing between 1999 and the present:

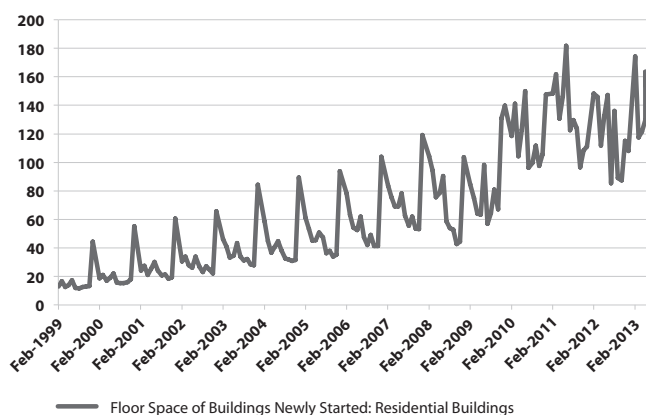
Table 4.
Housing Completions 2001-2011

Year	Residential new construction (Completions, in mln m2)	Est no of units in mln (72 m2 each)
2001	225	3.1
2002	325	4.5
2003	325	4.5
2004	380	5.3
2005	490	6.8
2006	530	7.4
2007	582	8.1
2008	590	8.2
2009	702	9.8
2010	612	8.5
2011	776	10.8
Total	5,537	76.9

Source: NBS

Chart 6.
New Housing Starts (1999-2013)

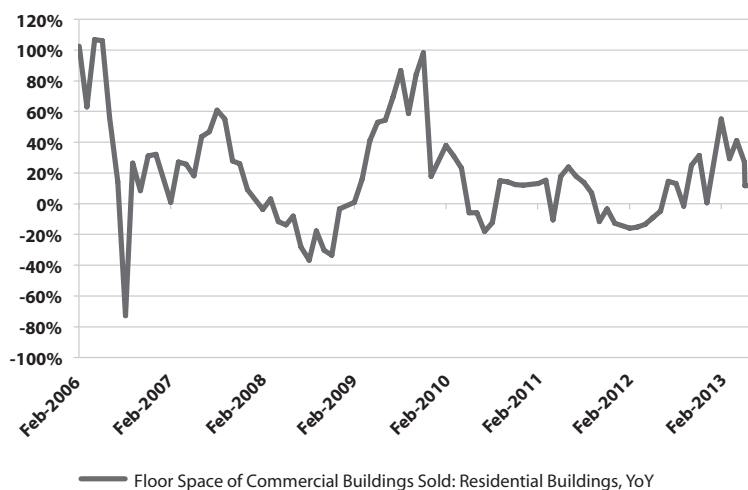
(in mln sq m)



Source: NBS

Sales of residential space have followed the same pattern.

Chart 7.
Residential Property Sales (2006-2013) (YoY change)



Source: NBS

Prices since 2006 have risen by about 66%, with an average increase of roughly 10% per year in 2006-2010, significantly higher than the increases during the U.S. real estate bubble.

Table 5.
U.S. and China Nominal Price Growth for Real Estate

Year	US Residential	China: High-end Residential	China: Lower end residential
2006	5%	13%	6%
2007	2%	13%	17%
2008	-6%	4%	-2%
2009	-7%	24%	25%
2010	0%	13%	6%

Source: U.S. Census, NBS, Wind Data, Wikipedia, J Capital

Table 6.
Percentage Change in China's Real Estate
(2006-2011)
(Nominal Prices)

Type	2006	2007	2008	2009	2010	2011
ASP Total	6%	15%	-2%	23%	7%	6%
Residential Buildings	6%	17%	-2%	25%	6%	6%
High-End Residential	13%	13%	4%	24%	13%	1%
Low-Income Residential	4%	1%	10%	11%	17%	n/a
Offices	16%	8%	-3%	27%	8%	8%
Commercial	4%	10%	2%	17%	13%	10%
Other	11%	7%	-4%	14%	12%	2%

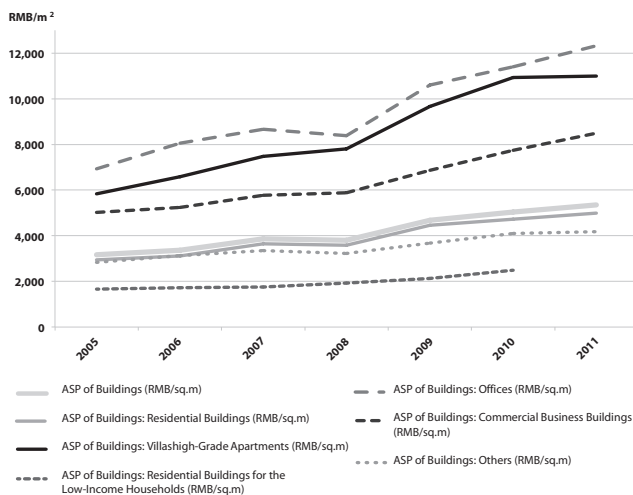
Source: Wind Data, NBS

Table 7. U.S. Nominal Price Growth for Housing
(2000-2010)

Year	US Avg Nominal Housing Price Growth
2000	5%
2001	3%
2002	8%
2003	8%
2004	12%
2005	7%
2006	5%
2007	2%
2008	-6%
2009	-7%
2010	0%

U.S. Census Bureau, Wikipedia

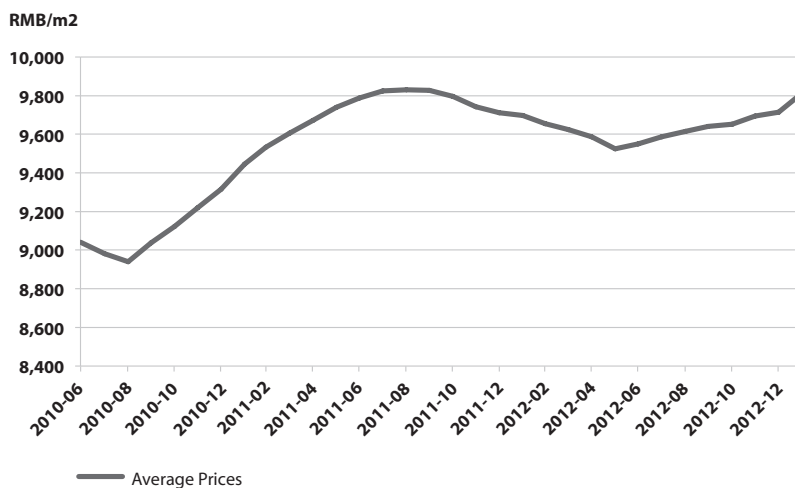
Chart 8.
Average Sale Price of Property in China 2006-2011



Source: Soufun/CREIS, J Capital Research

The average price of housing has risen only incrementally in the last two years.

Chart 9.
Average Housing Prices Since June 2010



Source: NBS

We have price indices available for different groups of cities but no average price per city. This is not because the data are hard to collect but because, according to a China Real Estate Index System (CREIS) analyst, “price is too sensitive to report.” Cities are concerned on one hand that their markets appear robust and, on the other, that the central government does not target them for sale restrictions. The best thing, therefore, is not to stand out. When reporting prices, cities aim for price growth or reduction in the low single digits. To achieve it, they change the basis of comparison—for example, by choosing the city’s most expensive district as the former-year base for comparison rather than the whole city. Developers regularly discount by providing “free space,” so that the stated average price may be, say, 8,000 per square meter but an additional 30 m² are added “for free” to a 100-sq m dwelling.

Cities “give away” parcels of land to buyers who bid high at auction in order to maintain the appearance of high land prices. They frequently sell land by contract outside of the auctions and then execute through the public auction in amounts of land or money that they prefer to have recorded.

Starts and Completions are bureaucratic designations awarded to developers when they inject certain proportions of planned capital investment: based on capital injections and the developer’s receipt of certain construction permits, the square meterage is recorded in the appropriate category, such that the number of starts and completions has more to do with available funding than with construction. “Construction under way” simply consists of everything that has been started, with a one-month lag, but not moved into the “completion” category.

4.1.2. The urban/rural dichotomy

Among the great dichotomies that drive Chinese policy is that between rural and urban populations, which have traditionally been and are still subject to separate legal regimes, separate access to state resources, and ultimately very different levels of importance in government policy.

China’s management of residency permits or “hukou,” implemented at the very start of the People’s Republic, draws a fundamental distinction between urban and rural populations. The distinction is based on the implicit assumption that land provides all reliable subsistence and that rural populations, who have access rights to communal land, do not require the resources of an organized government. Instead, government is an entity that owns productive resources and manages their staffing, production, and distribution of products by an urban population.

As the Chinese imperial officials did before, the Party manages a system built around an apartheid that has led to partitioned systems of social security. An intricate architecture of bureaucratic rules specifies what sort of schools, hospitals, parks, and other facilities should be provided for rural residents and which for urban residents, driving a complex range of incentives in today’s economy. A Chinese citizen with a household registration designated “rural” may need only move a few meters away, but if the new area has an urban designation, then that resident will have access to better schools, bet-

ter hospitals, more parks, a better social insurance system, and a better chance for his or her children to get into university.

Therefore, that China has developed an enormous pool of seasonal workers, who move to cities unaccompanied by their families, is a result of a system of health care, education, and welfare that make it impossible or at least very expensive to raise a family away from home. Lacking an official hukou, which could designate them as legal legal urban residents, internal migrant workers in China are treated very much like undocumented immigrants in the United States or Europe.

As the housing market began slowing in 2007, local governments, fearing that their revenue from land sales would fall, increasingly used the urban-rural divide as leverage to get local populations to sell their land and purchase units in new towers that were replacing them. This is done by designating a portion of a county or a village "urban," a feat that can be accomplished with some difficulty given enough population, investment in capital infrastructure, and political adroitness.

The formula is to designate, say one-fifth of the land in a county "urban." The county then builds high-rise housing in the "urban" area and, at the same time, purchases land from rural people who live in another, larger portion of the county. The former farmers, who sell large plots of farming land, can use the proceeds plus a mortgage to purchase the new apartments of 90-100 square meters in the urban area, and by doing so, they obtain "urban" designations that entitle them to unemployment benefits, a small pension, and access to better schools and hospitals, hence eroding the implicit apartheid. For people doing subsistence farming, this is an attractive proposition. The problem is that it destroys farmland in favor of jobs that often have no economic basis.

4.1.3. Funding urbanization

Localities have two budgets: the fiscal budget and the "comprehensive" budget, the difference being that the comprehensive budget includes capital expenditures for urban infrastructure which are supposed to be funded from land sales, while the fiscal budget, in principle, comes from tax revenues, remittances from the central governments, and various fees.

The two budgets and the two funding sources become muddled and confused, but the formal requirement of using land sales to build out the city has underscored incentives for cities to expand: if they can justify leveraging land resources to get loans for a new city district, they can always make sure extra money is made available for more private agendas. Moreover, the very fact of expanding benefits the political leaders of a city: they can attract more tax revenue by increasing the population within their borders, and they may even win the bureaucratic brass ring: an upgrade in the system from "prefecture" to "town" or "county" to "city district," with associated emoluments.

Moreover, populations of rural areas also have powerful incentive to seek such upgrades. Add to that the commercial and financial incentives associated with "urbanization," and you have a situation in which everyone has reason to want to pave over the rice paddies proactively, in anticipation of a population increase that may or may not happen.

One difficulty is that governments, private industry, and individuals share a pro-cyclical interest in maintaining growth momentum and ensuring that property prices continue to rise. This generates a tendency to build new support systems for populations that only theoretically might exist in the city in the future. The support systems, whether transportation infrastructure or housing or urban services such as malls, are properly a cost of economic development and a means to heightened economic efficiency. Instead, these facilities are being constructed in order to generate economic growth through construction activity.

Because the construction is self-justifying, governments have only the vaguest plans for how they may be used. Tianjin, for example, has built three terminals for luxury cruise liners even though none stop at the city or apparently are planning to do so. Li-jiang, Yunnan has built apartments for at least 350,000 people who the city hopes may move there, although there is no evidence that anyone will; the empty units stretch for an unbroken 15 kilometers along a deserted highway. The city of Manzhouli in Inner Mongolia has built vast summer lodges in hopes that it may attract vacationers. China has new airports with no flights and libraries with no books.

4.1.1. A town in Shaanxi



New housing in the empty city of Shenfu, Liaoning. Photo by J Capital 2013

A town in Shaanxi Province not far from the city of Xian provides a typical example of this prospective construction. Feeling left behind by wealth so nearby, the town fathers targeted a thinly populated farming region within the town borders and chose a local property to develop it and invest the initial capital required to raze the villages. The

developer mortgaged the initial piece of land the town provided in return for a bank loan used to pay compensation to 5,700 or so people who were displaced. The company then built 1,460 apartments in high-rise towers, which the families paid for using the compensation payments: the new apartments, though smaller and very Spartan, were technically now part of an urban area in which public services would be of higher quality; additionally, the developer had offered these former farmers jobs managing the apartment buildings, easier work than tending fields. The developer has promised them additional income from the rental fees for souvenir stalls that will be built and let out; the area is in a valley between two mountains, with a fast-running river passing through.

Once the initial group of people had been moved, the developer could go to the bank and demonstrate that the first phase of the new development had been sold out and completely occupied. They built shopping plazas as well, which promised to be good investments and were easy to finance. The next phase, however, is more challenging: in order for the company to make enough money to pay the locality for the “borrowed” land, it must build housing and commercial space to accommodate 100,000 people, 70,000 more than the town’s population. The developer hopes to attract middle class families from Xian who will buy apartments to use as vacation homes. Meanwhile, the farmland is gone, and the original residents, now “urbanized,” depend completely on the success of the development for their livelihoods.

The developer says that overall net returns from the project are expected to be about 35%. The developer plans to operate a small hotel in the area, as well as a market and shopping center.

4.2. Private-LGFV cooperation

The Shaanxi town development is typical of recent financing models in that the locality need put up no cash and yet benefits from the upgrading of land from farmland to urban land with basic water, power, and gas infrastructure in place and original residents resettled.

Urban development in most cases begins as an entrepreneurial enterprise. Some of the projects, such as roadways and light rail systems, might have been on the cities’ wish lists before the LGFV financing mechanism was devised. But for the most part, cities are not undertaking construction of new government districts, pedestrian malls, development zones, and villa complexes because local residents want these facilities or because existing housing is insufficient—although it may be—they do it as a profit-making venture.

The LGFV that took on development of a neighborhood in the capital city of one southern province provides a typical example of how urban planning is designed principally to enrich the localities rather than for the benefit of the new construction to residents. The company signed an agreement with the city land reserve to buy 41,800 mu or 2,787 hectares of virgin land at a low price and pay for its upgrade. The city, which is the company’s principal shareholder, helped the company raise money by gifting it a defunct beer brewery; this helped the company list on the Shenzhen exchange. It then

invested RMB 1 bln of its own capital plus about RMB 3.5 bln raised against the land collateral to clear the land of its residents and put in basic infrastructure. The agreement with the city was that, once upgraded, the land would go to auction at a price that would enable the developer to realize a gain of at least 5% should some other developer buy the land. If the land fetched a higher price, then the company would get 50% of upside from the winning bid.

Now, the company is bringing portions of the land to auction, and the city is designating functions that they think might attract buyers—an exhibition center (with the city guaranteeing revenue from exhibitors), a five-star hotel, villa developments. But the city government, strapped for cash, has now reneged on its deal with the development subsidiary, so the developer does not intend to enter the land in the auction. In retaliation, the city is imposing taxes on the land and a high fee on the water connection.

4.3. The Northeast

Just as in the United States a deflating tech bubble was revived by the Fed's loose money policy and rose again as a housing bubble, so in China did the re-capitalization of the banks in 2002-2006 lead directly to an asset bubble in housing.

China's bailout strategy was similar in superficial ways to that of the United States: the government established four Asset Management Companies (AMCs), each of which was paired with one of the Big Four state banks. The AMCs became receptacles for the bad loans from the corresponding banks. After the AMCs were created, in 1999, the government transferred into them large portfolios of bad loans in return for which the AMCs paid cash, at 100% the value of the dead debt. This could happen because the Ministry of Finance had filled the AMCs with capital in return for their bonds, i.e.: promises to pay back the MOF in 10 years. A decade later, the MOF simply extended the bond maturities by another decade.

Essentially, the bank bailout was accomplished in several steps between 1998 and 2006. In 1998, the government gave the banks about RMB 270 bln in capital and then moved deposits into bank equity. The next year, the AMCs paid RMB 1.4 trn to the banks for the first tranche of non-performing loans. In 2003, the banks received another RMB 93 bln in write-offs and were given injections of about RMB 300 bln more, this time from the nation's foreign reserves. They then auctioned off nearly half a trillion in additional bad debts via government-sponsored auctions. Between 2004-2006, the AMCs gradually sold their NPLs in a quasi-commercial process, recovering about 20% of the booked value of the loans.

More recapitalizations of banks followed. The cash injections cost around RMB 2.24 tln, about 20% of 2002's 12 tln GDP. The repressed financial income to bank depositors, if counted as part of the cost of bailout, as it really must be, bring the cost to roughly 40% of GDP.

These injections are simply those that have been documented in China's press, bond prospectuses, bank filings, and the work of researchers like Walter and Howie (2011); based on what AMCs say, there appear to be some quiet injections that are not reported.



A development in Changchun built to house displaced farmers. Each family received multiple units in order to have rental income. But they say there is no rental market in the area, which is in the distant suburbs of the city. Photo by the author.

But taking only the reported injections, there has been a lot of cash for the economy to absorb.

The logical outcome has been a housing boom. The statistics on housing, as unreliable as they are, show dramatic ramp-ups in construction, sales, and prices over the last seven years, with all three parameters exceeding the growth in the U.S. market at its height of folly through 2006. But the numbers do not tell the whole story.

4.4. Boom! Bust!

The localities with the most cash have also been the most prone to extravagant bubbles and sudden busts. Two such localities have been widely publicized, albeit with information edited to ensure that the cities, Wenzhou, Zhejiang and Ordos, Inner Mongolia, present story arcs affirming their exceptionalism as well as the deftness of government authorities in coping with the investment excesses and their consequences.



Abandoned towers in Ordos. Photo by the author October 2012.

Ordos is to the Chinese boom as Vegas to that in the United States: lurid in its excess, dire in its fall, but it is also a classic, representative of what is happening in many other cities in China, as the current crisis quietly filters through the country.

The local government had some of the highest tax revenues in the nation by virtue of sitting on one-third of China's coal reserves. During the nation's re-nationalization of coal resources, Ordos was well-placed, because the county had never sold its mines to private operators, as Shanxi, the biggest coal-producing province, to the south of Ordos, had done, and therefore was well positioned to negotiate attractive terms with Shenhua, the national coal company that wanted to mine Ordos coal. The county could also realize profits of mining directly rather than only taking tax income.

Ordos has tumbled from having the highest GDP per capita in Inner Mongolia to, in July 2013, the lowest. On paper, Ordos was wealthier than Beijing and Hong Kong, but the county's wealth calculation is based on GDP per capita and does not mean that individual incomes are anywhere near those in Beijing or Hong Kong; although the area produces quantities of coal and petrochemicals, the beneficiaries are the national resources companies that mine or manufacture them and not the residents, who earn very ordinary salaries.

The flood of money that created Ordos' bubble came from the county's land resources. Ordos is an arid region with long stretches of sandy desert once thinly populated by migrant herdsman. Large purchases of the herding land by the local government coincide with a national policy framed as protection against encroaching desertification but connected with China's deep mistrust of ethnic minorities. Inner Mongolia's herdsmen

are by and large non-Han people, and government subsidies designed to create fixed residences for them, allocate a few head of cattle to each family, and build milk-collection stations in villages dovetailed well with the incipient property investment fever.

The buyouts brought windfall income to hundreds or even a few thousand families. Herders might have had annual income of a few thousand Renminbi per year; suddenly, they were given, say, RMB 50,000 to vacate 5 mu of land where their cattle traditionally grazed, and were given a new apartment to live in. Most people had no idea how to spend all the money. They might spend 10,000 on a new television and a motorcycle, put some savings in the bank, and then look to invest with a trusted friend who would provide a higher return. In this manner, hundreds of private investment funds were created—and went out of business in 2011. The local government created a financial “platform” company that assumed the obligations of many of the private funds, but there has been little public information on how much of the local people’s investment capital was lost and how much was paid out by the local government.

In addition to financial investments, the people of Ordos were reported in the Chinese press to own an average of 10 housing units per family.

In October 2011, the crash came suddenly to Ordos. That year, prices for housing had posted monthly increases, which accelerated to weekly and then started to rise every day. Suddenly, confidence collapsed. Now, much of the population has left: the wealthy people to live overseas or in Beijing and Shanghai, the migrant laborers to return home. The remaining population seems to have high rates of unemployment, although this is not reported. National news reports last winter estimated that personal income had halved in a year.

In the early autumn of 2012, asking prices for property in Ordos were 50% of the prices a year previously, and even so, transactions were at a halt. Most developers could not sell, because the price at which the property would sell is now below their cost of land and construction. Given that bankruptcy is not permitted, sale at such a loss would help no one: the developers would lose their assets without clearing debts, and the banks, which cannot take losses without political approval, would refuse to accept a settlement of the loans. Real prices in Ordos’ New District of Kangbashi, however, if there were to be transactions, might be 10-20% of the 2011 peak. The local government, short of cash, has borrowed so much money from two state-owned coal companies that the government had to grant the companies land to placate them. The government has spent the yield from the sale of some sixty small mines. Kangbashi remains so empty that the government knocked down schools in outlying villages in order to force teenagers to move there.

Ordos is portrayed nationally as a freak exception that arose because coal miners were inexperienced in managing their new wealth. The property financing is said to have come exclusively from private sources. Things got out of control. The pyramid inverted, but the Big Four banks, at the CBRC’s instruction, stepped in with a credit infusion to roll over the loans and slow the hemorrhage. Crisis averted.

But the truth is more complicated: from the local to the national banks, private financiers to government officials, everyone participated. There were the direct loans from the commercial banks and rural cooperatives around the county. There were loans

against guarantees issued by the local gray financiers. There were trusts that worked with banks like ICBC, which sold their WMPs and probably bought their loans.



Half-finished apartment houses in Ordos. Photo by the author 2012

The government's other example of a bust saved from ruin is Wenzhou, the city in Zhejiang renowned for sending successful private businesspeople around the world. Like Ordos, in autumn of 2011, Wenzhou reportedly asked the central government for a RMB 9.3 bln loan, and in winter of 2012, the central authorities quietly set up a bailout fund and moved central officials to Wenzhou to manage the fallout from the bust, according to Wenzhou's Finance Office. As of July 2013, prices for housing in Wenzhou had fallen each month for 23 consecutive months; overall decreases of 40% in price are not enough to persuade buyers to purchase the inventory. The Chinese press has reported that, in the last two years, about 3,000 homes had been seized for auction, although only a small portion has sold.



A commercial space for sale in Wenzhou. On a visit in April 2013, around one in five shops downtown were shuttered and for sale. Photo by the author April 2013.

In 2011, debt defaults in Ordos and Wenzhou heralded the crises that forced bank bailouts, and still those cities are in a sort of economic lock-down, with property transactions frozen and construction stopped. In April 2011, three large defaults were reported in Wenzhou and one in Ordos. In Wenzhou, one private manufacturer, called Jiangnan Leather, defaulted on unspecified debts when its chairman, who was said to have lost millions at the tables in Macau, disappeared. Next, three lending companies defaulted, leaving the private parties who had contributed capital without recourse. In Ordos the next September, a large property developer reportedly committed suicide when he was unable to repay about \$50 mln borrowed from 370 individuals.

4.5. The next dominoes

The Ordos and Wenzhou asset bubbles inflated and deflated most rapidly because both economies lacked the backing of large, state-owned institutions that might have helped them hide their distress by extending new credit or buying the failing assets. Far more extended than either city and yet still building is the Binhai area of Tianjin, the major port city south of Beijing.

Tianjin has always suffered from a complicated mixture of resentment and envy of Beijing. A port and a heavy manufacturing center, the city has never quite found the economic focus that would help it thrive, instead seeking investment for one renovation plan after another.

In recent years, Tianjin has made a successful bid to become the financial and logistics center of the north, as Pudong, the zone developed to the east of Shanghai in 1992, has been to the Yangtze River Delta area. Tianjin won approval to build its thinly populated port area into nine zones, each with its own investment focus. The heart of the zone is to be Yujiapu, the financial center they call “Little Manhattan” and that is building a replica of the Rockefeller Center, a Chrysler Building, and a Lincoln Center, all within view of a local river that promoters have dubbed “Tianjin’s Hudson.” Planned office space amounts to one-third the size of the real Manhattan, all at a cost that could be three quarters of a trillion RMB—as of the end of 2011, the district had already consumed more than RMB 500 bln, or nearly half of the GDP of all of Tianjin in 2011, and it received much more funding in 2012.



On the way over the bridge to Yujiapu District. Photo by J Capital 12/2/12

Since late 2012, money has run out at Yujiapu, and construction slowed, leaving only enough activity so that the zone remains just plausible as an investment target when potential investors visit. Yujiapu, and most of the rest of the huge Binhai area, is now quiet, and estimates of the debt the city must somehow absorb run to roughly the annual GDP of Tianjin.

One simple way to identify a city in distress is to find those cities whose outstanding loans have exceeded the banks’ deposit base and to look at where the lines cross. On that criterion, Haikou and Yinchuan tipped into a red-light area for debt by the end of 2010—the last year for which the PBOC made most numbers available.

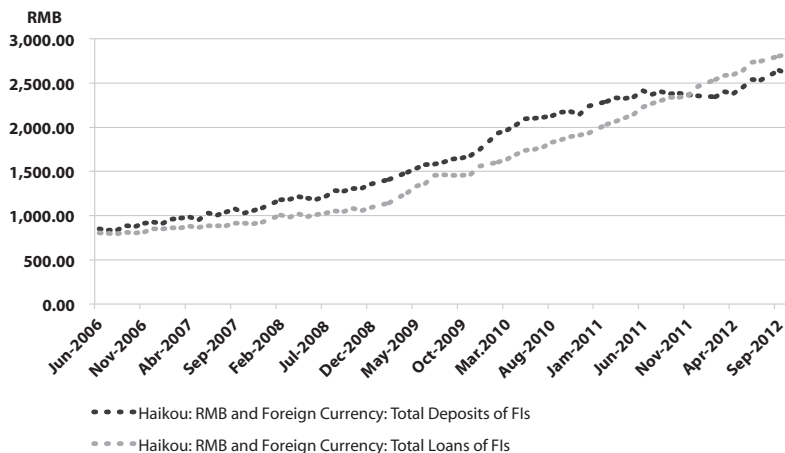


The district as envisioned by planners. Photo: Backchina.com



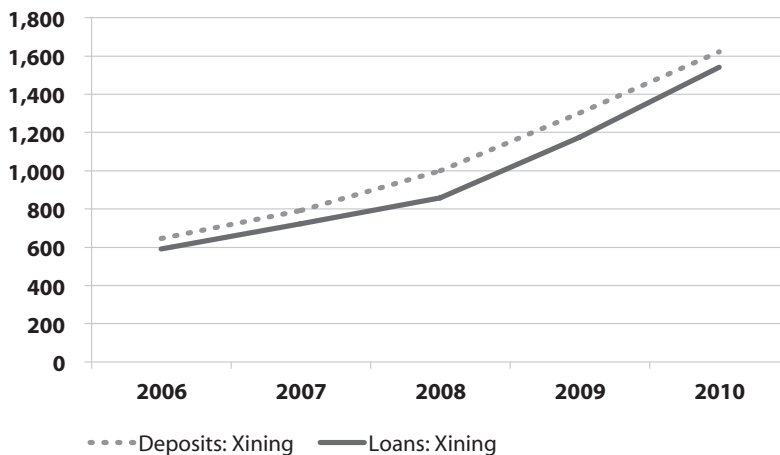
Degree of completion. Photo by J Capital 12/2/12

Chart 10.
Haikou Loans and Deposits (2006-2012)



Source: Wind Info, PBOC

Chart 11.
Yinchuan Loans and Deposits (2006-2010)



Source: Wind Info, PBOC

Cities that were cash rich during the boom are the ones that seem to be most imperiled. Those cities would include the coal-rich regions of Inner Mongolia (Ordos, Baotou, Hohhot), the stimulus-engorged areas of Guizhou, especially Guiyang, and Hefei in Anhui, and the forever murky, fast-money markets in Hainan, including Haikou and Sanya. The following cities in late 2010 were close to the crossing mark:

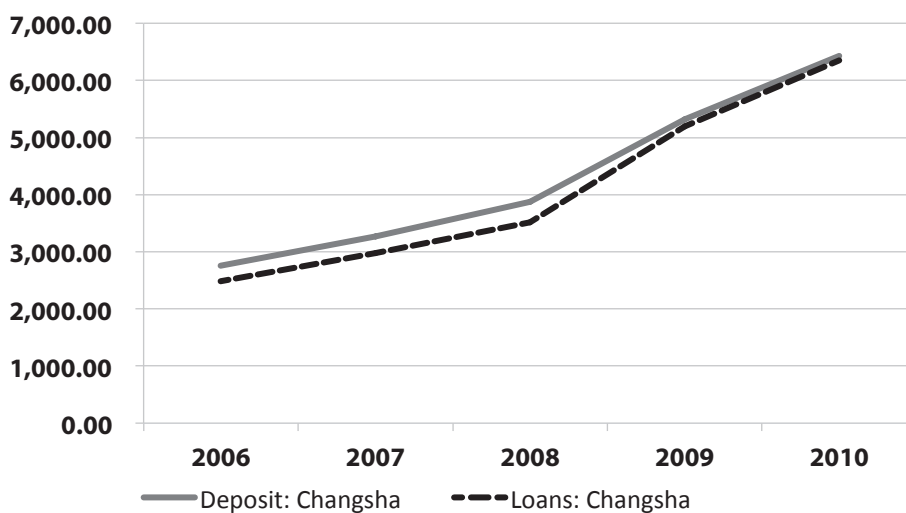
Table 8.
Deposits and Loans in 2010

City	Deposits (RMB 100 mln)	Loans (RMB 100 mln)
Taiyuan	6,965.19	5,054.75
Hohhot	2,678.92	2,522.52
Changsha	4,985.90	4,557.44
Harbin	5,956.36	4,126.95
Ningbo	9,755.52	9,414.20
Hefei	4,541.78	4,214.08
Fuzhou	5,961.07	5,005.53
Changsha	6,427.95	6,353.68

Source: PBOC

The lines in Haikou crossed in November 2011.

Chart 12.
Changsha Loans and Deposits (2006-2010)



Source: Wind Info, PBOC

In 2013, these defaults are beginning to ripple across the country like a tablecloth being shaken out. The market revivals in April and the one started in September did

succeed in reviving both the property and materials markets, but not without cost: because the government hopes to contain the doomed expansion of property values, it has limited credit to that sector through the banks. Instead, credit runs into alternative channels, from private equity to entrusted lending. This only serves to raise the cost of credit to property, which ultimately makes the bubble worse.

A critical difference between these alternative channels and the banks is that government regulators are not able to contain defaults in the shadow-banking sector. The institutions are too heterogeneous, and their liabilities too difficult for regulators to assess.

As a result, the more credit that flows into these channels, the more certain a crisis becomes.

China's particular tragedy is that, even without a financial crisis, the utopian housing build-out has created all the preconditions for a social disaster. In rural and suburban areas all over the country, people who formerly lived in neighborhoods, perhaps poorly serviced and with rudimentary infrastructure but neighborhoods nevertheless, have been clustered into cement high-rises thirty or forty stories high, in which they often no longer see or speak with neighbors, now sitting in the soaring towers alienated, and now often unemployed. Very often, the new residents of the housing blocks cannot afford the life of a city resident, with its higher electricity and water bills, its heating requirements, the need for trash-removal service. As the economy flags and then tumbles, these services will often be curtailed or cut, while the developments themselves will become crucibles of crime and poverty, plagues of which Chinese cities had been blessedly free.

Chapter 5:

Financial Innovation

5.1. Banking and shadow-banking

Since China recapitalized and listed its State banks, the government has made a political commitment to maintaining low rates of non-performing loans, in part, in order to retain the support of exchange investors and enable the banks to pay dividends. The government also maintains a GDP growth target, and the critical tool for achieving this growth is the investment capital that the government can deploy, directing capital to favored, State companies at about 6% despite nominal GDP targets well in excess of that rate. In other words, regulatory authorities direct credit preferentially, at losing rates, to the State sector. Logically, this process generates losses at the banks. The resolution to the contradiction between optically strong balance sheets and aggressive over-lending has been found in the shadow-banking sector.

China's shadow banks work in complete identity with the formal banking system. Where the banks must lend to low-profit areas, the shadow institutions create profitable connections to high-return businesses considered too risky for direct interface with banks. Where the banks must present the appearance of sound financial management and strong balance sheets to the investment community, the shadow institutions can effectively offload debt and provide needed liquidity through discreet channels that will not be visible to international institutions, whose admiration for China's financial system is so critical to its ability to capture new capital flows.

Financing added to the system gets split between banks and the shadow institutions, one formal and low-interest, the other higher-interest and higher-risk. The role of the banks is to channel a limited amount of credit at preferential rates into nationally targeted companies and programs. The shadow banks take the balance of the money being printed by the center and direct it into truly commercial channels. The banks offer to the shadow institutions their risk-free balance sheets, and the shadow institutions provide the banks profit without risk. The symbiosis between the banks and the alternative financial institutions is designed to provide credit well in excess of the economy's ability to digest it, while giving regulators the sense that they can maintain control over the money supply. Credit continues to surge, so, when regulators require the banks to be more prudent, the gray sector must swell. The money has to go somewhere.

Shadow banks, which include any institution outside of the banks that manages money, are tracked by the People's Bank of China under its "Total Social Financing" (TSF) category. This TSF does not include everything but does encompass Renminbi loans, bonds, trust funds, stock issues, and commercial bills, "entrusted lending," and pawn shops.

During the post-2008 growth in financing, the non-banking portion of finance has swollen, and RMB loans have become only about half of the pool of capital.

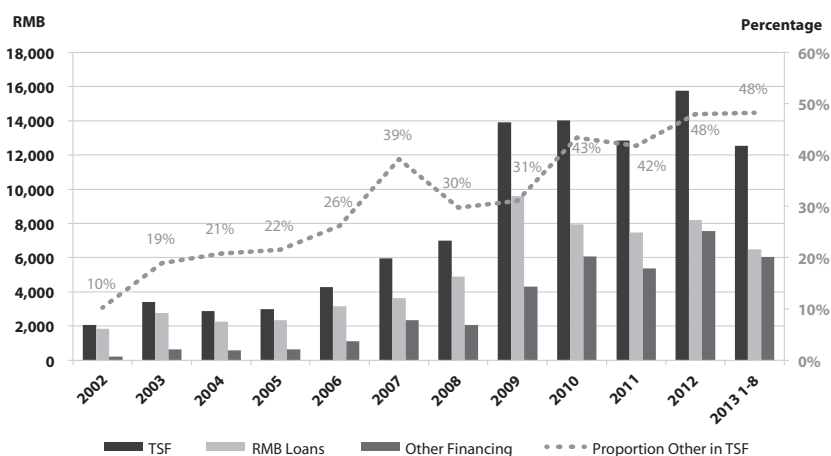
Table 9.
Total Social Financing Growth (2002-2012)

Year	TSF (RMB bln)	YoY
2002	2,011.30	n/a
2003	3,072.70	53%
2004	2,863.00	-7%
2005	3,000.80	5%
2006	4,269.70	42%
2007	5,966.40	40%
2008	6,980.40	17%
2009	13,910.50	99%
2010	14,019.10	1%
2011	12,828.60	-8%
2012	15,763.20	23%
2013 (1-8)	12,529.50	24%
Average YoY (2003-2013)		26%

Source: Wind Data, PBOC

The thrust of financial policy has been to push more financing into alternative channels, without acknowledging how tightly linked those channels are with the banks.

Chart 13
Total Social Financing vs RMB Loans 2002-2013



Source: Wind Data, PBOC

The shadow institutions are co-dependents to the commercial banks in two ways: banks are reliant on the shadow institutions to supply their liquidity, and shadow institutions get a lot of their capital from the banks.

5.2. Taxonomy

Fundamentally, there are two ways of classifying shadow banking, formal and informal, the latter including the underground market, inter-personal funds and loan schemes.

The funding of land assets over the last few years of borrowing against property has meant that people all over China have cash windfalls representing future years of potential growth. These treasure troves have found their way into the burgeoning private market and are largely undocumented.

Based on a CASS study some time ago, in cities like Wenzhou, located in Zhejiang Province, this sort of private lending scheme had risen in 2011 to an amount equivalent to as much as 20% of bank deposits. In other areas of the country, private investment schemes may account for 10% of deposits. These are deposits for which the banking system is no longer competitive.

Besides formal and informal, the TSF world splits into non-bank asset-management products and non-bank credit-creation, with lots of overlap of course. The credit-creation type includes bonds, entrusted loans, financial leases, bank acceptances, pawn shops, and financial guarantors; asset management channels include private equity, brokerage fund management, bancassurance, trusts, wealth management products (WMP), etc. One of the dangers of China's financial innovation of the last four years is that these assets are mostly going into short-term loans, and the loans they favor are those that are too risky for the banks.

5.3. Asset Management

5.3.1.1. Wealth Management Products

Similar to term deposits, these are higher-yield investment packages that can contain all sorts of instruments but often contain bank loans. Some 90% have terms of one year or less. They are managed in pools and often timed by banks to come to term on the monthly or quarterly audit date, so that the banks can report the cash as deposits. Then they issue new WMPs to pay out the old ones. Currently, about 80% of WMPs are issued inter-bank to promote bank liquidity.

Statistics on WMPs overlap with other categories. WMPs include bank products and non-bank products, but we will count only the bank-issued WMPs so as to avoid over counting. The Banking Regulatory Commission reported that bank-issued WMPs stood at 7.5 tln in Assets Under Management in 2012, an increase of 32% over 2011.

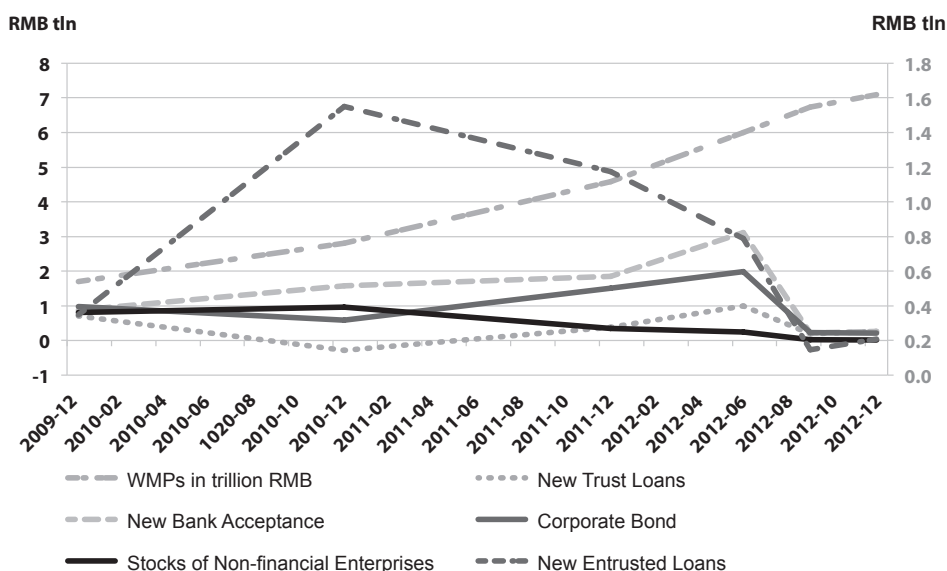
The average rates of return offered by bank WMPs fell by about 15-20% over the course of 2012, from between 5-6% to between 4-5%. Each week, there are around 550 new WMPs issued and around 570 coming to term. Around 5% are in foreign currency.

Over 60% are for one to three months, 20-25% are for three to six months, about 10-12% for six to 12 months, around 5% for under one month, and two or three products each week are launched for 12-24 month periods.

In other words, the WMPs are securitized loans. But the standards of collateralization and due diligence tend to be much lower than for bank loans.

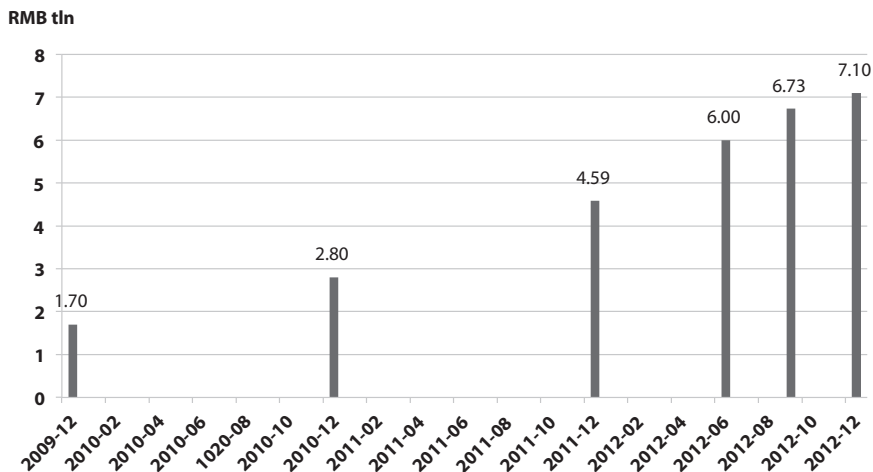
Wealth Management Products (WMPs) are investable derivatives of virtually any financial instrument. While WMPs have been around for a long time, they have only become important in China's economy since 2009.

Chart 14.
WMP Growth and Other Non-Bank Credit Growth



Wind data, PBOC, news reports

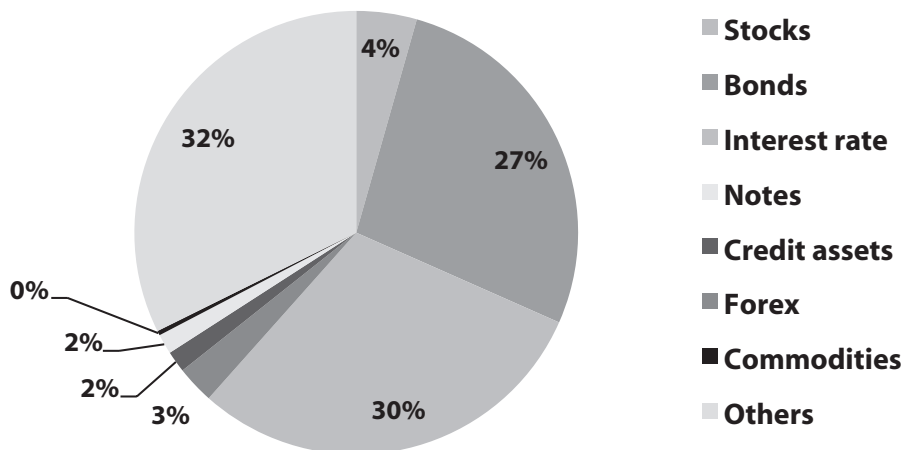
Chart 15.
WMPs Outstanding (2009-2012)



Source: Wind data, news reports

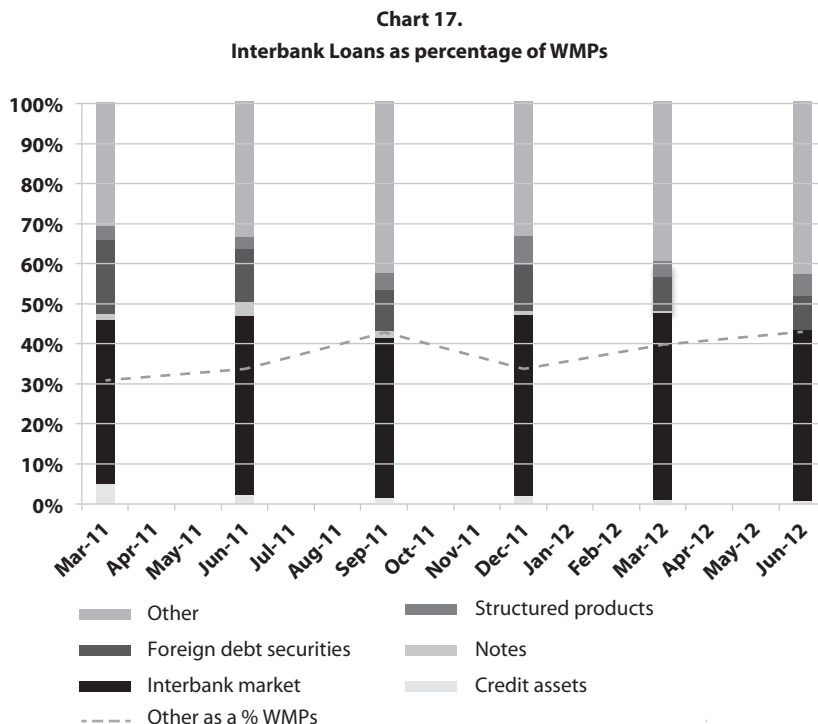
In practice, most assets underlying WMPs are interbank market obligations including interbank loans, Chinese sovereign debt, and repos. The breakdown in 2012 was reported as follows:

Chart 16.
WMPs by Type



Source: Wind data, J Capital Research

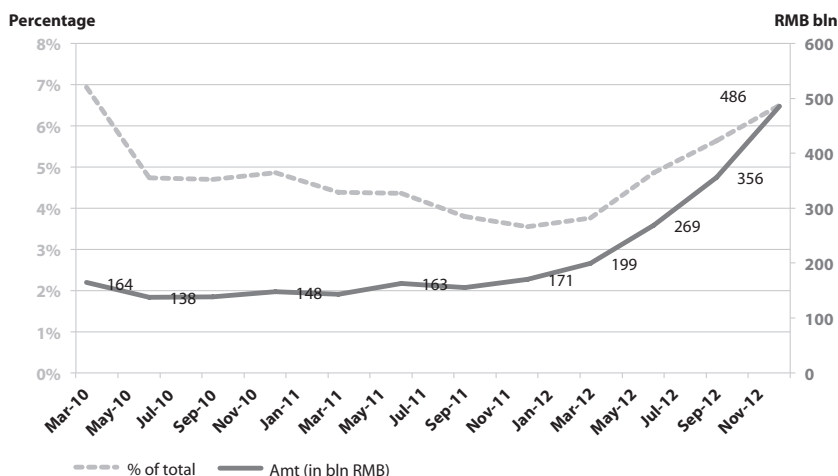
The “Other” category comprises mainly loans that banks move from their balance sheet into WMPs. While the proportion of bank loans in WMPs is unclear, the trend has increasingly been toward interbank loans.



Source: CN Benefit, J Capital Research

WMPs can be paid off at maturity not only by the cash flows from their underlying assets but from cash inflows from later WMP issues.

Chart 18.
WMP Trust Assets



Source: China Trust Association, Wind data

5.3.1.2. Bancassurance

Bancassurance increasingly is nothing more than a low-interest alternative deposit channel. Deposits are locked up for 5-10 years, with no principal guarantee. Rates are usually the same as bank deposit rates or at most 50 basis points higher. There is a small life-insurance component involved.

The amount of funds currently managed by bancassurance channels is difficult to track, but JRJ Finance News reported that five-year term bancassurance funds in January 2013 amounted to RMB 230 bln. As there are also longer-term funds, the real number should be somewhat higher. Banks sell them to their depositors, usually in return for agreement from the insurers that the bancassurance companies will place deposits at the branches that are doing the work of distribution.

5.3.2. Credit creation

5.3.2.1. Trusts

Theoretically, trusts represent capital pooled for a common purpose. There are now 66 licensed trusts in China with nearly 4,000 individual funds under management.

The trusts came into existence with CITIC in 1979; they could take deposits and finance projects but were focused on corporate deposits and finance. Bankruptcies in the late 1990s led to closings and a clean-up of the industry, which ended in 2007. Returns

in 2010-2011 were 8-10%, compared with bank deposit rates 3-3.5%. Until they were restricted, real estate trusts were about half of the total.

Critical to enabling the banks are separate pools of capital that can be used to push bank deposits on and off balance sheet. The key enabling institutions are the trusts.

The trust format was established in 1979 with the China International Trust and Investment Corporation, founded by “red capitalist” Rong Yiren, who persuaded Deng Xiaoping that he should be permitted to compete with the business of the Bank of China. The trusts took deposits and financed projects, and were iterated around the country at the provincial level. But in 1998, the default of the Guangdong International Trust and Investment Corp. (Gitic) on a \$150 mln debt led to curtailment of the entire trust industry.

The clean-up of the industry did not end until 2007, when licenses for trusts were reissued. Only three years later, the trusts had roughly RMB 6 tln under management,

Theoretically, these institutions represent capital pooled for a common purpose. They must be state owned, and they are licensed on a provincial level.

In 2013, trusts grew 74% YoY in the second quarter, and now are reported to have RMB 9.45 tln under management. Trusts work hand in glove with banks to channel money into off-balance-sheet loans.

5.3.2.2. Brokerage funds

Brokerages are now managing large pools of cash for institutional clients. According to the Chinese Securities Association, brokerages are managing RMB 3.4 tln for banks and asset-management companies. According to the Financial Times, this number grew by 600% YoY in 2012, and it appears to have doubled in 2013. This is because brokerages have more leeway than banks to invest funds in distressed property and other high-yield vehicles.

5.3.2.3. Bonds

Bonds are a preferred category for raising money these days. Now being issued at a rate of about 200 bln per month, they are traded by banks and SOEs. According to China-bond, outstanding bonds in 2012 amounted to RMB 8.57 tln. Of those, RMB 5.86 tln were central government bonds, RMB 2.5 tln were “entrusted” bonds (the kind that the central authorities issue on behalf of local governments), and about RMB 9 bln were bonds issued collectively on behalf of small and medium enterprises.

Outstanding issues rose by 12%, but the central government bond issues fell by 16%. Some RMB 647 bln were for centrally owned SOEs, whose issues rose by 160% year on year.

Companies can do inter-company financing at up to 4x the benchmark rate, with a bank normally channeling the funds. Given that many SOEs are cash-rich, and that they earn very low returns from their core businesses, entrusted lending to subsidiaries in property or finance is a no-brainer.

Like every other credit channel, this one has risen steadily since 2009, with a sharp spike at the end of 2012. Growth in 2011 was 43% over 2010.

The inter-company loans through the banks represent only a portion of the total—perhaps 60%. For companies in miserably depressed industries such as shipbuilding or steel, it's too tempting to take extra cash and put it into high-yield lending.

5.3.2.4. Financial leasing

These companies buy equipment and lease it to an industrial company, with the option for the company to buy at the end of the term. The contracts are three to five years at 9-12%. The last two years have seen an explosion of financial leasing companies under the Ministry of Commerce instead of under the China Banking Regulatory Commission. This is because credit raised by the MOFCOM-regulated companies does not come under the purview of the banking authorities and so is not tightly regulated.

The China Leasing Association reported in January that the top 20 financial leasing companies had RMB 800 bln in outstanding leases.

As anywhere, pawn loans are for quick credit in small amounts at steep discounts to collateral and at nosebleed rates. The difference in China is that, instead of extending loans to cover gambling debts against heirloom rings, pawnshops extend the majority of their loans these days against real property collateral, and the average loan amount has been rising.

Financial guarantors, unlike regular guarantors, have the right to extend loans themselves. Based on interviews, it can be estimated that the credit extended by these guarantors is roughly equal to 20% of the guaranteed loans.

5.3.2.5. Commercial bills

Commercial bills are used in both domestic and international business to settle trade. The most common type of bill in China is the bank acceptance, issued to the seller of goods on behalf of the buyer's bank in lieu of payment in cash. For example, an auto dealer will typically pay for autos from the manufacturer by issuing a bank acceptance. Acceptances have a range of maturities, but all mature within six months. If the manufacturer from our auto example wanted cash before the acceptance matures, they will need to sell the bill at a discount on the bill market. This means that the manufacturer will accept, typically, around 96% of the face value of the bill in cash. The buyer of the bill will typically hold it until maturity or may sell it again depending on his own liquidity needs.

Bank acceptances and other types of bills are off balance sheet for the banks until redeemed, but they do have an impact on the balance sheet. In order for the bank to agree to issue a bill in the amount requested, the auto dealer must have a certain percentage of that amount available in deposits at the bank. In China, banks require 50% of the acceptance amount to be available in deposits. In some instances the margin is as low as 30%.

But in China, banks cooperate with their closest and largest clients to iterate this process until the desired results are achieved. Firstly, the bank will issue a loan to its client, which will then be deposited as margin for a bank acceptance bill. Then, the bank will issue the banker's acceptance to the client in the agreed upon amount based on the margin rate. The bill will be discounted and sold on the secondary market at the market rates. If the discount rate is 5% and the initial bill's face value is RMB 100, then RMB 95 will be deposited in the account. The bank will then issue another bill based on the pledged deposits, which now includes the deposited RMB 95 from the previous discounting. So the next bill issued will have a face value of RMB 190, because the size of the bill issued can be twice the value of pledged deposits. This process can be iterated several times, until the bank and the customer are satisfied. The customer wins because it will have access to a large amount of credit at very competitive discount rates and the bank will increase its deposit base.

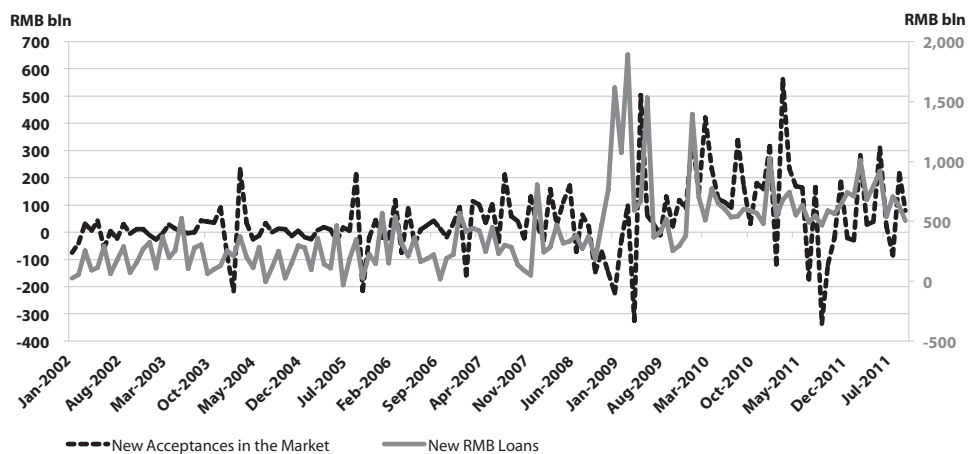
In other words this iterative process is a way of providing credit to a customer while sucking up deposits from the gray market. .

Banks may have generated on average 20% of their deposits from issuing commercial bills. Mid-tier banks may have generated around 50% of their deposits in this manner depending largely on their share of bill issuance.

Acknowledging that BAs are a channel for credit, the PBOC tracks them as part of total social financing. But the amounts recorded are for the new BAs issued in a given month, not the amount outstanding. And even so, the PBOC numbers show ballooning BAs. By January 2013, BAs were equivalent to half of RMB loans; there was RMB 5.8 tln outstanding in acceptances.

Commercial bills, especially bankers' acceptances, are a critical portion of the system because they can be issued at the discretion of any bank. Even better, acceptances are a form of off-balance-sheet financing that does not count against the bank's Loan to Deposit ratio. For this reason, issues have been expanding very rapidly and might have reached as much as 60 tln last year. This number is inexact, because banks report net new issues each month. The PBOC does keep statistics on total outstanding acceptances and bills, but the statistics can be hard to read.

Chart 19.
New Acceptances vs. New Loans

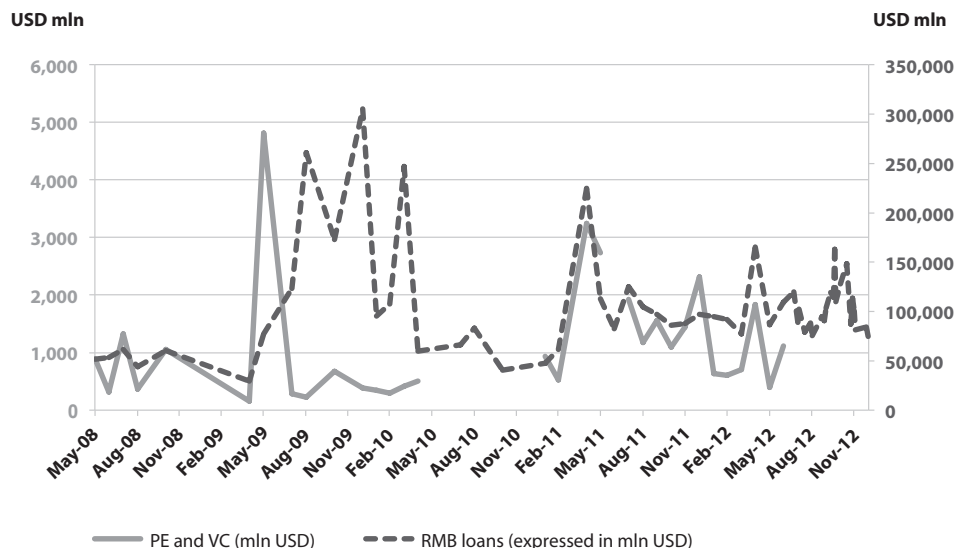


Source: PBOC

5.3.2.6. Pawn brokers and guarantors, as anywhere.

Private Equity (PE) funds have become such a supple channel for capital that returns are quoted weekly, and most banks own their own PE institution. Domestic news reports say that bank-owned private equities channeled RMB 60 bln in capital in the first four months of 2013, and that the funding accelerated through July 2013. In reality, most private equity funds are actually high-interest lending channels, with the loans secured by collateral in the form of equity in special interest vehicles established for the purpose.

Chart 20.
PE and VC Funds Raised vs. RMB Loans Extended (2008-2012)
(*H2 2010 data was not reported)



Source: Wind data, news reports, PBOC

Among the biggest of the new private equities, Minsheng Royal Fund Management Co., owned by Minsheng Banking Corporation, was formed in April 2013 and has reportedly raised RMB 50 bln since that time. Other banks with private equity subsidiaries include Everbright, Ping'an, ICBC, and Construction Bank. Press reports say that Minsheng Royal alone has more than 30 local banking partners, which all use the PE channel to place loans. Agencies like How Buy and Noah Holdings, which help banks place money in PE vehicles, reported phenomenally high returns from private equity investments this summer. The top three PE funds tracked by How Buy claim one-month returns over 9,000%, and the top 50 funds all claim to have made double-digit returns for their investors within the last 30 days.

There are no available statistics on total amount of money passing through private equity funds; one of the problems is definitional, as a PE fund might just as well be an agreement among friends to make certain types of investments. What is certain is that everyone agrees PE is accelerating. According to China Venture, July raises for private equity funds were about \$6.6 bln, compared with \$500 mln in June. Since the new breed of PEs are really pass-through accounts, without a fixed amount of capital under management, it would be impossible to track the money by looking at the PE companies; it is the banks that would need to be scrutinized by auditors, and the whole point of using PEs is for the banks to have a shadowed channel.

5.3.2.7. The underground market

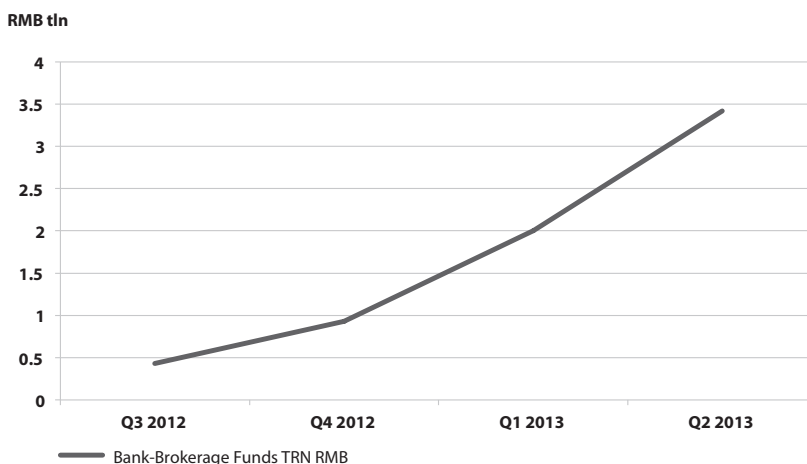
Although small, the gray- and black-market funds formed among individual's probably cause the highest anxiety for public officials. In some counties, government researchers have estimated the informal market at 20% of total deposits. Generally speaking, in China informal funds may represent an additional 10% of cash in society, over and above bank deposits, according to PBOC estimates.

Mostly, the underground market takes the form of small loan companies, which technically are not permitted to accept deposits but often do. They might set up websites for micro-financing. They might form an investment club or a venture capital company that is registered as a consultancy. This portion of the market is truly a black hole from the regulators' point of view: investors may believe they are investing in a government-backed scheme. They may be the types of vulnerable individuals whose losses would pull heartstrings in the case of a default, and yet there may be little documentation associated with their investments.

5.3.3. Bank-brokerage funds

Perhaps the most commodious channels for bank credit are the asset management plans in which banks and brokerages cooperate. According to Caijing magazine on August 2, 2013. While asset management business of securities companies grew 600% in 2013, to RMB 3.42 tln by mid-year.

Chart 21.
Assets Managed by Bank-Brokerage Channels



Sources: Caijing, Hexun

These assets under management are largely bank deposits, simply moving through a new channel. Domestic press coverage acknowledges this, as does the regulator: the CBRC has said it would establish a private equity division and begin tracking asset management companies as part of Total Social Financing.

5.3.4. Derivatives

Chinese banks are inventing new types of derivatives at blinding speed. In one example, pre-IPO shares in a company are packaged into a trust. The trust is sold, with the guaranteed return being the estimated share appreciation. A securities company guarantees the product, which is then sold as a pool to retail investors.

Brokers and underwriters also underwrite private-equity debt instruments and sell them to insurance companies, investment companies, and state-owned enterprises, offering high returns.

There is a popular new type of “small and medium enterprise bond,” which apparently started from 2007 and has grown aggressively in recent years, with vigorous support from local governments. The bonds are to finance small companies that aren’t qualified to list on the Enterprise Board; ten or so companies are packaged into a joint “SME Collective Bond.” The collective not only collects bond proceeds but can also receive bank acceptances.

The explosion in shadow banking has wrought several changes in Chinese society, generating a profusion of new, high-yield financial products and new channels for credit and, in doing so, creating competition for bank deposits. Meanwhile, shadow banking has created a runoff of cash into the hands of people politically connected with the banks. For that reason, shadow banking may have been one of the greatest contributors to economic inequality yet to be seen in China.

5.4. Quasi-Money

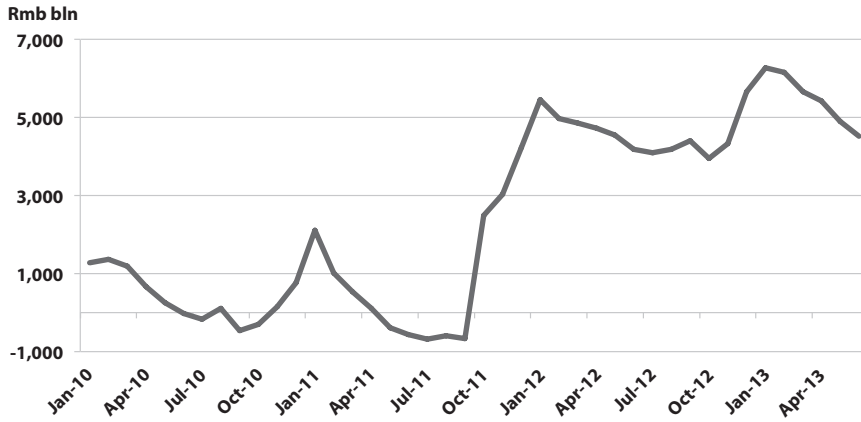
As the shadow system has created high-return financing channels, the banking system has had motivation to create credit, and reliance on shadow currencies, financial instruments like commercial bills that circulate and can be exchanged for cash, has grown rapidly.

Over the period since the 2008 stimulus, the financial system has been generating new types of virtual money, now representing nearly three-quarters of the money in circulation. Although this is not so unusual for a financial system, in China, the virtual money tends to represent highly illiquid investments, in property or in capital goods, and so new money must be issued when the holders of these instruments want to recover the old. It’s like paying for your house with an IOU that the family who sold it then uses to pay for groceries, and the grocery store uses to pay salaries. At some point, someone in the value chain wants cash, but if the only way to obtain it is to sell the house, it might take a long time.

Since 2012, the pace of quasi-money creation has outpaced total deposits; between the end of 2011 and the first quarter of 2013, over RMB 5 tln was created that did not

end up as bank deposits. That money could represent capital flight, but also the money being created in the statistics could, to some extent, be fraudulent.

Chart 22.
Gap Between M2 and Deposits



Source: PBOC, Wind Info, J Capital

Table 10.
M2 Growth 1985-Feb 2013

Year	M2 (RMB tln)	% Change	Reported GDP (RMB tln)	M2/GDP
1985	¥0.52		¥0.902	58%
1986	¥0.67	29%	¥1.028	65%
1987	¥0.83	24%	¥1.206	69%
1988	¥1.01	21%	¥1.504	67%
1989	¥1.19	18%	¥1.699	70%
1990	¥1.53	28%	¥1.867	82%
1991	¥1.93	27%	¥2.178	89%
1992	¥2.54	31%	¥2.692	94%
1993	¥3.49	37%	¥3.533	99%
1994	¥4.69	35%	¥4.820	97%
1995	¥6.08	29%	¥6.079	100%
1996	¥7.73	27%	¥7.118	109%
1997	¥9.06	17%	¥7.897	115%
1998	¥10.45	15%	¥8.440	124%
1999	¥11.99	15%	¥8.968	134%
2000	¥13.84	15%	¥9.922	139%
2001	¥15.83	14%	¥10.966	144%

2002	¥18.50	17%	¥12.033	154%
2003	¥22.12	20%	¥13.582	163%
2004	¥25.32	14%	¥15.988	158%
2005	¥29.88	18%	¥18.494	162%
2006	¥34.56	16%	¥21.631	160%
2007	¥40.34	17%	¥26.581	152%
2008	¥47.52	18%	¥31.405	151%
2009	¥61.02	28%	¥34.090	179%
2010	¥72.59	19%	¥40.151	181%
2011	¥85.16	17%	¥47.310	180%
2012	¥97.41	14%	¥51.932	188%
2013 (Feb)	¥99.86	15%	n/a	n/a

Source: Wind data, PBOC

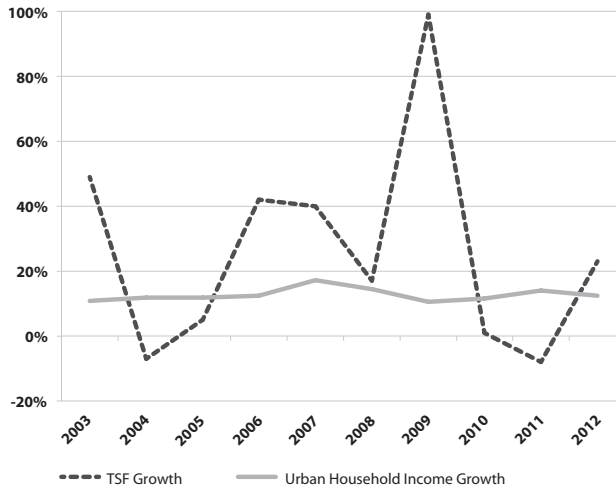
Not only does the shadow market fund the banks, but banks also fund the shadow market: banks are the ultimate source of many “non-standard” financial products. Just about every small local lending institution has a beneficial owner or a director who is also a director of the local commercial bank. That person or institution acts as a bridge to convey cheap bank loans to the more expensive private lending channel. The whole market is running on the rate arbitrage between official channels, which lend at 6.5-9.5%, and gray channels, which lend at 12-60%.

5.4.1. Falling deposits

The data show that, despite fast reported growth in deposits and even faster loan growth, in reality, deposits from conventional savings have shrunk. This means that banks have fewer resources to meet short-term liquidity demands. As the pool of short-term money (demand deposits and money in circulation) represented by M1 decreases, banks need to acquire these funds elsewhere, in the interbank money market or through other means. This trend would seem to make future liquidity crises all but inevitable.

The core of the banking system consists of deposits generated from corporate or family savings. But household income has not risen anywhere near fast enough to support the credit growth China has required to fuel its GDP.

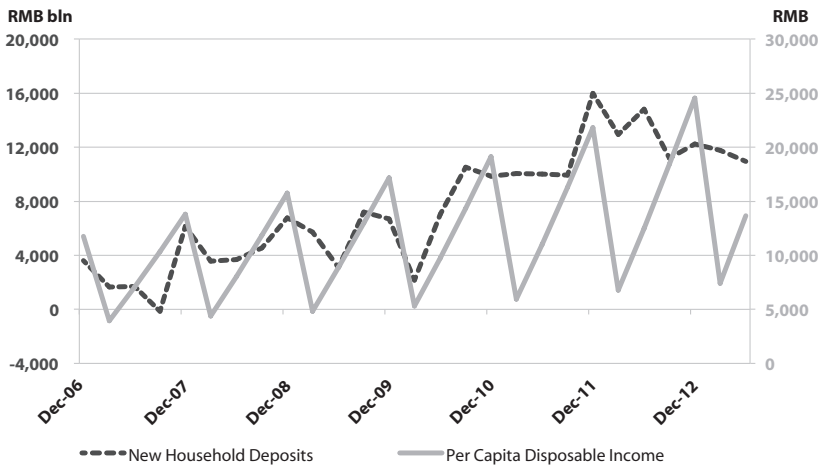
Chart 23.
Household Income and Credit Growth per Year



Source: NBS, PBOC, Wind Data, J Capital analysis

Here is another look at the deposits that should be generated by conventional savings, based on household disposable income rather than total income.

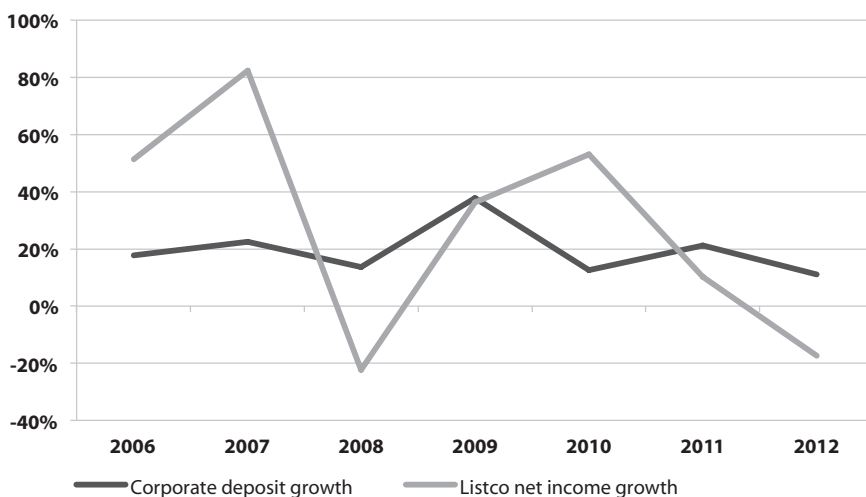
Chart 24.
New Deposits and Disposable Income



Source: PBOC, NBS, Wind Info, J Capital

Corporations show the same divergence between reported income and reported deposits. Reviewing the net income reported by China's 1,500 or so companies listed on the Shanghai and Shenzhen stock exchanges and comparing the income growth to deposit growth, corporate income started to plummet in late 2011, while corporate deposits continued rising. The same occurred in 2008, when corporate income fell 22% but corporate deposits rose, as China started pushing credit into the economy.

Chart 25.
Listed Cos. Income and Corporate Deposits



Source: Wind data, J Capital Research, PBOC

Loans generate deposits. The surging credit of the last few years has ensured that deposits would grow faster than GDP. But deposits generated from loans are short-term and volatile. As loan growth falls, the banks need to find deposits elsewhere. Increasingly, they are relying on questionable strategies that essentially fake their deposit levels, and this thins the cushion for China's banking system, making it more vulnerable to the shocks that will inevitably shake the system within the next year or so.

The Cinda case

When China's last financial crisis began, in 1998, the strategy for recovering from the expansion of credit was to recapitalize the banks by segregating bad debt into four Asset Management Companies—one for each of the China's four major banks. These empty vessels were created in 2002 by issuing bonds to the Ministry of Finance based on the idea that the bad debts they had assumed

were really worth full value. The paper fiction formed the seed of what have now become China's most powerful multi-service financial institutions.

The public offer of Cinda provides an opportunity to look more carefully at the implications of the once and continuing bank bailout. Documents issued by the company cast more shadow than light. The entity proposed for listing, for example, shares a name with the Cinda AMC parent company and owns the same subsidiaries, but its balance sheet is nowhere near big enough to be the same company that swallowed up non-performing loans back in 2002. Instead, this company appears to be a carve-out, which must be leaving a bigger and more indebted parent company behind. The company claims to have settled RMB 1.49 tln in distressed assets, and it has a fast-climbing stock of assets held for sale, which may represent new packets of non-performing loans (NPLs), but the company offers no explanation for the assets it owns, its business rationale in acquiring new ones, or how it will make money for investors if it manages to attract them.

The documents available to the public present entities that make little sense as freestanding entities; instead, they are like the parlors in American Colonial homes, formally decorated anterooms dedicated to the reception of guests and never used by the homeowners lest the appearance of wealth and ease be marred by wear and tear.

Overall, it is striking how provisional the arrangements for handling distressed debt always seem to be. For example, in 2009, bonds issued by the AMCs were set to mature and could not be paid, so the State Council simply extended the maturities by a decade. In 2010, the South China Morning Post linked the Construction Bank's new, \$1 bln investment in Cinda to an impending default on interest payments. Top officials in CCB are the top Party officials in Cinda, so an already close interest became even closer with this equity investment.

In addition to disposing of distressed assets, Cinda is involved in brokerage, fund management, insurance, trust, and financial leasing. In 2011, it claimed RMB 6.85 bln in profit on 21.79 bln in income. It employs 20,500 people. It holds interest in Bank of Xi'an, China Everbright Bank, Guotai Junan Securities, its own real estate subsidiary, and a dozen other companies listed in Hong Kong as well as unlisted SOEs.

When Cinda and the three other Asset Management Companies were established in 1999, the government explained that their mandates were to liquidate the assets related to NPLs from the major banks, and then they would be shut down. They were to be put to sleep in 2009, a decade after their creation. Instead, they have morphed into comprehensive financial-service companies, politically powerful, with access to funding from a range of public and private sources.

These entities took roughly half the identified NPLs from the banks, almost RMB 1.5 tln in total, and posted recovery rates from 10% to 40% of par, averaging about 20%. How they then became leading members of China's pantheon of equity investment players is the story of China's all-but-magical financial services sector.

While comparisons are frequently made with the Resolution Trust Corporation in the U.S. and the NPL solutions deployed by other Asian nations, China's AMC approach stands starkly alone. From Korea's KAMCO and Japan's Resolution and Collection Corporation, to the Thai Asset Management Corporation, each of the other governments that have bought distressed assets from the banks did so at a deep discount and sold at a gain. China's asset management corporations took the loans off the big four state banks at 100% of par value and in the aggregate realized 20% of the value. That would not seem to be a formula to become savvy modern players in China's financial sector.

Another important thing to note is that the government determined that it had to deal with NPLs only in 1999, after two years of celebrating its avoidance of the crisis that had swept across the rest of Asia. Their NPL program was not driven by an acute external debt crisis. It was the result of the normal workings of China's economic development model. In other words, the accumulation of massive levels of non-performing loans was deeply chronic to the relationship of China's financial sector to the real economy. And it continues to be so.

Lifting the veil to improve visibility into the instruments and processes put to use in China to address massive NPL accumulations is a step toward assessing the sustainability of China's rapid development and the reasons that crisis looms behind prosperity. (And there is a Chinese proverb about that from which my Chinese name is taken.)

Briefly, Cinda is the smallest of four AMCs created in 1999 to remove NPLs, which were running at about 40% of total loans, from the banks. The best account of this financial history is in *Red Capitalism* (Walter and Howie, 2011), well worth reading. During the 1999 first-phase bailout, the banks transferred about half of their non-performing assets to the four newly created AMCs (one for each of the Big Four—Cinda was dedicated to Construction Bank but also took on about 100 bln RMB in bad assets from the State Development Bank). The AMCs in return issued bonds to the banks at par value.

Cinda reports that it "completed the first tranche of restructuring" in 2006, "amply demonstrating Cinda's innovation ability." Recovery was around 20%, including equity conversion, but what happened to the 80%? There was no write-off by the CCB. The debt seemed to move off to the Ministry of Finance, which issued a notice that in 2005, preparatory to bank IPOs, that it would "support" the bonds if needed. This guarantee with Chinese characteristics seems to exempt the bonds from being counted as a central government debt.

Cinda reports that, historically, it has acquired RMB 1.49 tln in distressed assets and recovered 240.3 bln in cash while also retaining equity that was swapped for debt. It reports that it is the "industry leader" in disposing of bad assets. The company cautions that its mission is to help the government manage and dispose of bad assets—not to assume the debt.

In effect, Cinda is an anteroom in which Construction Bank parks distressed assets while the Cinda team tries to auction, convert, or otherwise optimize them. But, like the subway station in *The Matrix* to which passengers always re-

turn no matter which train they take, the AMCs seem to be virtual holding tanks where the debt doesn't stay and doesn't depart either: the 1999 bond tranche has been wiped clean from the Cinda balance sheet, but where did the unpaid obligations go?

Despite the low recovery rates, the AMCs got the choicest batch of NPLs. The rest stayed with the banks and were swapped for IOUs from the Ministry of Finance that did not entail any particular repayment schedule. The AMCs were to assume debt from fundamentally viable companies and swap it for equity. This was part of the massive SOE restructuring plan of the time: the AMCs were expected to act like private equities—stern and dispassionate board directors motivated by profit. It was thought that this would help create SOEs that thought and acted like commercial companies. To the contrary, the result was an implicit guarantee to SOEs that they would not go bankrupt, which in turn supported the general disregard for debt-equity ratios and any calculation related to servicing debt.

The AMCs were to dispose of the bad assets through auctions and then, their mission accomplished, dissolve. But, at the close of the first decade, when the AMCs had lost 80% of their assets, closing them would have entailed accounting consequences: losses to the banks or avowed government debt. No one wanted either.

By 2009, the AMCs were conducting themselves like mutual fund managers; Cinda was among the most prestigious organizations in the country. It had branched out into brokerage, financial leasing, private equity, insurance, and was reporting profit. UBS and Standard Chartered invested in 2011, and now the company will IPO in Hong Kong. Rather than dissolve the AMCs and accept a black mark on the record, the government extended their bond maturities for another decade and created, through sleight of hand, institutions that rival JP Morgan in the appearance of financial sophistication and wise management.

It appears, given the record of payment on interest to CDB, that Cinda's cash collections of 65.3 bln were not handed over to the banks as repayment of principal but used to pay interest on the bonds. This way, CCB could continue to report that its assets were current. This is perhaps the most self-serving part of all this sleight of hand by the banks: it meant that, now-listed, they could keep reporting payments even though they knew the principal had been lost.

Meanwhile, the actual deficit seems to have disappeared. One chunk of debt sits in the accounts of MOF as obligations held in trust, whatever that means. Another portion has been extended without penalty for a decade. Part of it resides in the original capitalization for the AMCs from PBOC and subsequent subsidies, on obscure bases, that were made. The banks continued selling NPLs in new tranches. In 2004, for example, the PBOC bought 320 bln in NPLs at par and then sold them to the AMCs for 40% of par value. This happened again in 2005 and 2006.

The simple way to look at the creation and continuing funding of the AMCs is that they represent a gargantuan "quantitative easing" event. In effect, the PBOC injected several hundred billion into the economy in 2005 and 2006, years of

reported high GDP growth. In reality, this is a form of deficit spending, not a monetary operation. The main difference is that deficit spending is generally backed by bonds and is approved by the NPC.

Like the big SOE banks, Cinda manages to look like an attractive investment if historical debt is ignored. There is the argument that the banks cleaned up and now operate on a more commercial basis than they did prior to listing. The simplest piece of evidence that this outlook is inaccurate comes from bank-lending officers around the country. They generally estimate that about 50-60% of their loan portfolios are evergreen loans, reliably rolled over and never paid off. Some additional portion consists of loans for which the borrowers get cash on the short-term market to pay off the obligations mere days before the bank will issue a new loan—another type of evergreening with a different accounting treatment.

In other words, banks in China are in the business of transferring capital from depositors in the private sector to SOE borrowers, who keep it. Walter and Howie (2011) pointed out that, despite being nominally the best-capitalized and most profitable banks in the world in 2009, China's Big Four failed to buy all the distressed financial assets in the United States. Why did they miss this once-in-a-century opportunity? Because the funding mechanism for Chinese banks could never work in a country where depositors have choice.

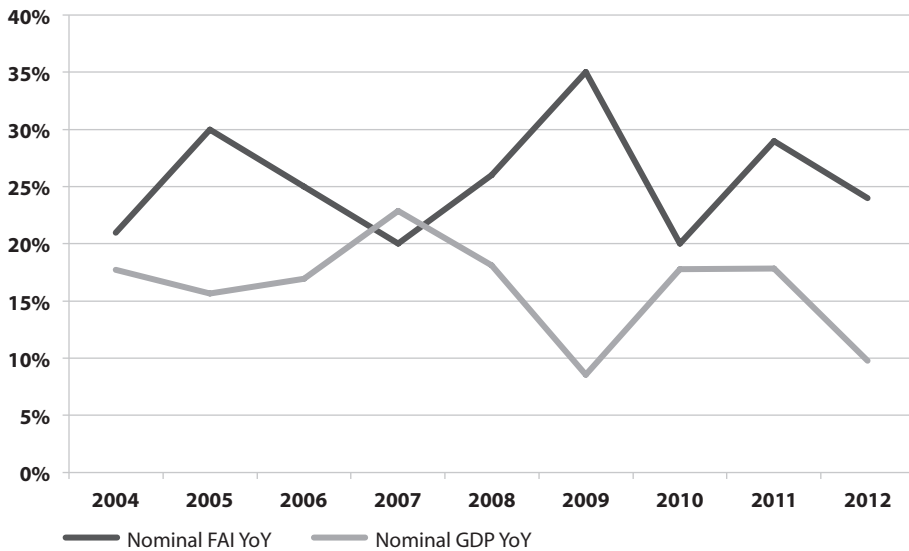
Chapter 6:

Triggers to Crisis

6.1. The gathering storm

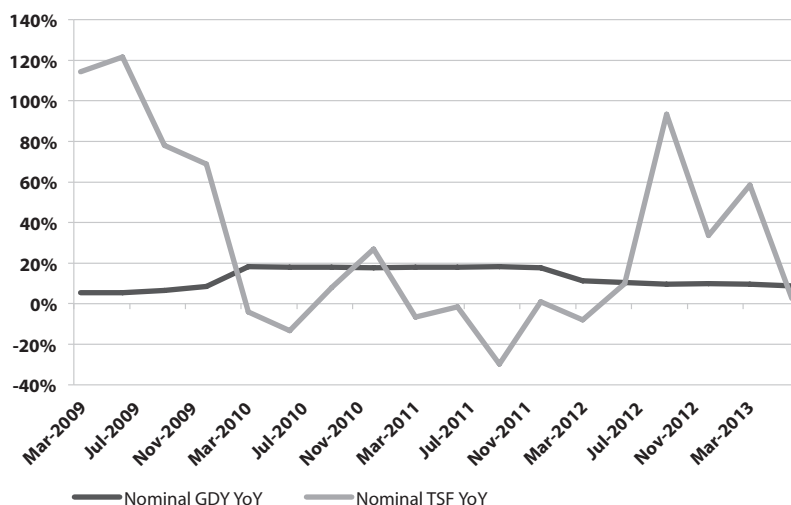
China's economy has long been an inefficient user of capital, but the 2008-9 stimulus elevated the degree of waste and brought returns on investment drastically lower. Investment as a proportion of GDP, always untenably high, has grown.

Chart 26.
Fixed Asset Investment and Nominal GDP Growth



Source: NBS

Chart 27.
Credit and Nominal GDP Growth



Source: NBS, PBOC

With indebtedness reaching as much as 250% of GDP by late 2013 amid slowing economic growth, current levels of investment have become untenable, and a financial crisis looms. Potential catalysts could be sudden, **triggered by anything from a crisis of confidence** around a financial default to the gradual erosion of willingness to hold the currency.

6.1.1. Defaults

In mid-March 2013, pictures of two different types of failure dominated the news: thousands of bloated hog carcasses floating down a river outside Shanghai and the messy bankruptcy of Suntech Power.

In a strictly economic sense, neither incident moved the needle. The 8,000 hogs mysteriously dumped in the river were a rounding error in a country that slaughters over 600 million hogs a year. Suntech's total of \$2 billion in debt makes it puny next to debtors like, say, the city of Tianjin.

And yet both incidents had ominous symbolic importance. It is impossible to ignore the prospect of hundreds of thousand of infected pigs floating down the river (there are tens of millions raised along it), and it is impossible to ignore that there are hundreds of Suntechs waiting to collapse. The consequences of the pig flotilla could potentially be a demand shock that would push up international commodity prices and drain China's trade surplus more quickly than it accumulates. The Suntech collapse and subsequent revelations exemplify key things about debt mismanagement that is endemic in Chinese enterprises.

Defaults on more than 100 million RMB in debt are a weekly phenomenon in China--so common, in fact, that the law of averages suggests one of them, unpredictably, could provide the spark that leads to a cascade of unmet claims. Suntech's bankruptcy itself is supremely unsurprising: like China's other solar manufacturers, the company has been gorged on credit and demonstrates that operating a company on the premise that you cannot go bankrupt creates a complete lack of interest on the part of executives in debt/equity ratios and other measures of fiscal health.

Small, localized defaults have been frequent since 2011. In early 2013, the South China Morning Post reported that a branch manager of Pudong Development Bank (PDB) in Zhengzhou created her own "wealth management product" from funds gathered from PDB depositors, paying out a reported RMB 1 bln to 70 original depositors before the scheme went bust. Estimates of losses run from RMB 82 mln up to RMB 6.2 bln, the latter number being what local financiers in Zhengzhou say is the total amount of capital that apparently was extended, including through leveraged loans. The most remarkable part of this story is that the branch manager, named Ma Yijiang, was detained for taking illegal deposits back in October 2011. The scheme was widely reported last April, but the news reports were then deleted and remain inaccessible on the Internet. In May 2013 in Zhengzhou, about 40 people gathered with placards to demand their money back.

The bankruptcy of Suntech Power Corp., China's largest solar panel maker by volume of sales, in one critical aspect resembles the relatively small default that set off the 1998 banking crisis: foreigners are involved, and so many of the details are public. In the 1998 default by GITIC, it was because foreign bondholders were informed that GITIC became a symbol both of Guangdong's profligacy and of China's honor.

With a public company like Suntech, lenders are disclosed, so we know that Bank of China is the company's largest lender, with 20% of Suntech's loans or about \$371 mln. Bank of China is also a significant lender to near-bankrupt LDK Solar. If Bank of China holds its own weight in solar-sector loans that would mean roughly RMB 20 bln. After the default of Chaori Solar in December 2012 for RMB 5 bln, Datang Tech and Xintai the previous year, and many companies shuttered now for lack of business, the failure of write-downs to cascade through the credit system only suggests a build-up of pressure that is likely to become spasmodic when released.

Defaults in 2012 were plentiful. There was a rash of failures by steel traders, solar producers, private lenders, and property developers. But the only private default that attracted the attention of central authorities was the one that led to a protest at a bank in internationally visible Shanghai. Henan Xin Tongshang, a financial conglomerate, had already defaulted a year earlier in Henan. But the local government helped the company pay its original investors by issuing a new "wealth management product" in Shanghai through Huaxia Bank. When that new issue defaulted, investors gathered at a branch of Huaxia in Shanghai until authorities insisted that the bank make good on principal.

This type of event is by no means guaranteed to occur. But, given the vast number of poorly regulated and capitalized institutions around the country that have been issuing debt, defaults are very likely.

Should one of these random events not puncture China's debt bubble, then the indicators to watch are mostly around net inflows of capital. That is why the pigs might

matter: a hog market this size need only shudder to create a demand shock internationally. In 2007-8, a shortfall in Chinese pork production led to a spike in imports. In 2009, the mere announcement that China might lift a ban on U.S. imports drove up prices for pork internationally. Since 2006, according to the U.S. Department of Agriculture, Chinese hog prices have been significantly higher than U.S. prices. An import spike could push China's trade balance into negative territory, reducing the cushion the country has against shocks domestically.



CCTV image of pig carcasses being hauled away on a barge. Photo GB Times.

If not hogs, it could be corn, chicken, milk. Infant formula continues to be heavily imported following the tainted-milk scandals of 2008, which were never really resolved; in a sign of how much authorities care about hard currency, the government recently limited the import of baby formula from Hong Kong. Rice imports are rising since disclosures that about 10% of China's rice contains dangerous levels of cadmium.

Most of these cases are hushed up, but a major contamination event or natural disaster that is widely known could force imports to supplement the food supply. A quick move from imports of about 3.5% to 10% of China's pork, for example, would create a price shock worldwide. Were that to happen, China could see its trade surplus flip very quickly.

Crises are triggered by sentiment. Ultimately, what will trigger financial crisis is a loss of confidence in the core institutions of the system. The banks are laden with bad debt but can forebear as long as depositors are willing not to claim their cash. Retail investors who are deep into shadow-sector investments largely believe that the banks will keep them whole. Private lenders will forebear as long as debtors can continue borrowing to service their debt. Property prices will rise as long as buyers don't try to sell their holdings. But everything unravels once people start to worry about getting out, absolutely need liquidity, or decide to test the recoverability of their investments. In China, a turn of sentiment could rip through the economy at a furious pace.

Domestically, the trigger for economic crisis ultimately will be a sharp decline in property values, which in turn will stop the speculative buying and bring even more inventory onto the market. As developers fail to sell, they will also fail to get new financing to roll over old loans, and bank loans, trust loans, WMPs, and other miscellaneous credit instruments will default.

6.1.2. Major move in exchange rate

Kenneth Rogoff and Carmen M. Reinhart's authoritative study on financial crises, *This Time Is Different* (2011), notes that any deviation from trend of exchange rates tends to precede a financial crisis. In China's case, under pressure to improve exports and attract foreign capital, depreciation is more likely than strengthening. It is evident that the PBOC is forcing the rate into very minor appreciation cycles in defense. Also, the push to increase circulation outside China has gotten very intense.

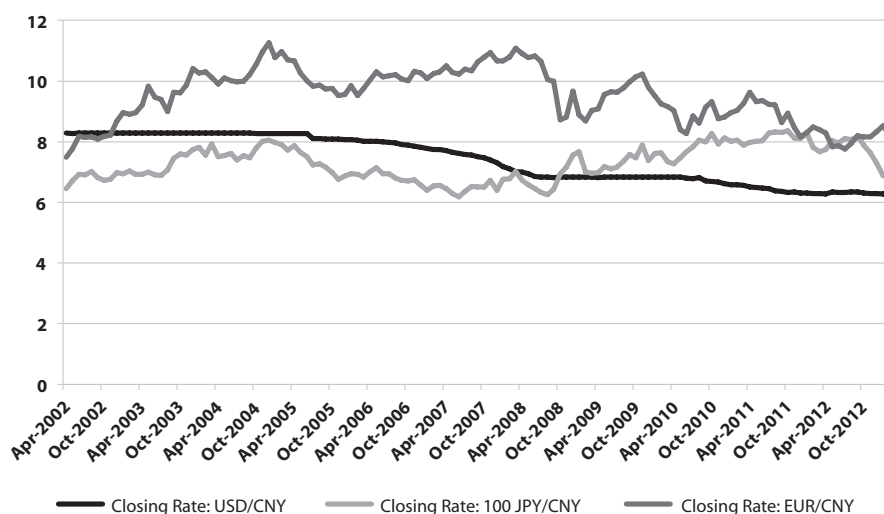
A move of more than 5% in a 12-month period, countering historical trend, should represent trouble in the following year. This perspective suggests that 2009 should have been a year of crisis.

Table 11.
RMB Appreciation Against the USD (1996-2012)

Year	Appreciation/Depreciation against the USD
1996	1.48%
1997	0.24%
1998	0.18%
1999	0.01%
2000	-0.36%
2001	0.36%
2002	0.02%
2003	0.00%
2004	0.00%
2005	0.00%
2006	2.61%
2007	3.51%
2008	7.62%
2009	4.83%
2010	0.16%
2011	3.48%
2012	4.21%
2013	0.51%

Source: PBOC/Wind Data

Chart 28.
RMB Exchange Against the Euro/USD/Japanese Yen



Source: Wind Data, PBOC

6.1.3. Fiscal deficit

When the gap between government revenues and expenditures widens, this is a sign of mounting debt and should be watched. Table 12 shows the annual gaps between reported revenue, tax and non-tax, and reported expenditure from 1990 through 2012 (i.e.: annual budget deficits). Again, 2009 appears to represent a year of divergence from trend and excess deficit spending.

Table 12.
Annual Reported Budget Deficits

Year	Annual Deficit
1990	-4%
1991	-4%
1992	-4%
1993	-3%
1994	-4%
1995	-3%
1996	-2%
1997	-3%

1998	-3%
1999	-3%
2000	-5%
2001	-4%
2002	-6%
2003	-7%
2004	-7%
2005	-6%
2006	-7%
2007	-9%
2008	-9%
2009	-10%
2010	-9%
2011	-8%
2012	-7%

YSource: NBS, J Capital Research

6.1.4. Debt obligations

China's external debt is quite low, but central government obligations for domestic debt have been rising steeply. In 2012, interest payments rose sharply.

Table 13.
Government Interest on Domestic Debt

Year	Interest Payments on Domestic Debt YoY
2003	42%
2004	-21%
2005	7%
2006	20%
2007	8%
2008	24%
2009	14%
2010	24%
2011	29%
2012	169%

Source: Ministry of Finance, J Capital Research

6.1.5. Short-term capital inflows/GDP

Ultimately, trade surpluses and FDI are the raft holding the financial system afloat. At the moment—despite problems of fraud in the statistics—China has net inflows to rely on.

Table 14.
Trade Flows and Reserves 2002-2013

Year	Imports (USD bln)	Exports (USD bln)	Surplus (USD bln)	Forex Reserves (USD bln)	Reserve Growth YoY
2002	\$325.62	\$295.33	\$30.29	\$286.41	
2003	\$438.47	\$413.10	\$25.37	\$403.25	41%
2004	\$593.65	\$560.82	\$32.84	\$573.88	42%
2005	\$762.33	\$660.22	\$102.11	\$818.87	43%
2006	\$969.33	\$791.79	\$177.54	\$1,066.34	30%
2007	\$1,218.64	\$955.95	\$262.69	\$1,528.25	43%
2008	\$1,430.69	\$1,132.57	\$298.13	\$1,946.03	27%
2009	\$1,201.61	\$1,005.92	\$195.69	\$2,399.15	23%
2010	\$1,577.75	\$1,396.25	\$181.51	\$2,847.34	19%
2011	\$325.62	\$295.33	\$30.29	\$3,181.15	12%
2012	\$325.62	\$295.33	\$30.29	\$3,311.59	4%
Jan-Feb 2013	\$326.74	\$282.34	\$44.40		

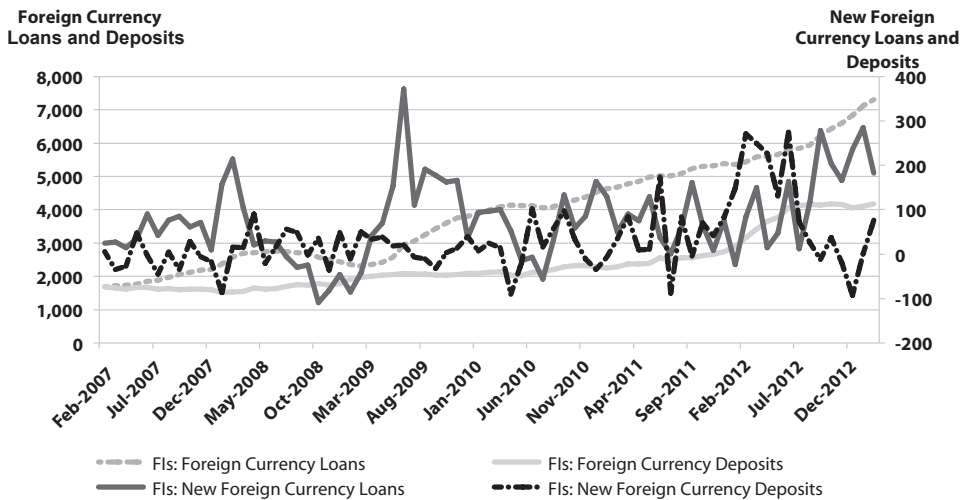
Source: China Customs, Ministry of Finance, Wind data

Table 15.
Foreign Direct Investment

Year	FDI (USD bln)
2003	\$53.50
2004	\$64.03
2005	\$60.33
2006	\$63.76
2007	\$68.02
2008	\$92.40
2009	\$90.03
2010	\$105.74
2011	\$116.02
2012	\$111.62

Source: Ministry of Commerce, Wind data

Chart 29.
Foreign Currency Deposits and Loans



Source: Wind Info, PBOC, J Capital Research

6.1.6. QE as Co-Dependent

One of the fingers in the dyke of a potential Chinese outflow has been the expansionary monetary policy of the United States, because, as long as international rates remain very low, the average wealthy person in China will export only a small portion of his or her capital, for security, and invest the rest in China, where a bank account can earn *as much as 8% when counting supplementary interest that some banks pay as sweeteners to large depositors. But the United States signaled in mid-2013 that it will back off its bond-buying policy in the autumn. Any rate adjustment in the U.S. market will have an immediate impact on China's ability to capture incoming capital and thus the viability of its financial system.



A luxury housing development in Hainan still selling at the top of the market but apparently abandoned. Photo by the author.

6.2. Reports vs. observations

In late summer 2013, Chinese GDP growth was reported at 7.5% and climbing, with consumer spending at 13%. Consumer durables companies reported high sales growth, and yet interviews in many cities across China indicate plummeting sales of luxury products, from fashion to wristwatches and liquor to autos, with an average YoY decline between 20% and 30%, according to the interviewees. The gap between observations and reported numbers is puzzling and has several sources. But the key to the gap is China's investment culture.

For two decades now, China's has been an investment market. Entrepreneurs, companies, investment funds, and indeed the nation as a whole have sold the idea of a China that will grow into the world's dominant economy, where future dividends will pay handsomely on the investment made to capture share today. Profits taken and wealth created have been from capital gains in IPOs, share appreciation, and M&A deals, not, by and large, from the operating returns earned by companies.

As a result, the incentive system of corporate managers is heavily weighted toward showing growth at the cost of margins, sustainability, or even accuracy. Consider the returns made by the management teams and private investors in such well-established frauds as Longtop Financial, China Media Express, Sino Forest, and many other compa-

nies that have been the subject of public exposes since 2010. Consider the e-commerce companies seeking high IPO valuations that pay double, triple, even six times their gross revenue in “marketing costs,” meaning of course that they buy their own products. Consider the companies whose share incentives deliver millions of dollars in compensation to executives at companies making very ordinary products and margins.

Even well-established, conservatively managed international companies fall into the trap, as investors reward them for double-digit growth in the China operations, while U.S. and European sales lag. Incentives get built around the fantasy rather than the reality. Sales teams put up high targets and are promised bonuses if they exceed them. Managers are handed share incentive plans and know that the share price will rise with accelerating sales. In time, the whole China organization becomes united in its focus on meeting the unrealistic growth target, just like the Chinese government. And, as with the government, the target will be met, one way or another.

Part of the explanation for the widening gap between reported results and observable reality lies in inventories held in distribution channels, which are really just another form of debt; the brand owners, being large and investable companies, rather than the distributors, which tend to be small and poorly regulated, make public reports, and the world reacts to reports from Prada and Swatch, not from the operator of the stores in Henan, China. The state system favors large manufacturers, usually state-owned, because the state is more comfortable dealing with large organizations, with high fixed assets that can be attached for debt, with a large formal workforce to mobilize, provide for, or control, and with fixed locations that make it easy for regulators to find the company and impose rules.

Manufacturers or brand owners have market power; service companies, including retailers and distributors, have little, and this created a situation, especially during the years of high investment and rising prices, in which distributors competed to represent high-margin brands. The brand owners were in a position to demand high monthly sales targets, and distributors reasoned that, with rising prices and ample credit to support inventory, there was little downside to building up warehoused product. It was an appreciating asset. This is the logic that has driven bankruptcies in recent years among steel traders, distributors of white spirits and medical equipment distributors.

In some categories with valuable inventories, such as premium liquor, wristwatches and jewelry, and, recently, autos, dealers have built fantastically high backlogs of inventory, often marked as sold at the brand-owned level. For the large community of dealers in high-end white spirits, such as Moutai, this has been a disaster: distributors built up to three years’ worth of inventories as the price of Moutai was appreciating. Now, Moutai’s price has fallen by over 60% in a year, and it will take years to work off the inventory if it is sold at all. Dealers of luxury automobiles as well have purchased cars from the OEMs and reported them as sold, because, in an effort to move vehicles in a sluggish market, many have already given away future rebate payments to buyers. If the dealers now sell fewer cars, they will miss their targets and will not receive the incentive payments, which means losses. Because bank credit is readily available to fund inventory, the dealers are able to pre-buy vehicles in the hope that they can offload them in the near future.

6.2.1. Falling consumption

The willingness to build inventories is a legacy of the investment-driven behavior that has guided commercial decisions in China more or less throughout the reform era. Driving growth with investment, however, has consequences, and the most visible is fall in consumer spending that was under way in mid 2013. Using high investment growth to power top-line GDP growth necessarily means that the Chinese people must finance the investment by consuming less and saving more at negative rates of return. They consume less as their wage growth lags inflation and more of what they earn goes to pay the basic costs of housing and food.

A sharp downturn in consumer spending occurred around the autumn 2012 anti-corruption campaign of Xi Jinping, in which officials receiving expensive gifts, such as luxury wristwatches, were targeted, and the military was instructed not to consume Moutai, a premium liquor, at publicly funded banquets. Sales of the luxury end of these two commodities fell precipitously—but have not recovered a full year later: a falling economy generates fewer flows of graft money just as other streams of income are constrained. The premium end of watch sales, for timepieces that cost more than \$12,000 each, has all but disappeared as of late 2013. Lower-end purchases, for fast food and the mass-market items sold in Walmart and Carrefour stores, are also flattening and, in some cases, shrinking. This is inevitable and will continue.

Chapter 7

Lines Across the World

7.1. China as overseas investor

An economic crisis in China will begin to unwind the many ways in which China's rise has had rapid and surprising effects on other nations. Many subscribe to the incremental view of China's emergence as a global power: it takes time to build strength, revenue, and international experience, but China is on the cusp of a breakthrough into the world economy. The recent sharp acceleration of Overseas Direct Investment (ODI) by Chinese companies confirms the view.

The reality is that Chinese ODI is fundamentally an extension of China's domestic economy, where high-level national targets require accelerating investment. The macro numbers are in themselves the goal, and the specific deals do not really matter that much. As a result, investment targets tend to be guided by the short-term advantage of connected parties.

Why, for example, in 2013 did the chairman of a government-owned telecom company, with no visible experience, financing, or motive, announce he would raise USD 40 bln to dig a canal through Nicaragua, the fat upper thigh of Central America? Some believe that the plan represents long-term strategic vision. This canal will be wide and deep enough for the supersized ships that can carry vastly more iron ore to the East, and it could open up an "economy of the Pacific," with triple the shipping volume that currently crosses the Atlantic. The entrepreneur, Wang Jing, could just be a visionary who won the bid to participate.

But another, more cynical view observes that Xinwei, the telecom company of which Wang Jing is chair, believes it can capture government financing for a huge contract in Nicaragua associated with the "canal," which will never happen. One should expect enormous kickbacks all around. Xinwei, a historical money-loser, will likely try to IPO on a burst of income from the project. Nicaragua gets Chinese capital and the deal gets sold in China because of the vision of controlling strategic passage south of the United States.

Despite a huge promotion program and heavy soft lending, Chinese ODI did not really start until about 2006. In 2004, China's ODI was a meager USD 2 bln; by 2006, that number had risen by a factor of 10. By 2012, the total invested overseas has again more than tripled, to USD 77.4 bln. Now it seems that everyone wants a piece.

What a short time ago it was when international companies all felt they had to come to China to sell to China's rising middle class: if each Chinese person bought a Coke . . . Now that international world has slipped effortlessly into a reverse dream: a billion Chinese people will come to their countries to buy decaying real estate and rusting industrial plants and, in so doing, will pay to rebuild foreign infrastructure. The myth is so potent that a Canadian real estate broker recently had employees pose as potential buyers from China in order to create buzz around its Vancouver properties.

China is investing much more aggressively overseas, but rare are the truly private deals, and they do not seem to convey much advantage to the acquirer or the acquiree other than, sometimes, by overpaying. The government is doing the great majority of the deals. The acquirers may be SOEs, as in the CNOOC acquisition of Nexen, AVIC's acquisition of AIG's aircraft leasing division, or Sinopec's purchase of Total.

Many of the "private" deals are executed by a private company but planned and backed by the state. The recent Sino-Mexican venture "Dragon Mart," which is a complex whose main purpose is showcasing Chinese manufactures to Latin American buyers, was originally announced as a purely private sector deal involving Mexican businessmen and China's Chengkai Investment Company. It was not until after the approval of the project's license by Mexican local authorities that information regarding the participation of Chinamex Middle East Investment, a SOE under MOFCOM's supervision, became widely available.



The Dragon Mart project as portrayed in Chinamex's website.

The reality is that the big deals come bearing the flag of national strategy, but wrapped in the flag is short-term gain, and it's probably personal gain rather than corporate.

7.1.1. Capturing loans

For one thing, each large deal provides more leverage than the acquirer could get without the strategic goal of a foreign acquisition. The Shuanghui acquisition of Smithfield, for example, will cost USD 7.1 bln for both equity and debt. Henan Shuanghui Investments, the ultimate parent of Shuanghui, has a reported total asset value of RMB 20 billion or about USD 3 bln, but Bank of China has pledged a credit line of USD 4 bln to support the deal.

Why is it that Wanda, the company that acquired the U.S. theater chain AMC the U.S. theater chain AMC *in 2012* for USD 3.1 bln for USD 3.1 bln, can be planning to invest \$20 bln per year, according to Chairman Wang Jianlin? According to Xinhua, this sprawling entertainment and real estate conglomerate had gross revenue of about \$17 bln in 2011. The company received \$490 mln in loans from China Development Bank plus unspecified amounts from a syndicate of six other domestic banks.

Founded in Dalian in 1988, Wanda has accessed public markets only through Hengli (0169.HK), a smallish property company of which it is part-owner. The China assets reversed into the Hong Kong-listed company, then called China Fair Land Holdings, in 2008. Where has Wanda gotten its capital, and what is really inside the closed box of the company? Is this a Chinese entertainment company with a brilliant strategic vision?

Each one of the big Chinese ODI deals becomes a sort of Rorschach for Western hopes and fears: China's solar industry, having successfully undercut all international competitors, will extend into power plant operations with similarly devastating effects. China will corner oil resources internationally. China will help Latin America develop a higher-value automotive industry. Chinese money will provide investment capital to enable Australian miners to explore new resources.

Most of these deals, however, have failed to return value to investors or lenders.

7.1.1.1. Suntech Power

Suntech Power in 2007 formed the "Global Solar Fund," or GSF, with nearly \$300 mln. The GSF formed a group of Italian solar farms, or at least reported that it did. In the subsequent years, Suntech not only sold its solar panels to these companies but claimed big gains from mark-ups in the fair value of the projects. It also guaranteed about \$731 mln in loans for the GSF projects.

In Suntech's messy slide toward bankruptcy, the company made an admission that surprised no one but perhaps the SEC: the investments are fraudulent.

GSF achieved for Suntech sales that otherwise would not have been possible, as well as gains in value that supported the share price, but not the long-term Chinese vision in the solar industry.

7.1.2. Venezuela

Venezuela has received \$42 bln in soft loans from China for oil infrastructure—not including complementary loans to Chinese companies building infrastructure in Venezuela. As in many regions, the loans come with contingencies requiring Venezuela to use Chinese contractors and equipment, and these contingencies have generated revenue streams for other clients of the China Development Bank. Business generated in Venezuela by the loans, include a contract for the State Grid Corp (Sanderson and Forsythe, 2013). to build power-transmission facilities in Caracas, a contract for ZTE Corp. to build an underwater telecommunications cable, and contracts for 17 other Chinese companies. CAMC Engineering derived two-thirds of its 2011 revenue from the Venezuelan contracts.

7.1.3. Autos

Chinese automakers have a stated ambition to increase exports and to sell into the developed markets, especially the United States. BYD Auto, among others, has regularly shown concept cars at U.S. shows and has periodically announced pending sales in the United States that turned out not to happen.

Given this ambition, the logical thing to do would be for Chinese automakers to establish assembly plants in Mexico, which is by far the biggest supplier to the U.S. market. But Chinese automakers have evinced an almost total lack of interest in investing in Mexico; the single deal there, between First Auto Works (FAW) and Grupo Salinas, a Mexican electronics chainstore owner of highly dubious background, failed to complete the investment plan. FAW was accused of using its “direct investor” status to import 50,000 cars per year into Mexico tariff-free.

Then there are the Chery Auto investments in Brazil and Uruguay. With \$400 mln committed to a plant in Brazil in 2011, Chery has not started building but instead is selling cars into Brazil from its plant in Uruguay. In Uruguay, meanwhile, Chery opened a small plant together with the Argentine company Socma, but again, the plant would appear to be a means to get cars cheaply into other markets: it is importing completely knocked down kits. Meanwhile, industry experts claim that the Uruguayan government agreed to purchase a certain number of cars from the plant to make it viable.

7.1.4. Nicaragua Canal

The project to dig a canal through Nicaragua to accommodate super-sized Panamax ships carrying fantastic loads of iron ore was announced recently, after Xi Jinping returned from a visit to Central America. The promoter and manager of this project is a mysterious new company called HKND (for “Hong Kong Nicaragua Development”) headed by one Wang Jing, chairman of the state-owned Xinwei Telecom, which is the chief promoter of China’s chosen TD-SCDMA telecom standard.

Trading in sister company Datang Telecom has been halted since late March in Shanghai on news that Datang is undergoing reorganization. The original reorganization plan, floated in 2009, was for Datang to absorb the Xinwei assets (they have the same parent company). So it seems that Xinwei will become a listed company.

So, whether or not this canal is built, its planning and initial financing are very likely to lead to contracts for Xinwei. And even if such contracts do not come through, surely the A-listed Datang stock will pop when it starts trading again.

7.1.5. Sundance

China has, for some time, expressed interest in the Australian mining concern Sundance, which is developing mining assets in Africa. The \$1.3 bln deal had a setback in March 2013, however, when the founder of the company executing the acquisition, Sichuan Hanlong, was arrested, reportedly for insider trading.

The Sundance deal is a classic of the type of Chinese ODI under state plan—it is an asset that the government wants to obtain and was being financed by the China Development Bank. But 23 months later, there have been accusations of illicit personal gain but no deal. That is because those involved lack a strong commercial driver.

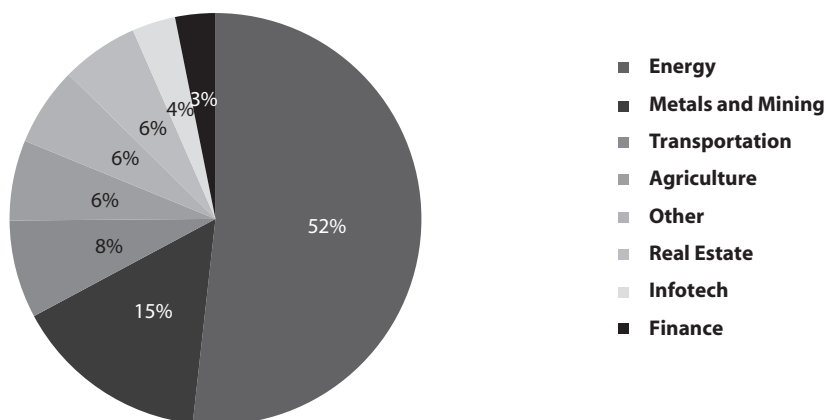
7.1.6. The macro drivers

One aspect of ODI that belies the idea of Chinese companies emerging onto the global stage is the lopsided focus on acquiring resources. This is clearly government-, not company-driven.

As chart 30 shows, in 2012, 52% of China's overseas investment was in energy and 12% in minerals. The size of the energy projects skews the statistics—57% of projects are in Asia, as of 2012, but 45% of the investment in North America, and that's all about oil—mainly the \$15.1 bln Nexen deal.

Some of the purpose of these investments is to capture contracts for new infrastructure projects—90 of them in 2012 in mining regions in Asia, Africa, and Latin America. So the ODI creates a mechanism for Chinese banks to invest in Chinese projects that happen to take place offshore.

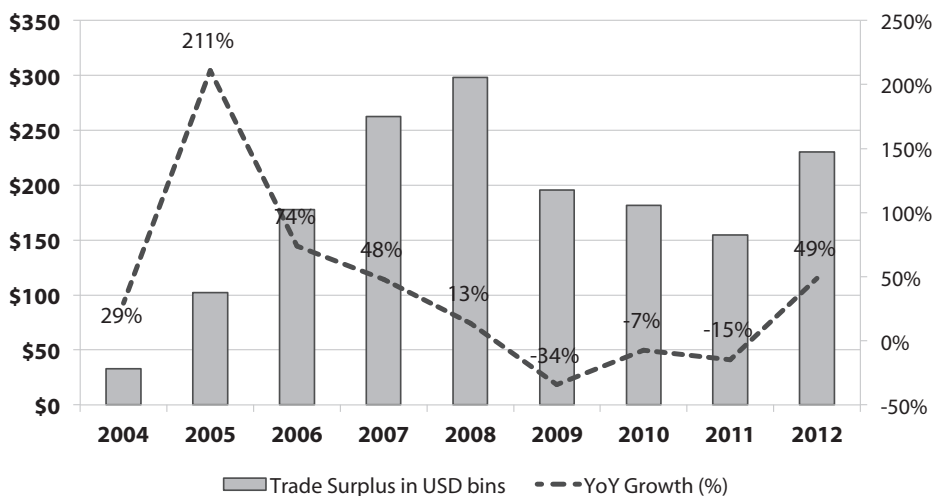
Chart 30.
Chinese Overseas Direct Investment 2012



Source: CASS Institute of International Investment Studies and Heritage Foundation

The proximate causes of expanding ODI are clear: China has been consuming 40% of global commodities since the housing boom began and wants to secure access to these resources. Meanwhile, credit has been flowing, and the trade surplus was growing faster than any time before or since.

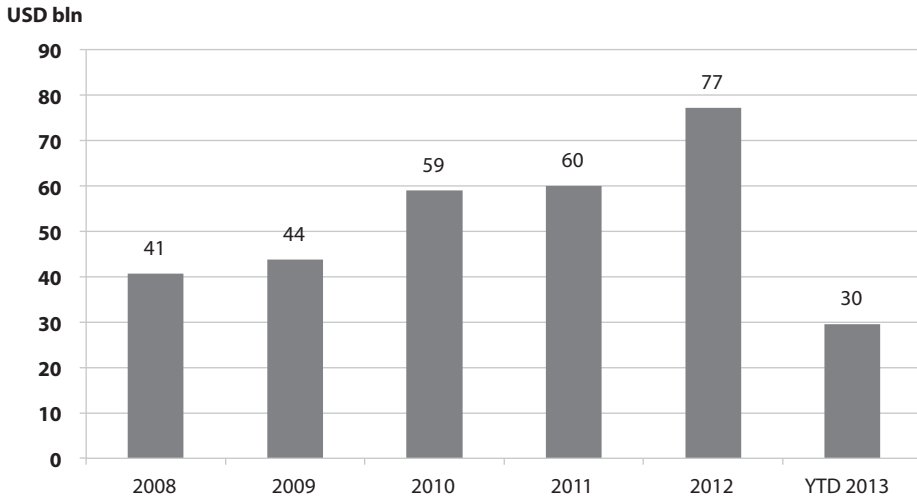
Chart 31.
TSF and Trade Surplus Growth
(in bln USD and %)



Source: China Customs, PBOC

In U.S. dollar terms, the trade surplus was cumulatively \$1.07 tln for the years 2004-9. The correlation with expanding credit is clear.

Chart 32.
Chinese Overseas Direct Investment



Source: NBS

On a macro level, it appears that the key driver of Chinese overseas investment has been government surpluses, which means that ODI flows should ebb.

China's ODI is simply a microcosm of Chinese economic policy: investment-driven growth. The strategic framework articulated by various parts of the political establishment actually undermines the economic soundness of the projects. If Shuanghui, for example, is seen to be achieving national strategic objectives, it may not matter that the company cannot technically hope to pay back the debt.

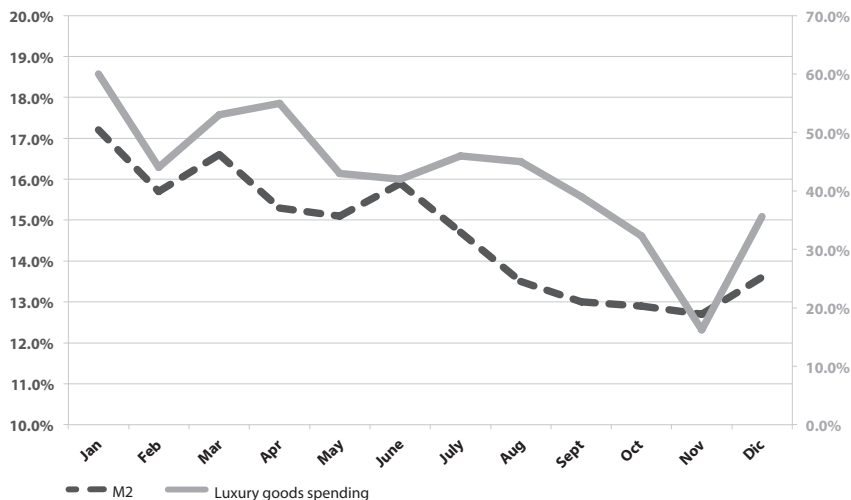
7.2. China as consumer

The most obvious way in which China affects the world is as a buyer. In the luxury markets, it's all about Europe. Chinese consumers, for example, inside or outside of China, buy more than 60% of Swiss luxury watches. The luxury sector generally derives 22% of sales globally from Mainland Chinese at home or traveling—well out of proportion to China's weight in the world. China accounts for around 14% of the global economy. However, China economic slowdown has affected the luxury sector, though it is hard to know by how much.

Spending on luxury goods has a high correlation with M2, which provides support for the contention that luxury goods are both a money-laundering channel and a stor-

age measure for wealth in China. The correlation between luxury spending and M2 back in 2011 was high.

Chart 33.
M2 and Luxury Spending YoY Growth in 2011



Source: PBOC, J Cap

Table 16 presents a list of China's major suppliers in 2012. One thing to note: Hong Kong and the FTZs should be heavily discounted as suppliers of imported products, since the numbers are significantly swelled by fraud and so are problematic for analysis.

The drop in imports from Japan has been heavily political over the recent period of bellicose disputes with Japan. Quantitative easing has meant that the yen dropped significantly in late 2012 and early 2013, yet even that has not revived sales to China, which may never come back to former levels.

The increase in buying from the United States was heavily biased towards agricultural commodities.

Table 16.
China's 2012 Imports: Major Suppliers

Amount (USD bln)		Change YoY
Japan	\$177.81	-9%
Korea	\$168.65	4%
HK/Chinese FTZ	\$142.86	17%
U.S.	\$132.89	9%

Taiwan	\$132.18	6%
Germany	\$91.91	-1%
Australia	\$84.56	2%
Malaysia	\$58.30	-6%
Saudi Arabia	\$54.83	11%
Brazil	\$52.30	-0.20%
Total	\$2,048.95	4%

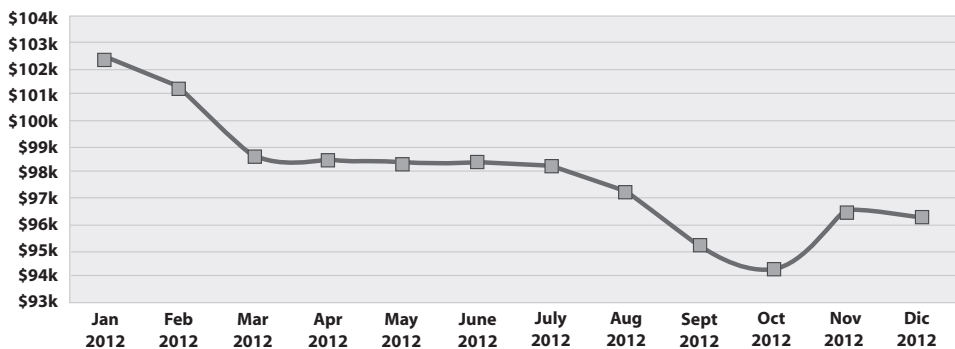
Source: China Customs

7.2.1. Australia

Probably the most obvious way that China's presence is felt internationally is in the commodities markets. By 2010, China was consuming almost 40% of the world's copper, iron ore, aluminum, and cement and, therefore, was determining their international prices. The steep rise in demand from China has driven bubble markets in each of the supplier nations. In 2012, Australia shuddered from the collapse of commodity prices, and it's a matter of time before a permanent decline in commodity prices reshapes the Australian economy.

The phenomenal speed with which China has covered its land territory with housing has fed a corresponding boom in Australia, particularly in the west, leading to the "cashed-up bogan" meme—young blue-collar men with money to burn. As of 2012, blue-collar workers in Australia earned more than white-collar; the average salary in mining was A\$164,372, according to MyCareer, but it is coming down very quickly:

Chart 34.
Average Australian Salary in Mining (2012)



Source: MyCareer website

The natural result has been a housing bubble: housing prices rose 130% across Australia from 1996-2010. In many cases, the rise has been accompanied by aggressive mortgage practices—too much money to unload. Ultimately, this will impact at least some of the Australian banks.

7.2.2. Brazil

Brazil is all about commodities: between 2000 and 2012, commodities exports rose from 25% to 50% of Brazil's total exports. The export drive has been accompanied by a massive appreciation of the currency. And the export growth has been heavily driven by China. Here's the chart of iron ore exports:

Table 17.
Brazilian Iron Ore Exports

Year	China	Europe	Japan/Korea	Other	Total	Value (USD mIn)
2008	96	79	49	58	282	\$16,538
2009	145	36	33	52	266	\$13,247
2010	153	63	40	55	311	\$28,912
2011	164	63	52	52	331	\$41,817
2012					326.5	\$30,988

Source: Brazilian Customs

Note the fall in 2012. Less demand from China was the principal culprit for Brazil's GDP growth of just 1%.

But during the boom, Brazil's housing prices rose relentlessly: 10% across the country just in 2012. In Rio and Sao Paolo, housing has been up 20% annually for about five years, and mortgages up 40% CAGR for a decade. That will not last.

7.2.3. Africa

Africa is also a key commodity supplier to China, which invests heavily to acquire access to oil, copper, and other commodities—\$40 bln through 2010 (McGregor, 2012). In July 2012, Hu Jintao pledged another \$20 bln in credit for Africa. Although trade has grown fast, that's largely been a secondary effect of massive infrastructure construction to ensure that the resources get out—roads and bridges in Angola, power stations in Zambia, mass transit in Nigeria, telecommunications in Ethiopia, water works in Ghana.

Angola is the big one among the trade partners: China imports 750,000 bpd of Angola's oil, making Angola the second largest supplier, and China has supplied at least \$12 bln in loans since 2004 to support the oil fields.

Ghana received a \$3 bln loan from China in 2011 to develop its oilfields, representing 8% of Ghana's GDP, according to Sanderson and Forsythe (2013). The condition on these loans, as with most of the money from the China Development Bank, was that 60% of the work associated with the public projects goes to Chinese contractors.

7.2.4. Mongolia

Poor Mongolia. Its market is totally captive to China because of the difficult logistics: China purchases 85% of Mongolian exports, meaning that Mongolia basically has no say in pricing. But the importance of minerals to the Mongolian economy cannot be overstated: Mongolia produces 35% of China's coking coal, and its Oyu Tolgoi copper and gold mine contributes 30% to Mongolia's GDP.

Mongolia has been counting for the last five years on a minerals boom that would float its economy into membership in the First World, and now that just won't happen. As the prices drop, Mongolia's budget has gone into deficit. Promised "equity" distributions to citizens cannot be funded, and big infrastructure projects, like a train line in a diagonal across the northeast of the country, are on hold.

7.2.5. Russia

China is Russia's biggest trading partner, with Russia principally selling crude oil and natural resources. Russia has been among the recipients of Chinese largesse, with a \$25 bln oil-for-loans deal.

Perhaps the most astonishing statistic in China's quest to secure resources is its soft lending: \$1.029 tln in outstanding loans, according to Sanderson and Forsythe (2013)

7.3. As competitor

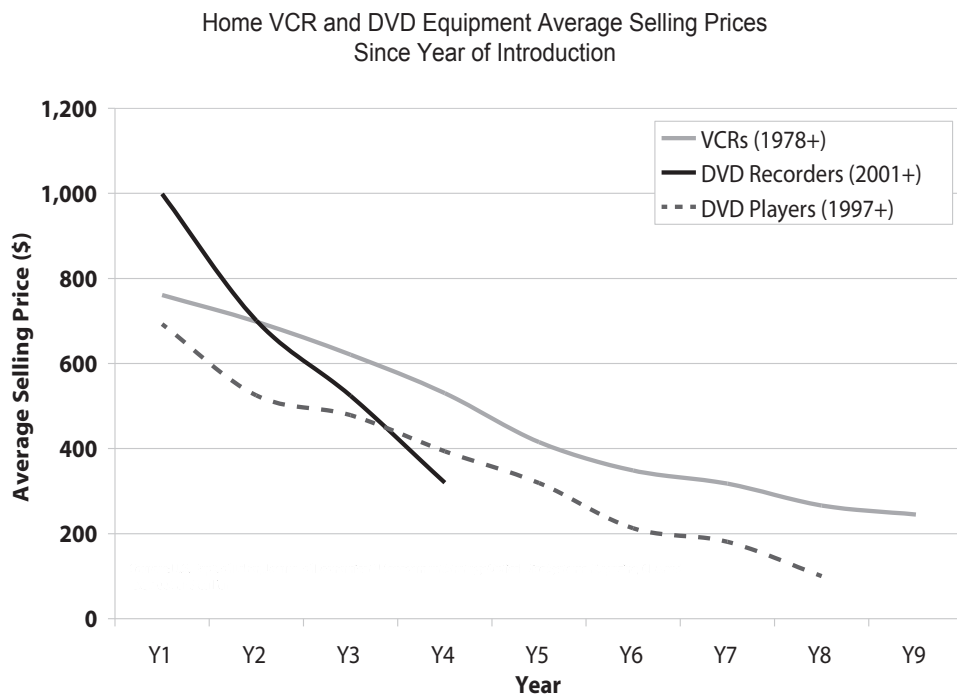
Perhaps the most important way in which China interacts with the United States and Europe might be termed "hollowing out": Chinese companies focus like a laser on niche demand areas internationally and replicate as much of the technology stack as possible, leaving only the premium portion of a value chain for the original incumbents. In the process, all sorts of technologies are "commodified" and made cheaper—ultimately benefiting consumers but not really benefitting the Chinese companies that attack these segments. This happened in consumer electronics throughout the 1990s, in machine tools and steel and machinery in Europe, and so many other areas.

Take solar, for example. Before 2005, there were essentially four international incumbent companies that made the whole solar value chain, from polysilicon to cells and

wafers to solar assemblies. As capital markets provided commodious financing, China moved in and cracked apart the value chain, driving prices down and greatly expanding the market. Unfortunately, the great Chinese solar companies are now all teetering on the brink of bankruptcy and, in a more commercial economy, would already be dead. Probably the biggest beneficiary of this whole chapter of commercial history has been the biggest consumer of cheap Chinese technology, Germany, whose own great incumbent company, Wacker, is hardly the worse for wear.

As the hollowing out occurred, prices were driven down to brutal levels. Here are prices for several electronic devices through 2004:

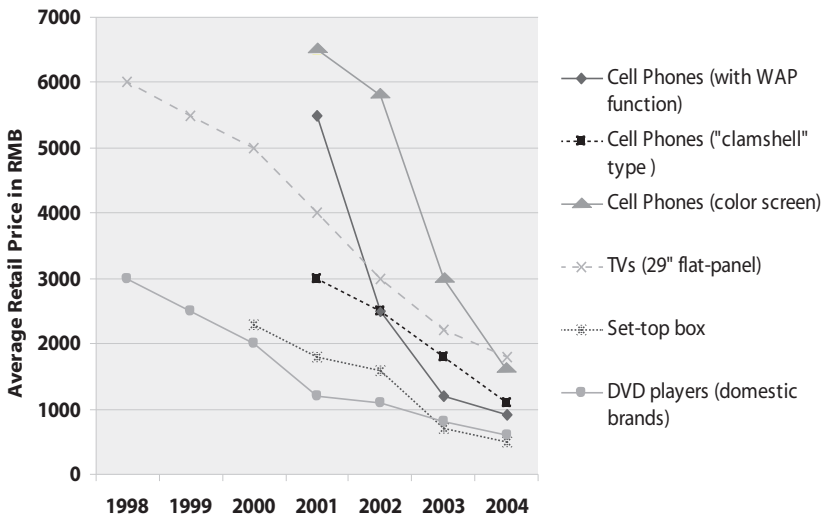
Chart 35.
VCRs and DVD equipment prices since their year of introduction



Sources: U.S. Dept. of Labor, Journal of Economics & Management Strategy Optical Disc Systems Magazine, CEA and IDC, 2004 and earlier.

And another chart from 1998-2004:

Chart 36.
Retail Prices of Selected Chinese Electronics



Sources: Sources: MFC Insight, CCID, Sina Tech, Sohu Tech, company reports

Without the lubrication of financing, what happens to China as a competitor? Note that all the international consternation about “indigenous innovation” and China’s millions of trained engineers has disappeared now, turning in a distant dream. Pretty soon, long history in China will be reminding people that they used to think of China as their biggest competitor, and people won’t really remember.

7.4. Mexico’s future

Mexico, which is principally a competitor to China rather than a supplier or a customer, will benefit from China’s decline. The Mexican economy is all about manufacturing—the primary sector is only about 7% of the economy.

NAFTA came just at the start of China’s great rise, and, since 2001, despite its logistic and tariff advantages, Mexico lost quite a few maquiladoras to China. In fact, in everything except auto parts, China gained share of global manufacturing faster than Mexico did through the 1990s—in spite of NAFTA.

Now, given the ramp in real estate prices in China, higher Chinese wages, and higher transport costs, manufacturing costs have lost their competitiveness. At the same time, the boom in cheap natural gas in the United States provides an advantage to Mexico as its neighbor. The pending reform of investment rules in Mexico’s oil sector should also attract more petrochemical investment. Overall, the new administration is hoping

to boost GDP growth from 2013's 3.3% to 5% and to bring investment from 19-20% of GDP up to 25%.

In the end, Mexico's growth depends more than anything else on the recovery of the U.S. economy. Mexico's companies tend to be efficient and well-managed, tempered by a challenging economy and with—outside of the monopolized oil and telecommunications sectors—very little help from the government. Mexican investment in China (like Chinese in Mexico) is negligible, but there are a handful of Mexican companies that operate successfully in China, such as Bimbo.

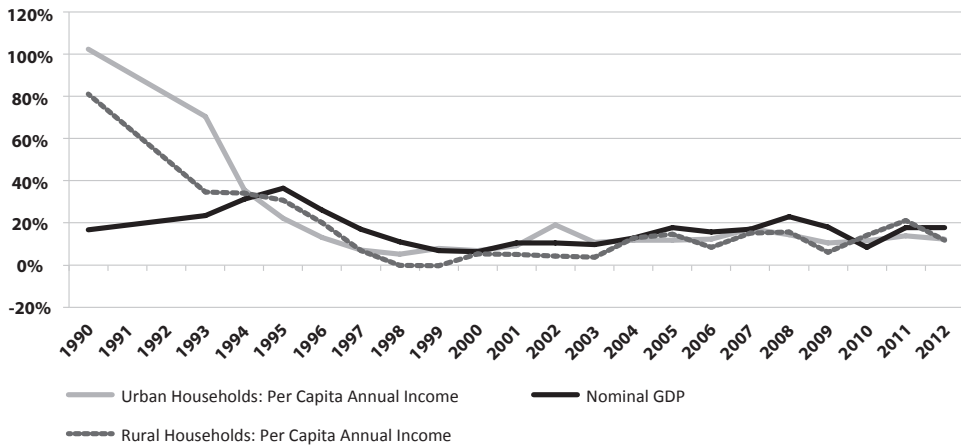
7.5. The erosion of the Chinese dream

The China of 2013 has changed subtly, sadly from the halcyon years of the 1990s and early 2000s. Expansionary economic times meant that the range of people who could aspire to social mobility, and even to wealth, was greatly expanded. Chinese educated overseas flocked back to start their own companies or join start-up teams and were enabled by a robust apparatus of support programs that offered everything from start-up grants to free office space, introductions to partners, and subsidized mortgages for anyone who was ethnically Chinese whether or not he or she had been born in China. Chinese companies eagerly participated in delegations organized by the Ministry of Education to identify talented Chinese technologists overseas and offer them financing to bring their technologies to China and set up companies. Any 30-year-old with an MBA could start his own private-equity fund.

In the 1990s, those at the low end of the socio-economic scale as well had a good chance of making it off the farm. Migrant laborers were visibly becoming wealthier, buying cell phones and motorcycles and computers and eventually homes. Many were moving permanently to more developed areas of the country.

In the late 1990s, as China began its most concentrated phase of investment-led growth, incomes fell below GDP growth and, except for one year, in 2002, have never grown as quickly as GDP since that time.

Chart 37.
Nominal GDP vs Income Growth 1990-2012



Source: Wind data, NBS

Consumption as a proportion of GDP fell from a high of over 50% in 1978, at the start of the reform period, to 34% in 2010, an extraordinarily low number, indicating high savings or investment, which is the same thing. This might be viewed as a measure to identify who in a society has the right to enjoy its resources. In China, the answer is very clearly the state, which induces individuals to save and deploys the savings as investment capital.

As those who live in China complain ever more bitterly about degradation of the natural environment, problems with food quality, medicine and fake products, the quality of education, and low access to health services, it is clear that China has become a less attractive place to live. A degree of cynicism has crept into the public dialogue that had not been present for many years in China. The average person believes that the Renminbi is worth little, that the government lies, and that public officials are rapacious and unimaginably corrupt.

A bit of black humor overheard on a train to Shenyang sums up the general view: a woman was complaining that the government had stiffed her on disability payments. Her companions said, "Why didn't you tell them you were on this train? They would have given you a free trip home!" The usual remedy for someone like this woman would be to travel to the provincial capital and petition the higher level of government there. However, a thuggish industry has developed to intercept petitioners such as her and return them home forcibly to be dealt with. All listeners immediately understood the reference to this kind of kidnapping of petitioners.

The crisis advancing across regions and industries now in China will not be of short duration; the retreat of real growth has undermined the ebullient support that the gov-

ernment had from a broad cross section of people hoping that lives for their children would get better. Without that constituency for economic openness, and with dwindling support from international capital, a xenophobic tone has crept into the communications of China's leadership. Foreign observers used to say of China's reform process that the nation could "never go back," because the benefits gained were too great. But the great benefits of privatization have now been harvested by the elites, and going back is precisely what China has done.

Chapter 8:

The Next Dynastic Cycle

8.1. Openness and closure

Through its history, China has endured or undertaken cycles of openness and closure, sometimes engaging with other nations through trade and investment and sometimes rejecting commercial attachments. The Chinese people historically have endured these cycles in their own rhythm of hopes raised and modulated again, most recently during the decay of the Qing at the end of the nineteenth century, after the Communists took over in the early 1950s, and again since the Dengist revolution in 1978. These moments of euphoria brought the diaspora back to China with the hope of building a more open, participatory China, and the revolutions again sent the diaspora radiating through the world, where Chinese people, unlike their nation, have managed to penetrate every corner of the globe with their communities, their food, and their commerce.

Whether going through its cyclical expansion or its contraction and turn inward, China has never integrated itself into the international system so much as selected portions of its practices to deploy at discretion. In some ways this has been adaptive, insulating China from many of the shocks in the international system. The isolation that China cultivates has protected it from the worst international financial contagions, including the oil crisis of the early 1970s, the Asian crisis in 1998 and the financial crisis of 2008. At the same time, China missed out on much of the prosperity created by industrial advances of the nineteenth and twentieth centuries. As China was not directly struck by the catastrophe of debt in the United States and Europe in the 2000s, so these countries will be less directly harmed by China's collapse as an economic power. The effects, however, will be deep and unpredictable.

The selectivity with which China has approached the international system of trade and diplomacy makes available many of the benefits of membership in the World Trade Organization, World Bank, United Nations, technical standards bodies, and other international organizations without forcing change internally, and without, in turn, effecting change on the international system. This indicates that disengagement also can be rapid, as in decoupling a train. China's emergence as an international power since the early 1990s has not so much been transformative to the international governance systems as to its members: Chinese competition has forced companies to shed costs, offload lower-value portions of their businesses, develop new distribution models, and reduce employment. It has galvanized higher levels of efficiency throughout the industrialized world.

But China itself has absorbed relatively little of the world's benefits, intellectual, cultural, and economic. The commercial environment has emphasized the need for foreign companies to adapt to Chinese commercial realities as defined by the government, rather than for the Chinese economic environment to become more internationally commercial; because of this, Chinese companies have failed to develop brands and

businesses that are effective in international markets. The policy of bringing foreign technologies into China, for example, has focused on wooing scientists and technologists of ethnic Chinese origin back to China with their technologies to commercialize them there; foreign nationals and multinational corporations are seen perhaps as necessary evils but ones to be suffered only as long as it takes for Chinese to absorb the needed skills. No single Chinese corporation has integrated with a foreign counterpart, something that is commonplace in the world, even in developing nations such as India. Instead of becoming internationalized itself, the country has focused on gathering in the Chinese diaspora, redefining what it is to be Chinese into a quality of the bloodline and a historical relationship to the Chinese language.

In the late 1990s, as China was applying to join the WTO, governments, businesses, and citizens argued contrasting views on China's intentions as a weighty new member of the forum. China's denial of the Tiananmen massacre had instilled deep mistrust of what Beijing said about its own intentions, and many in the West believed that Beijing should be shunned, whether on ethical grounds, by virtue of its unrepentance, or practical ones, in case China were to use enhanced equality in trade to undercut international companies in their own markets.

Here was a government that had changed seemingly overnight from closed, suspicious, internally tyrannical, and externally belligerent to one that actively, almost disarmingly, solicited foreign investment and trade, seemed businesses, and by extension to its people, and was shedding the restrictions" and Hay que borrar el "on, and was shedding the restrictions and prohibitions of the Maoist era like a heavy suit of clothes in warm weather. The most junior of foreign businesspeople could meet with government ministers and would be asked for views on the state of an industry or on development strategies. It felt as if the entire nation had awoken from the Maoist dream and wanted to make up for lost time. Chinese everywhere were charmingly open about the problems of their own country and admiring of the West.

The Chinese government had made extraordinary efforts to develop completely new models for everything from the social security system to the very process of making and enforcing laws. Information was gathered on delegations and study tours, seminars and exchanges, by sponsoring papers, and commissioning studies of international models. At the same time, newly private exporters became adept at finding and homing in on export niches the world over, no matter how arcane: crawfish in Louisiana, sandstone gravestones, pre-carved and sold in Georgia at 40% less than the local headstones, though they had been shipped from Tianjin. Investors, meanwhile, found it easy to put money into China but hard to make a profit: their partners would copy their technology and sell it out the back door, they would be denied licenses to import needed components, they would be barred from delivering or servicing their own products and might find the companies they employed to do so sabotaging their products in the market.

Two quite different constituencies overseas stressed the reality closest to their own interests: competitive, threatening China and admiring, cooperative China; one growing into a belligerent threat to world peace, the other encompassing a vast new market, which no foreign company could afford to ignore.

Neither the proponents nor the detractors for a moment imagined the China that would emerge over the coming three decades, a nation many times bigger and more prosperous than could have been anticipated then, with disruptive influence on the world's resources, and outselling, outwitting, undermining, and ultimately destroying some of the biggest and most august companies in the world.

Economically, China's emergence as an economic power has had effects comparable to those created by the IT revolution. Just as technology cracked apart value chains and forced whole industries—the print media, music and film distribution, fixed-line communications, to name a few—to remake themselves, so China's explosive growth as an economy has transformed international value chains. Complacent old manufacturers of machine tools in Europe, iron and steel in Asia, consumer electronics and white goods in the United States, LED fabs and solar panel manufacturers in Taiwan have been driven out of business, as hungrier, well-financed and equipped Chinese competitors hollowed out the middle of the industry, commoditizing all but the very highest premium products and services. The international companies they once emulated were forced to move up the value chain and to keep innovating and iterating their products to stay ahead of the Chinese competitors eating away at their businesses. By the early 2000s, how could any U.S. manufacturer compete with a Chinese-made DVD player that could effectively sell in Walmart for \$19.99, including a software system that would allow it to play the media of any region, Blu-Ray capability, a wireless connection, and two coaxial cables?

As a consumer, China became such a colossus by the early 2000s that it has been consuming 40% of the world's commodities ever since. China's consumption patterns have driven tremendous price volatility and uncertainty, as well as growth in the wealth of exporting countries like Brazil, Angola, and Australia.

However, despite its growth to economic prominence, China has been unable to project power in a way comparable to other great economies in different times, such as Greece, Rome, Italy, Germany, Russia, Japan, Korea, and the U.S. Given that the nation's historical memory is one of cycling regularly through volatile periods of union and fragmentation, China has seen its borders, its culture, and its people as threatened rather than enriched by contact with the outside. China, whose economy for most of history has been the world's largest and most successful, continues to view itself as the world's immobile center, needing periodically to expand its borders to acquire needed resources, but viewing trade as an inconvenience, investment in other nations much like missions of exploration to other planets, places you go well supplied, in constant communication with home, and returning as soon as possible.

Ideologically, despite the efforts made with the Confucius Institutes and Chinese television overseas, vast China has failed to project its culture, while its relatively tiny neighbor, Korea, has influenced music, fashion, and entertainment throughout the world. In ideology, Buddhism swept out of India across China and was adopted institutionally by the Tang rulers, but the native ideologies of Taoism and Confucianism never took institutional root elsewhere. It is not a historical accident but a matter of volition that the rulers of China have consistently maintained a level of cultural, not to mention linguistic, isolation. Great global disruptions like the Renaissance, the Enlightenment,

and the Industrial Revolution happened without a discernible contribution from China or impact within China. Conversely, the grinding civil war, the establishment of the People's Republic and China's self-imposed isolation for a full generation did not prevent nations around the world during that time from achieving the highest standards of living for the largest numbers of people the world had ever seen.

Historically, when China has turned in after such a period of expansion, the returned diaspora has again departed, and the international companies attempting to adapt to China have either been nationalized or gradually disappeared.

8.2. The 2013 transition

In March 2013, the Communist Party under Xi Jinping began a new reign in earnest. Domestic and international hopes rest on the vision of Xi Jinping, the leader who visited farmers in Iowa and traveled overseas with his pop star wife before his ascension to power, suggesting a style far more populist and personal than his predecessor.

These gestures suggested a new degree of transparency that Xi's subsequent statements have proven to be founded on false hope. In summer of 2013, his first official year in office, Xi launched a "Rectification Campaign" that involved meetings of party officials around the country to engage in detailed self-criticism sessions. Xi himself attended many sessions, indicating the extraordinary investment of his personal time. Some of the sessions were televised, and the campaign got top billing on Sina and other news outlets. Among the remarkable aspects of this campaign was the focus on criticizing mental attitudes rather than actions.

There has been a clear consensus inside and outside China that the reform initiative, now a generation old, has reached an inflection point. Facing this critical moment, analysis of what Xi and his government intend for the Chinese economy generally organizes itself around an axis of "reform" versus "retrogression." Those hoping for reform define it as a simultaneous liberalization of the economy and the governance system, as one, almost axiomatically, requires the other.

The framework, however, misunderstands the degree to which the policies now taking shape in Beijing form part of a continuum with those of modern China, and especially since 1979. The reform process has consistently been focused on the number and scope of market-like vehicles designed to convey resources into the state economy while remaining walled off from the full force of markets, so as not to create structural change that would diminish the control and benefits of the Chinese Communist Party. When innovation is needed in order to generate growth, a territorial and legal carve-out will be created, a special zone in which the economic innovation may occur with minimal impact on Chinese society at large. Should the new zone be useful, other regions will apply to open their own, so that the "reform" is iterated in tiny, walled-off areas, Special Economic Zones, Economic and Technical Development Zones, Bonded Zones, and so on. This is the system that is now being expanded to banking and finance in the new Shanghai Free Trade Zone, which opened in September 2013 and which at least nine cities hope to emulate.

The difference between this system, which has been in operation with various levels of efficacy since 1983, and now is that, as in the late 1980s, decades of massive investment have created side effects and imbalances that are fueling restlessness among the people and instability in the economy overall. These threaten the ruling position of the Communist Party.

8.3. Returning to the tried and true

The stupendous wealth accumulated by the nation's political rulers has tended to mar the moral authority that they trailed from revolutionary times and that the Party apparatus has so cannily nurtured by fusing the historical Chinese sense of oppression by foreign nations with claims to Taiwan, Tibet, and Xinjiang and with central-government authoritarianism generally. The 2013 trial of Bo Xilai, with testimony of villas in France and chartered planes to fetch raw meat from South Africa, attests to the levels of decadence that the current ruling class has achieved.

Partly in reaction, President Xi prioritized his flagship fight against corruption. Corruption at all levels of the Party, from the "tigers" to the "flies," is very much on the minds of the disenfranchised and the privileged alike. In the early days of reform, some analysts cited literature on emerging economies, arguing that, in the early stages of transition of a state-dominated economy to a market one, corruption needed to be tolerated. The argument noted that corruption itself was a kind of market forerunner, and anyway, bureaucrats who were set to lose in the marketization process needed to be bought into the program by reaping some short-term personal benefits.

Whether you accept the argument for tolerance or not, it is self-evident that, as structural change occurs, as market forces take over and bureaucrats surrender control, the potential for corruption declines. In China, on the contrary, the passage of time has amplified corruption. Indeed, corruption and the growing concern about it are not the causes of China's current plight but symptoms of China's failure to have made the structural reforms promised by the "socialist-market economy" model and the parallel reforms of the governance model.

The Rectification Campaign threatens to remove from position any Communist Party cadre who fails to rid him or herself of "formalism, bureaucracy, hedonism and extravagance." The campaign has been supplemented by a wide-ranging effort to bring public thought and comment into line with officially sanctioned ideology. High-profile arrests of people like Wang Gongquan, the founder of CDH Investments, and televised "confessions," including by internationalized figures like Soho founder Pan Shiyi, suggest that the "campaign to cleanse the Internet and media of bourgeois liberal tendencies" has real bite.

The statement of purpose made by Xi Jinping at the summer 2013 retreat of the top leadership served as a sort of manifesto of retrogression. In the speech, as reported in *People's Daily*, he identified "universal values" and "freedom, democracy, and human rights" with subversion and "Western values."

Much of Xi's recent thought was distilled into a document called Document 9, which argues, among other things, that it is a seditious Western notion that the public has a

right to know anything about the assets and activities of the Party leaders. The degree to which this and other policy statements represent a hardening of both political and economic stance, an “anti-reform” position, has been poorly appreciated by China analysts, who cling to the hope generated by Xi’s more forthright style that a more Westernized and open China is in the offing.

In June 2013, a remarkable article in PLA Daily, highlighted by Willy Wo-Lap Lam in *The China Brief* on July 12, called on army members to nurture “red genes.” The Xi regime has also promoted children of top leaders to political positions that would formerly have been discouraged. Xi himself comes from the red nobility, being the son of Xi Zhongxun, who established the Shenzhen Special Economic Zone. The emphasis on red blood under Xi suggests what is important in modern China: the survival of the current ruling class. The shift of power between leading factions in the CCP that occurred over the last three years is a clear ascent of those born into the manor over those who climbed from poverty into positions of Party power.

The Party’s internal political dialogue has always had a hermetic vocabulary whose resonance in social and economic policy is not obvious. Xi is called China’s “president” only in English; in Chinese, he is called “chairman of the country,” a sort of euphemism for General Secretary of the Party, and the term “president” is viewed as incorrect, because his principal role is Party governance. The “premier,” Li Keqiang, would seem to have the governance portfolio, which in many ways seems to operate independently of the party’s campaigns. A closer look, however, indicates how much in sync the two really are.

8.4. Stimulus the only idea

As the choices on the path forward become starker, the government leans more determinedly on its most powerful tool of governance: its ability to quickly amass and deploy the resources of a massive unified nation. So effective has been the use of credit to stall and cover over problems associated with China’s antiquated political system that it has proven to be irresistible. For the whole of the 2000s to date, China’s has been the most capital-intensive economy in the world, with the result that, by 2013, China’s domestic debt had reached somewhere between 200-250% of GDP. At this writing, one unit of GDP growth requires roughly three units of credit growth—a ratio that has worsened dramatically since before the global financial crisis in 2008. China is like a man who has burned all the trees around his house to keep warm and now is tossing his furniture into the stove. Financial resources, in the end, are limited, and the acceleration in credit to forestall what inevitably must be a sharp recession cannot last much longer.

Understanding how perilous the nation’s finances are, China’s central government experimented in 2011 with squeezing off credit to the property sector by barring banks from lending to developers and, as they had done in 2008, attempting to drive investment capital into industries. But industrial over-capacity was already chronic, loan demand low, and, by the first quarter of 2012, the economy started into an alarming dive. The fear in Beijing was palpable. New credit quickly came on line for the developers, as

the government feared that the whole value chain, from mining to steel to construction to property, would break.

Now, the Xi government is unleashing a new easy-credit tsunami that will likely take the form of new special zones, new types of financial institutions, and new types of investment products, all of which will be called “reform” and packaged as responsible monetary policy by the State media. A new urbanization plan may be promulgated, promoting the establishment of “metropolises” that bring the mega-cities that already absorb the majority of China’s resources to the next stage.

8.5. “Likenomics”

Many Chinese academics have been publishing analyses of “Likenomics,” the economic views of Premier Li and the program he is undertaking. These views tend to emphasize more populist values of reducing income inequality and providing more social benefits across society, increasing consumption and calibrating investment. This economic language, however, is as much encoded as the political language of Xi. “Consumption” in the Chinese code means giving more consumer goods to the common people: cars, electronics. The method of stimulating consumption is simply to distribute goods at subsidized prices or sometimes for free. Methods of promoting income equality are strictly Old School: they include investing in “indigenous innovation,” pushing out state investment in housing as somehow more appropriate to China’s real needs than is commercial housing investment, and funding state investment in hospital and educational facilities and equipment but not liberalizing the content or delivery methods of education or medical care.

This view of consumption involves a paternalistic notion that the Party must ramp up fixed asset investment for the benefit of, and on behalf of, Chinese citizens. The Party knows better how to spend the nation’s growing wealth than the households, who get a world-lagging distribution of GDP of around 35%. But to pursue the Party’s model is expensive, because it is inherently inefficient and corruptible. So how is it affordable?

What is important to recall is how well the Li policies, favoring populist capital investment, and the Xi ideology of stifling opposition to the CCP are actually in harmony. The rhetoric of Li Keqiang in some ways resonates more with liberals, who retain some sympathy for at least a few of the socially progressive values of old-line Communists and therefore take a long view of CCP political repression as possibly required for the continuing benefit of the poor. Li is seen sometimes as a potential “Chinese Gorbachev,” someone who can effectively work from within the system to upend it.

This represents a misunderstanding of what the Chinese Communist system actually represents and why the reforms of 1979 fit well within its theoretical framework. East Asian communism throughout the twentieth century has differed from its Marxist-Leninist cousin in its more nationalistic emphasis. Chinese Communist aspirational ideology focuses less on lifting the masses from poverty than on creating a shortcut to modernity and providing an easy exit from the shameful backwardness and dependency that had kept China under the Qing and then the Nationalists under the yoke of

an alien dynasty in the former case and of foreign nations in the latter. That was a long period when China was mired in what orthodox communists would view as an “earlier stage of historical development.”

Communism, in other words, was a recipe for shaking free of foreign nations and becoming urban and industrialized. That was the theme of Mao’s ambitious and unsentimental reconstruction of Beijing throughout the 1950s, replacing magnificent imperial gates with coal-fired power plants, steel factories, and auto plants right in or near the city centers. The Deng revolution of 1979 fit right in, with the intention of restarting the industrial march forward after the fractious and destructive political and cultural campaigns of the previous decades.

Liberal measures to promote economic development have always been viewed as intermediate steps toward the more egalitarian and urbanized society that communism is building for China and, as such, are instrumental, not integral parts of governance. In theory, the temporary utilization of capitalist means, such as freer markets, would subside, as their relevance and utility for the future prosperity of the Chinese people declined. We have indeed reached the point of change, but for different reasons. For the last few years, as evinced in the official slogan of 2008, “the state enters, the private sector withdraws,” the embrace of these liberal measures has waned, as their success increasingly impinged on the prerogatives of the red ruling class.

The Dengist reforms that started in 1979 have been described, with little exaggeration, as a “management buyout.” Deng Xiaoping exhorted the red elite to distinguish themselves in commerce rather than in government, and he blessed the sometimes-covert transition of bureaucrats and military into business. The nomenklatura of the time had much to gain from the shift to market-driven reforms.

In 2013, the situation has changed. The top leaders in China have reached a level of wealth that surpasses any of the most notorious East Asian dictators of past legend. Richard McGregor’s *The Party* chronicles the pressure on party officials in today’s system to participate in corruption in order to advance and to repay the debts incurred while securing one’s position in the first place. The Party system operates as a massive network organized around patronage. The cost of maintenance of that patronage has risen dramatically, and continues to rise with the growth of the economy and the availability of extractable wealth. Bureaucratic corruption has reached beyond opportunism and has become an imperative for a successful Party career.

Its termination through systemic change at this point offers no benefit to the top leadership, which has mastered the system at the very peak and faces massive obligations itself. Structural change would very likely lead to an end to the CPC’s monopoly on power. Even if this were a peaceful transition toward power sharing, many in the current leadership structure would likely be prosecuted and lose wealth if not liberty and even life. There is no scarcity of examples in East Asia of former political leaders now sitting in prison.

Much about CCP rule works very well: Chinese cities are relatively safe, clean, and abject poverty and homelessness are unknown. Everyone has access to a very basic level of medical care and schooling, water and food. Incumbent leaders rightly consider that regime collapse could make things far worse for everyone.

Politically, transitions to the third, fourth, and fifth generation of leaders in post-reform China were celebrated for being smooth and orderly. That celebration was fully justified, in light of the fact that China in the previous century, and for centuries before, finds virtually no examples of orderly succession, except in hereditary generational succession during the better years of imperial dynasties. Within China's historic governance systems, which were by nature complex, fluid, and even elastic, ultimate power was sharply focused at the top, in an individual and his closest retainers. When the abuses of such concentrated power manifest, as they always did, and all efforts to hold the polity together gave way to rampant corruption and inflation, as it always did, there were no checks and balances to mitigate the problems and avoid a tumultuous end. There was no power sharing, no free media, no powerful church, no opposition parties, and no strong independent institutions to right the ship.

The unavoidable implication of this analysis is a belief that a genuinely new stage of Chinese development and prosperity, one that would truly liberate China from its past and achieve the modern and sustainable life that the leaders seek, would necessarily require the CCP to share power with other political centers, releasing a large measure of control through more liberal, marketized economic models.

Accepting this sort of shift is difficult and risky; more of the same provides a more predictable short-term path forward, and more of the same is what appears to be on the horizon.

8.6. The long sweep of reform

No one should be surprised that in a large and successful economy where the state itself or political elites own major assets, regulation should be used to protect those assets. Nonetheless, China has been a more open market in its early stages of development than other Asian economies. Open market policies were crafted with considerable care and ingenuity to meet the goals of accelerated growth of the economy overall without damaging the dominant position of China's domestic enterprises. Much of this study focuses on these policies and their positive and negative outcomes for the economy overall and consumers.

I have dwelled on the long sweep of reform as a way to gain insight into the future. The stresses in the current economic environment are aggravated versions of what the reform model has produced all along. From an analysis of China's miraculous growth since reforms began, there have certainly been ups and downs, as any economy experiences. But there has yet to be a fundamental inflection point, one in which the recognized drivers of imbalances and risk factors have been addressed at the ground level. In each of these dynamics, repeated deployment of short-term solutions has nurtured growth of the long-term problem. That is the simple result of privileging a top-tier growth target above all other measures of development success.

Under-distribution of resources to consumers constrains the urgently needed expansion of domestic household income, making the success of foreign consumer products a prime target. Chaotic expansion of debt and ever-wilder innovation to ob-

scure and sustain it create inflationary pressures that can be only temporarily offset with massive overcapacity and SOE losses. Inflationary pressures make the acquisition of foreign capital a rising imperative. Rising non-discretionary imports of food and energy threaten to create a sustained trade deficit, making China pull out all stops to acquire resources in an expanded sovereign space and put aside desperately needed environmental remediation to invest in high-polluting initiatives like coal gasification. Vast central-government spending, directly into infrastructure projects subsidies, and indirectly through credit issuance, enables success in regularly exceeding the high-profile growth targets. But it also drives the insatiable appetite for control of more of the economy's resources, and that returns us to the first item in this list, burdening not only China's own consuming households but foreign companies that stand as the only large actors in the economy the government does not own or control.

It is a classic goose-and-golden-egg situation. China's leaders demonstrate both their competence and legitimacy every quarter by hitting the GDP target, just as does the CEO of any large publicly traded enterprise.

8.7. Gathering crisis

Since about 2006, the most important driver of China's high GDP targets has been housing, and individuals who can pay up for the housing have been induced to spend as much as possible of the savings they had accumulated over the modern era. By 2013, there may be no city in China, no matter how humble, without vast, empty concrete towers. Chinese home ownership, already measured at a world-topping 90% in 2010, is in some regions 200% or 300%, as large portions of the population own three, four, and five apartment units. When the housing sinks in price, as it must, it will prove to have been the most efficient mechanism yet for extracting wealth from the masses of people and putting it into the hands of local political elites.

The mad build-out of housing has been a government affair. It is local governments that sell parcels of land, local governments that devise plans to build office parks and pedestrian malls where cropland once lay, and local governments who own the developers that build residential complexes. Local government officials have had every incentive to move people from their land, pave over the cornfields and rice paddies, and take a shot at building a shopping center; they can easily raise financing to do so, and even without kickbacks, that means jobs for the officials' friends, nice offices, outings and entertainment budgets: high living for a couple of years and, if the development plan doesn't work, no one has to take responsibility for the lost money.

The more successful the build-out has been in persuading people to buy new housing, the more ambitious governments have become in raising an unprecedented amount of capital, by ensuring that land prices spiral upward, supporting ever-higher borrowing, and by selling apartments at higher and higher prices, with longer and longer lead times, often two to three years before the property has been built.



A crowd in Qingyuan, Hebei Province gathers to demand apartments for which they had paid two years ago. The developer promised delivery in another eight months. Photo by the author, October 2013.

By any metric, this is unsustainable and will be unsustainable. Although the property market has died in many cities, there are still just as many where consumers are caught in a dream of an indefinite, leisured future that will be conveyed through the new apartments. While Marx's future communists had the leisure to hunt in the morning, fish in the afternoon, and criticize after dinner, the Chinese home buyer spends his or her weekends touring properties fitted out with ovens and jars of pasta in the kitchens, bathtubs, and wedding photos arranged on side tables next to open bottles of champagne: all furnishings that are alien to Chinese taste and experience but that are ritually arranged in the model apartments as something more than props: they are tokens, avatars of the sophisticated international lives that are promised as they enter China's middle class.

The middle class itself is an illusion, for China has never had and does not now have a class of citizens who can be secure in their property rights, wield some degree of political power even without great wealth, or realize income from assets rather than labor. Many have gotten wealthy beyond anything they ever expected, but within China, that wealth always comes fraught with risk; only the political class can expect to secure their positions of relative ease across generations.

The dream of a middle-class, international life, now so important to Chinese people, can now be sustained only by continuing to build these apartments, chimeras supported by steel and cement whose production represents the continued aggrandizement of GDP. This is China's social pact: the leaders continue to face an unstable and delicate balancing act between conflicting demands in the social, political, and economic spheres,

all of which are essentially about the economy. From the beginnings of reform, the deal has been that the Party can stay in power and the elites can continue to enrich themselves as long as large numbers of urban dwellers and smaller numbers of rural dwellers experience a palpable improvement in their economic situation. So the political durability of the Party and the workable stability of the society are both rooted in continued success of the economic model.

That model has outlived its usefulness, but neither leaders nor led have an easy way out. Throughout China's history, a cycle of reform and growth has led inexorably to excessive concentration of resources in the hands of a small elite, followed by a new cycle of contraction, "chaos," and reconstruction. The periods of rebuilding after a crisis have generally been the most creative and hopeful, times like the 1911 Republican period, the first few years after the 1949 Communist takeover, and the Dengist period, to name a few, when China has begun to develop new, grassroots structures for a more pluralistic governance system. Each of these periods of political ferment has been flawed, perilous, and full of promise that the country will successfully navigate its way to a more resilient, balanced, and responsive political system capable of fostering a modern economy.

China's rise through the 1990s was as glorious as any of the previous dynasties, and there is a historical symmetry to be found in the nation's coming decline. It is hoped that, in this dynastic change, China will emerge more balanced, more integrated, contributing to the stability, physical, financial, and military, of the whole international system.

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“China Alone. The Emergence from, and Potential Return to Isolation”

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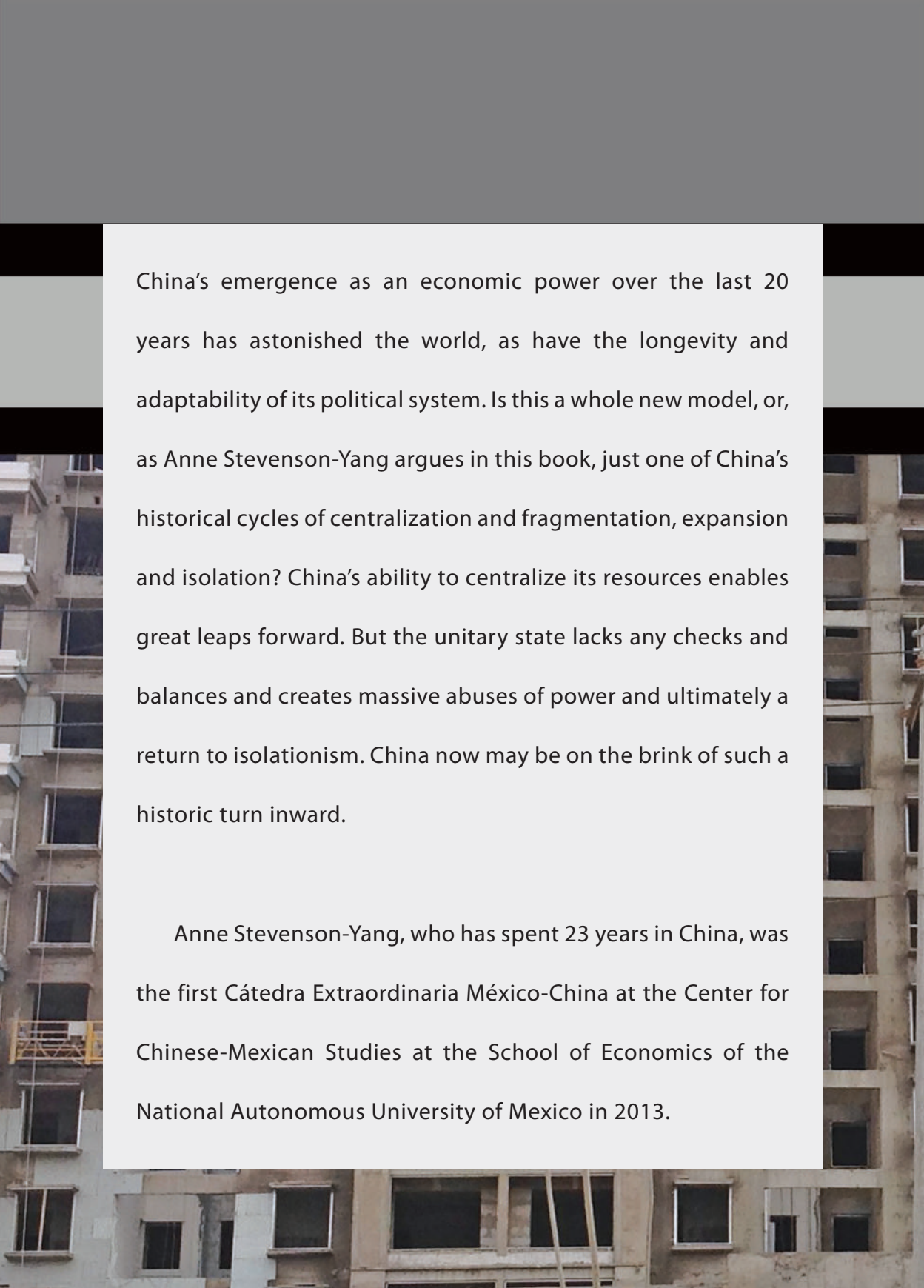
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China's emergence as an economic power over the last 20 years has astonished the world, as have the longevity and adaptability of its political system. Is this a whole new model, or, as Anne Stevenson-Yang argues in this book, just one of China's historical cycles of centralization and fragmentation, expansion and isolation? China's ability to centralize its resources enables great leaps forward. But the unitary state lacks any checks and balances and creates massive abuses of power and ultimately a return to isolationism. China now may be on the brink of such a historic turn inward.

Anne Stevenson-Yang, who has spent 23 years in China, was the first Cátedra Extraordinaria México-China at the Center for Chinese-Mexican Studies at the School of Economics of the National Autonomous University of Mexico in 2013.