Is China the Next Japan?

Roy C. Smith

Twenty-five years after a major financial crisis, Japan's powerful export-based economy has become a mere shadow of its earlier status as a financial superpower. Though different in many ways, China has followed Japan's economic development model and may now too be facing a financial crisis like Japan's that it may not be able to control and that could diminish its ability to become the next Asian superpower.

In 1970, American futurologist Herman Kahn published *The Emerging Japanese Superstate,* which summed up informed opinion on Japan twenty-five years after World War II. The war had been a disaster for Japan, but it purified the country of all of its *bushido*-driven prewar notions to allow a new Japan to emerge. The seven-year U.S. occupation forced a constitution and other democratic institutions on the new government that were accepted with little understanding or complaint. But beyond the American influence, the struggling new Japanese government understood that it had to create an economy that could grow the country out of the extreme poverty and hardship into which it had been plunged. After a relatively slow initial recovery, Japan's economy picked up during the Korean War (1950–53) when United Nations military forces were supplied from Japan (Dower 1999, 536–40).

After the war, Japan would create a protected market economy dominated by a collective triumvirate of industry, banks, and powerful government ministries, soon called "Japan Inc." by foreign observers. The mission of Japan Inc. was to create the maximum amount of growth the economy could achieve by manufacturing for export. The exports were initially low-technology goods manufactured in great quantity at low cost. The system worked extremely well. The Ministry of International

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Trade and Industry (MITI, reorganized as the Ministry of Economy, Trade, and Industry in 2001) would determine what the industrial focus would be. The Keidanren (Federation of Economic Organizations, or council of big business organizations) would cooperate to carry out MITI's guidelines. Labor unions would agree to accept an annual Shunto, or Spring Offensive, to set wages for all. The Ministry of Finance would ensure that banks, closely supervised but highly leveraged, made funds available to the large manufacturers, which were reconstituted from the powerful prewar *zaibatsu*s into mutually supportive *keiretsu*s (successor affinity groups, such as Mitsubishi or Sumitomo), to expand production capacity. "Trading companies" within *keiretsu*s would acquire the goods and sell them aggressively in overseas markets.

All of this was intended to maximize employment and create cash flow sufficient to restore a normal society in Japan. Though the system Japan installed was essentially a capitalist one, not unlike its prewar industrialized predecessor, there was very little private capital left after the war, profits were modest, and social claims on them were considerable. Capital for investment had to be generated from a high household-savings rate.

The new economic and financial system, launched under close American supervision, had some socialist characteristics, but only some. There was concern about Communist ideology spreading to Japan, as it had in the immediate postwar years in Europe, and the concern resulted in land reforms and other measures to provide government support for the common man, but the emphasis was always on creating a highly functional, democratic, free-market system that lifted everyone up.

A key condition of the Japan Inc. arrangement was that fair wages had to flow to workers and corporate distributions had to take a backseat to reinvestment for growth. The bureaucrats were smart and efficient, but they were also part of a new democratic political system that needed and received unquestioned public support.

A Miracle Economy

By 1970, Japan Inc. was an unqualified success. Japan's economic growth rate averaged 9.6 percent from 1946 to 1970 (Maddison 2003), and a stable middle class had emerged. It was a staunch, if passive, ally of the United States, with no territorial aspirations. The Japanese stock market, reestablished early on, soared for years, enriching many foreign as well as Japanese investors. The export-led Japan Inc. development model was a modern economic miracle that was carefully studied by South Korea, Taiwan, and other Asian emerging market countries.

Kahn greatly admired Japan's economic progress, but his book (Kahn 1970) anticipated problems of a "second" appearance of a Japanese "superstate" in the Pacific region. Among these problems were other Asian states' resentment of the reconstruction of the Greater East Asian Co-prosperity Sphere by other means, Japan's insatiable need to invest abroad to secure raw materials for its industry, and a growing expectation of Japanese resistance to its subordinate relationship to the United States.

Kahn needn't have worried. Three years later the "oil shock" precipitated by Arab oil-producing countries in 1973 in response to the Yom Kippur War in Israel nearly brought Japanese industry to its knees. A fourfold increase in the price of crude oil, almost all of which Japan had to import, brought about a global recession (and lack of demand for its exports) as well as a crushing increase in Japanese industrial operating costs.

But Japan Inc. rallied. It found ways to conserve energy, and it moved its exports up the technology curve from items such as textiles and steel to electronics, automobiles, and semiconductors. For the next decade, although Japan's growth rate was halved, to about 4 percent (Maddison 2003), much of this decrease was inevitable as Japan moved from competing on the basis of low wages to competing on the basis of more sophisticated products.

At the same time, however, Japan developed an increasing amount of conflict with the United States and other trading partners. These conflicts were twofold. First was the charge by U.S. industry groups and labor unions that Japan was unfairly "dumping" low-cost goods on the American market.[1] The second was that Japan deliberately blocked access to its home market by U.S. and other foreign companies seeking to compete there. Disputes over these issues lasted two decades or more, with concessions demanded of the Japanese, to which, periodically but as slowly as possible, they would agree.

Becoming Number One

In 1979, Ezra Vogel, a Harvard social scientist and professor of Asian studies, published *Japan as Number One: Lessons for America*. Japan had already surpassed Germany to become the world's second-largest economy, and Vogel, recognizing the inflation-ridden angst into which the U.S. economy had fallen in the 1970s, foresaw a future in which Japan, because of its cohesive cultural and organizational characteristics, would surpass the United States as well.

By 1979, the training wheels of the Japan Inc. control system had been taken off: the government had withdrawn from routine supervision of investment decisions, and business matters were left to individual companies to decide on the basis of market factors. The lessons Vogel (1979) had in mind, however, related to the collegial, cooperative, employee-friendly management and organizational methods used by Japanese companies to achieve steady growth and to add to broad social prosperity, despite having to adapt to unexpected changes in the world economy. These methods included lifetime employment obligations, company unions, worker participation in factory management, and various programs to inculcate company

1. "Dumping" is defined as selling goods abroad at prices lower than their cost of manufacture. Not many of the charges against the Japanese were validated by world trade organizations.

loyalty. Most of these "cultural" factors, however, had been adopted in the postwar period only because of the necessities of the times.

There was a great deal of support for Vogel's views. Japan was widely regarded as an economic superpower, even if it had become, in some critics' views, a society of hyperenergetic economic animals with little regard for activities or responsibilities beyond its corporate or national borders.

Indeed, Kahn and Vogel had underscored the uniqueness of Japanese economic success to such a degree that some considered it threatening. Chalmers Johnson (1982) suggested that the United States needed to take steps to "contain" the threat, much as communism had been contained during the Cold War, and this view gained support by unions and Congress.

The 1980s, however, brought in the *babaru keizai,* or "bubble economy," in which Japan's superpower status was destroyed by its own riches. As Japan became a more normal economy, its growth slowed to world averages. As this slowing occurred, Japanese officials sought to counter the trend with low interest rates and large amounts of easy money. The ensuing "excess liquidity" (the growth in money supply minus the inflation rate), which reached 5.5 percent of gross domestic product (GDP) in 1986 and 1987, did not pass into goods and services as inflation but into financial assets—mainly stocks and real estate—as value increases.

Both corporations and households bought these assets, very often with borrowed money, because of their belief in the limitless sustainability of Japanese economic success. The Nikkei stock-market index rose sixfold in the 1980s, compared to a threefold increase in the United States under the effects of Reaganomics. At the end of 1989, the market capitalization of all Japanese stocks was $4.4 trillion, reflecting an average price-earnings ratio of 70.6 (by comparison, the U.S. equities market was valued then at $3.5 trillion, with a price-earnings ratio of 14.1). The Nikkei reached its all-time high of 38,916 on December 29, 1989 (R. Smith 1993, 243–49).

An Economic Tsunami

Then the bubble burst, slowly at first, but it accelerated. The Nikkei index lost two-thirds of its value by August 1992. The market decline spread the panic into the real estate and banking sectors and jolted the real economy. The crash became systemic as margin loans were called, creditors were squeezed, and loan losses mounted in the banks. The crisis brought the Japanese financial system to a halt, but because it was considered a local one, it had little effect on markets or banks overseas.

The falling markets brought into the open many scandalous activities and relationships and false reporting of loan losses at the big banks and securities firms. Exposure of these activities ultimately resulted in waves of senior-management changes at almost all of the firms. To address the instability in the system caused by the economic crisis and the behavior of the banks and brokers, the government organized mergers of these firms to create fewer but larger mega–banking institutions. The fifteen or so large

"city," "long-term," and "trust" banks existing in 1980 were combined into three very tame behemoths; of four dominant securities firms, only one, Nomura, remains independent, but it is a shadow of its once formidable self (R. Smith 1993, 243–49).

A Sobering Anniversary

The twenty-fifth anniversary of the bursting of the *babaru* and the failure of the Japanese government and its large, world-famous corporations to turn things around was marked in 2014. Throughout this lengthy period, Japan's GDP growth rate averaged less than one percent. Government debt used to finance stimulus measures (mainly for public works and other infrastructure) and increased social welfare payments is now 230 percent of GDP, the highest by far in the developed world.

Though still a significantly prosperous country, Japan's relative standing has weakened during the past two and a half decades. Once a prospective number-one economy, Japan was overtaken by China for the number two position in 2010 and has sunk in global importance to being of general interest now largely as a laboratory for dealing with deflation.

Japan today is very different from what it was twenty-five years ago. Its population is aging and shrinking, youth unemployment is high, and its household savings rate, which was 14 percent in 1989, has dropped to about 2 percent, less than in the United States. Much of its export activity has turned to providing China with high-tech industrial machinery so China can flood the world with consumer products that used to be made in Japan.

The government has done what it could to stimulate growth but without much success. Japan's current government, the second of Prime Minister Shinzo Abe, has been heralded for a more aggressive economic recovery plan, called "Abenomics." There is not much that is new about this "three arrows" plan (easy money, government stimulus, and promises of "structural reform") beyond aggressive quantitative easing by the central bank, a two-stage sales tax hike, and a modest corporate tax break. The structural reforms proposed by Abe seem tepid: noncompulsory reforms to corporate governance practices, pension-fund reforms, and the formation of Strategic Special Zones with fewer burdensome rules (Abe 2014). Despite some early progress, there is little evidence that Abenomics will be enough to pull Japan out of the ditch it has been in for so long (K. Smith 2014). It appears difficult to be optimistic in view of the fact that after the first year of Abenomics real GDP growth was zero; then it was −0.6 percent in 2014 (Soble 2014), and 0.5 percent in 2015.

Explaining the Failures

Academics have made many efforts to understand Japan's persistent economic malaise. Paul Krugman (1998) describes a "liquidity trap," resulting from zero percent interest rates. T. Motonoshi and H. Yoshikawa (1999) point to credit constraints on

small firms, and Fumio Hayashi and Edward Prescott (2002) refer to a lack of growth in productivity. Ricardo Caballero, Takeo Hoshi, and Anil Kashyap (2008) note that "zombie lending" by banks has precluded necessary corporate restructuring. This argument is persuasive because it highlights a cultural condition in Vogel's cooperative Japan that amounts to a profound resistance to change that might disturb things in a broader political or social context.

David Moss (2010) has a two-pronged explanation for the lost decades. The first is the failure of stimulus efforts to restore growth because of a profound lack of confidence on the part of the general population that the spending would do any good and that growth would improve. Moss reminds us that even John Maynard Keynes said that for growth to occur, people have to believe it will and thus act accordingly. This is not happening in Japan. Household anxiety has been fueled by much higher unemployment (and underemployment) than occurred in the better days, especially among the young, and the lack of meaningful investment income and stagnant stock prices have discouraged at least two generations of Japanese investors since the crisis began.

Moss's other prong is the observation that many of Japan's deeply conservative large banks and corporations, going beyond Vogel's earlier observations, have grossly mismanaged the allocation and use of human capital. The mismanagement shows up in labor-market rigidities, the underutilization of women and immigrants in the labor force despite there being a growing shortage of workers in many sectors, and employers' inability to harness the creativity of the younger generation.

Rigidities also persist in commercial markets, where, for example, it is still quite difficult to get necessary permissions and financing to form a new business or to persuade customers that something new is better than what they are used to ("SME's in Japan" 2010). Disruptive new technologies such as social media have generated some threats to established Japanese corporations, but apparently not enough to matter much. Many older industries (e.g., the electric power industry, which mishandled the Fukushima incident in 2011) need some of Joseph Schumpeter's "creative destruction" to make changes that will revitalize them.

And, finally, Wayne Arnold and Orathai Sriring (2013) have noted that the proportion of the total output of Japanese manufacturers devoted to exports has decreased considerably due to the high cost of labor, land, and services in Japan. Outsourcing of manufacturing has pushed at least 18 percent of all production outside Japan, according to Japan's Ministry of Economy, Trade, and Industry, which has reduced manufacturing's share of Japan's GDP to 19 percent from 27 percent in 1983.

Deep Conservatism

What has been missing is a demand from the public for radical change to shake things up enough to get out of the slump. This demand has not been made, according to Peter Tasker (2011), an analyst who has lived in Japan for thirty years, because the

Japanese population has not suffered from the slump as much as many in the West believe, and it does not want to see a return to higher growth rates come at the cost of disrupting the country's social cohesion. The rising value of the yen has allowed an increase in lower cost imports; wage rates reflect modest productivity gains; and, on a real per capita economic basis, things are not as bad as they seem.

Many Japanese believe that because of their geography, history, and ethnicity, the cultural characteristics of their society are different from those of other countries and that other countries have to take this difference into account when dealing with them. This is a way of saying that any advice other countries give Japan may be ignored because it doesn't take the "Japanese difference" into account.

Further, the private sector in Japan has also resisted change. Though cross holdings of company shares by banks and other affiliated entities has declined considerably to well less than 50 percent, "hostile" corporate acquisitions continue to be rare in Japan. Such takeover attempts are much more common in the United States and Europe, where the concept of active "restructuring" to preserve "shareholder value" is more appreciated and effective and tends to keep companies sharp to avoid becoming a takeover target.

After its obsession with growth and profits that culminated in the bubble economy and the subsequent correction in asset prices that caused many Japanese to write down much of their personal wealth and income expectations, Japan has settled for a much more modest outlook for its future. It appears unwilling to accept a full transition to open, competitive markets that might threaten the stability of its balanced, equalitarian social fabric. Companies seem to resist restructuring and takeovers if they might jeopardize employment, legacy obligations, or community relations. Japan's many layers of red tape and other bureaucratic impediments to entrepreneurial activity remain in place to avoid disruptive competition. Even popular initiatives such as Abenomics never really contain much in the way of real change; there is no pressure for regulatory reforms to increase the size of the labor pool, to promote business innovations and entrepreneurship, or to rid Japan of its "special-nation" considerations. The country's aging population has something to do with this shift in attitude, but so, it seems, does its lack of confidence since the bubble days. That confidence now seems to be gone forever.

Lessons for China

Despite their tortuous historical relationship, China has closely emulated Japan in its methods of economic development. In 1978, Deng Xiaoping, China's successor to Mao Zedong, announced a modest policy of market opening and allowed some inward foreign investment. Not doing so, he believed, could result in the loss of control by the Communist Party of China (CPC) after decades of extreme economic failure and several years of political chaos under the Cultural Revolution and the Red Guards. "Let some people get rich first," Deng said, and "gradually all the people

should get rich together" (qtd. in Osnos 2014, 14). Communist economic philosophy was thus set aside in the interest of political control.

Despite these reforms, control was threatened again in 1989 with the uprising on Tiananmen Square. Deng suppressed the protests, but the event sharply curtailed interest in Chinese investment until Deng made his famous Southern Tour in 1992, a year after the dissolution of the Soviet Union, which enabled him to reassure colleagues and potential investors about China's changed political and economic outlook. Deng clearly recognized that to assure support by the people, the CPC would have to provide economic growth and a significant improvement in Chinese living standards. Chinese GDP per capita in the 1980s was among the lowest in the world.

Like Japan in 1947, China would use its massive low-wage labor force to manufacture exports to earn foreign exchange that would enable economic growth. It would also utilize the knowhow of Taiwanese companies and executives to set up the factories for this purpose and to train workers.

In this context, China's real economic change—to embrace a limited form of capitalism and to open markets to the extent that politics allowed—began after it had fully grasped Japan's thirty-five-year evolution from war loser to economic superpower.

Deng and others, however, were fully aware that Japan's economic history was quite different from China's. Before the war, Japan had been a highly industrialized society capable of sustaining and deploying a massive military force. In 1868, the 250-year feudal Shogunate was overturned by the Meiji Restoration, which led to Japan's rapid economic growth and modernization. Imperial Japan turned to militarism in the early 1900s after wars with China and Russia that included the annexation of Taiwan and Korea and the events that led to World War II; it was never a democracy or a "normal" developed economy.

By comparison, what economic development China experienced after 1900 was provided largely by foreign organizations that operated beyond the control of the Chinese government. By 1950, China was little more developed than it had been in 1900, and it regressed from there due to Mao's disastrous Great Leap Forward campaign of rapid industrialization and collectivization (1959–61), which led to a famine that cost tens of millions of lives (Tao Yang 2008).

Japan was an Asian country that had made a successful transition from poverty to development in little more than a generation, and China urgently needed to do the same. It could learn from what worked in Japan.

The government soon established a "China Inc." of its own to allocate resources to preferred areas of the economy and to be the sole party with which foreigners had to negotiate for joint ventures and other commercial arrangements. These negotiations with large Western and Japanese companies seeking access to China's low-cost labor pool and its enormous potential market for consumer goods invariably resulted in the introduction of the world's latest technologies for top-of-the-line production management into the Chinese manufacturing base.

In 1992, Deng made it clear that he meant business. "Development," he said, "is the only hard truth." He was prepared to shake things up to get the reforms he wanted. Between 1993 and 2005, 73 million jobs were cut from state-owned enterprises (SOEs), adding to the supply of workers seeking new jobs in more productive factories. The currency was kept cheap so exports could boom, and they did. In 1999, Chinese exports were less than one-third of America's—a decade later China was the world's largest exporter (Osnos 2014, 40).

China's success as a low-cost exporter, like Japan's up until the 1980s, produced a steady stream of foreign exchange, a portion of which was held in reserves (so that it wouldn't inflate the local currency), and these reserves, as in Japan, were invested in the government securities of its principal trading partners. These investments gave China a hedge against trade disputes and protectionism in countries that resented the hollowing out of their economies by massive Chinese exports. It could meet actions of this type with an implied threat to sell large quantities of treasury securities sufficient to destabilize another country's financial market.

To enable companies, including SOEs, to build state-of-the-art facilities, China Inc. directed its banks to provide funds accumulated from the country's extremely high savings rate. However, foreign direct investment (FDI) also has been one of the major sources of investment capital in China, contributing $1.2 trillion of investment capital through 2011, according to the Chinese National Statistics Bureau, and $120 billion in 2014. Starting from a base of less than $19 billion in 1990, the stock of FDI in China rose to more than $300 billion at the end of 1999. Ranked by the stock of inward FDI, China has been the leader among all developing nations (Graham and Wada 2001). The ability to attract this financing (mainly for de novo factory construction and machinery) was certainly an extraordinary achievement by a socialist authoritarian state with no constitutional protection for private property until recently.

In 1990, the government reopened the Shanghai Stock Exchange, closed since 1949, to provide a trading market in which local investors, on Deng's advice, could attempt to get rich. A second stock exchange was also opened in Shenzhen, and after the reversion of Hong Kong in 1997 a third exchange was acquired, which was available to foreigners for purchasing Chinese shares denominated in Hong Kong dollars. Chinese companies were subsequently also listed on exchanges in New York and London and issued securities there. During the 1990s, China had to create the entire infrastructure necessary to support private ownership of shares and other securities, including regulatory and enforcement institutions, accounting and legal capabilities, and an active broker–dealer industry.

The first privatizations of SOEs occurred after 1990. Selling a minority of the shares owned by the state to domestic and foreign investors through public offerings transferred the SOEs to the private sector, where, presumably both performance and governance would gradually improve to Western standards (Nakagane 2009). These issues also paved the way for favored nonstate entrepreneurial ventures to go public. These issues were very popular with investors, who saw them as opportunities to get

in on the ground floor of China's extraordinary development to come. Nevertheless, there was little doubt when these issues began to appear that they were inherently risky. There was no assurance that transfer of a minority of the shares to private investors removed the company and its management (appointed by the CPC) from government control, that disclosure of investment information would be timely and accurate, or that investors' rights would be enforced under Chinese law.

Like Japan Inc. however, China Inc. was able to attract far more private capital for economic development than it had at home or could obtain from traditional development lenders such as the World Bank.

Chinese stock prices reflected the improving view of the country's economic development. The Shanghai Stock Exchange market index (SHCOMP) rose gradually from 1,000 to about 2,000 in 2001, after which it slumped to about 1,500 in 2004, from which it then leaped suddenly to 6,000 in 2007, a fourfold increase, only to plunge with all of the world's stock markets in 2008 back to the 2,000 level. By December 31, 2013, the market capitalization of Chinese equity markets was $3.5 trillion, about the same as Japan's.

During the twenty-six years following the Tiananmen Square crackdown, China has grown and prospered as no other country has ever done,[2] and it has enjoyed one of its longest-ever runs of political stability. It, too, is now commonly referred to as an "emerging superstate" and the world's prospective "number one" economy.

Though the International Monetary Fund (IMF) ranked China's GDP per capita seventy-ninth in the world in 2014 (just behind Bulgaria but ahead of Venezuela), its large industrial base, massive foreign-exchange reserves, and its emerging population of dollar billionaires makes it closer to developed status than most other developing countries.

Capitalism with Chinese Characteristics

Though postwar Japan was influenced by U.S. democratic practices, it was a one-party, benignly authoritarian state from 1945 to 1989—its greatest growth years—and what the controlling Liberal Democratic Party wanted mainly it got. Nevertheless, Japan was no political model for China, which had followed Marx and Lenin until 1978.

It is likely that Deng was informed by the political experience of China's postwar rival, Chiang Kai-shek and his political party, the Kuomintang. Chiang Kai-shek fled to Taiwan in 1949 and ruled there autocratically until his death in 1975, during which time Taiwan developed into one of the celebrated high-growth "Asian Tigers." Like

2. The world's understanding of Chinese economic growth is dependent on Chinese-provided GDP statistics that are based on a national accounting system used by former socialist countries, which is very different from the system used in advanced countries, though China is striving to modernize its methods (Takahashi 2006). Since the stock-market correction in June 2015, broader skepticism of Chinese economic data has appeared, and "actual" growth rates are widely assumed to be less than those reported.

Mao, Chiang received his early training in political organization and control in the Soviet Union. Both were Stalinists at heart, with no intention of sharing power.

Chiang was succeeded by his son, Chiang Ching-kuo, who led the Kuomintang until his death in 1988. However, Chiang Ching-kuo, pressured by a population that had been heavily exposed to American ideas and political practices, was forced to rescind martial law and allow political opposition. He was replaced by a chosen successor, but after that successor open elections were held, and the Kuomintang's absolute power faded rapidly after thirty years of tight control.

In 1989, Deng must have thought that authoritarianism could still work in a more open, growth-oriented economy, as it had in Taiwan, Singapore, and South Korea. But he must also have seen that if China's absolute political power were weakened by notions of democracy and political rights, it could be lost altogether.

In 2014, the *Economist* noted the increasing occurrence of incidents of social unrest in China, which reached a reported 180,000 in 2010, double the number of only four years earlier ("The Lessons of History" 2014). Another report indicated that strikes or protests by factory workers in 2015 increased by two to three times their rate in 2011 (Griffith 2016). The unrest appears mainly to be tied to local incidents, but such protests have become increasingly widespread and are usually about local-government actions or corruption or against factory closings or layoffs. A few have been violent, but they have been contained. The rate of increase of social unrest parallels the rate of increase in GDP per capita, suggesting that as economic prosperity increases, so does the expectation of improvement in the social contract.

This expectation may challenge the great trade-off that the CPC has made with the people: that the former will provide economic growth in exchange for the latter's acceptance of political controls that enable the CPC to remain in office. A recent test was the popular protests in Hong Kong in September–October 2014 over local residents' ability to nominate their own candidates for leadership of the former British colony, as promised when Hong Kong reverted to Chinese control. Authorities passively endured the protests for several weeks until they finally died out.

So far, despite increasing incidents of social unrest, the great trade-off has worked, but China's vast population contains a large middle class (approximately 300 million, or about two-thirds of the urban population) with rising expectations of further prosperity, legal rights, and personal freedom. It also contains an almost equally large (240 million by some estimates) underclass of unregistered rural job seekers who have migrated to the cities. The vast rural population has not shared in the increase in prosperity to the same extent as the urban or the migrant sectors, and it has both its own expectations and, no doubt, its own resentments.

A study by Harvard sociologist Martin Whyte in 2009 shows a high degree of acceptance of the "rise of plutocracy" in China, but there is also resentment of the high degree of inequality of opportunity for those wanting to get ahead. Another study by Yinqiang Zhang and Tor Erickson found in other developing countries that education was the most important element in providing opportunity, whereas in

China the decisive factor was "parental connections," and "there are few traces of the reforms leveling the playing field" (qtd. in Osnos 2014, 269). A study by Steven Barnett, Alla Myrvoda, and Malhar Nabar in 2012 observed that despite the growth of the middle class Chinese development has been weak in the household sector as compared to the industrial sector. Indeed, China's share of GDP attributed to private consumption has been stuck at 36 percent of GDP for the past several years, lagging well behind that of other countries with similar income levels. Its private consumption also lags that of other fast-growing economies, in particular Japan and South Korea at comparable stages, where growth was more inclusive and led to a more stable and sustainable path of expansion.

In an effort to map China's middle class in 2013, Dominic Barton, Yougang Chen, and Amy Jim noted that generational change and the rising prosperity of the inland cities will affect consumption for years to come, but the principal buying power in the country will continue to reside in the 14 percent of the population described as "upper middle class," with incomes of $20,000 to $35,000 per year.

Therefore, Yu Xie and Xiang Zhou's finding in 2014 that income inequality has risen very rapidly in China is not surprising. The government reported inequality based on Gini coefficients of 0.47 for 2013, but an independent calculation in 2008 showed it to be 0.61, far higher than Japan's inequality level, 0.31 and even higher than the U.S. level, 0.45.[3]

Concerns about Minimum Growth

Between them, many Chinese officials and observers believe that the government must deliver a minimum growth rate of 7–8 percent for the foreseeable future to avoid a serious challenge to the CPC's political position (Yao 2013). Failing to maintain such a minimum-growth rate risks sharp increases in factory closings, unemployment, and public protests, which many observers believe the CPC regards as a risk to its authority and control.

The real-estate market for housing and commercial properties began to develop around 2000 and attracted substantial investment from households. The stock-market crash in 2008 further redirected investment flows into real estate, creating a new bubble in that sector. New construction and related real-estate activity helped to generate peak GDP growth of 13 percent in 2007. However, the real-estate bubble was in danger of ending in 2009 after the country's growth rate dropped sharply to 9.2 percent following the global financial crisis.

So it was no surprise when China initiated a $590 billion stimulus program in 2009 to offset the drop in the demand for exports to Europe, the United States, and Japan that pushed the growth rate below the threshold of concern. This stimulus per

3. According to a survey conducted in 2015 by Hurun, a luxury-goods group based in Hong Kong, China had more billionaires (596) than the United States (537) that year (Chew 2015).

unit of GDP was larger than similar programs launched in the United States or Europe at the time, and it worked—to a degree. GDP growth rebounded to 12 percent in 2010, in part because much of the stimulus went into reviving the real-estate market.

However, according to researchers at China's National Development and Reform Commission, the stimulus measures and the hyperactive construction they induced generated $6.8 trillion of "wasted investment" ("China's $6.8 Trillion Hole" 2014). Nearly half of the total amount invested in the economy after 2009 was "ineffective" because it went to support the steel, glass, cement, and automobile industries, which were already over capacity. A Western consultant estimated that an additional $1 trillion went "missing" due to weak oversight and the enormous opportunity for "skimming off the top" created by such an investment boom (Anderlini 2014a). Despite the investment boom after 2010, Chinese economic growth (and the real-estate sector) began a steady decline, dropping again below the 7–8 percent threshold.

A Nation of Scarcities

Damien Ma and William Adams (2014) have described China as a nation that has always seen essential economic resources (raw materials, food, energy) and public services (health care, pollution control, education, housing) to be in short supply. A great irony of China's success is that although these scarcities have been reduced as development has occurred, continued growth will disproportionately increase the demand for these resources, ensuring their continued scarcity in the future.

As Chinese GDP per capita increases, so does demand for protein for better diets, concrete for housing, and fuel for automobiles and home heating. The per capita availability of arable land and water in China is among the world's lowest, and energy and other natural resources are limited. Growth has considerably increased demand for these raw materials, food, and energy, but a large portion of these things has to be imported at rising so-called China prices. For example, as China's 1.3 billion population demands more meat in its diet, the meat has to be purchased abroad at market prices that reflect the increased demand.

Further, China's once seemingly infinite supply of labor is also showing signs of scarcity. Aging and the one-child policy have created a shortage of workers eligible to enter the skilled labor pool. The annual growth of the migrant workforce was 4.5 percent between 2005 and 2010, but it slowed to 1.5 percent in 2014. According to the World Bank, China's "excess rural surplus labor" is nearly exhausted (Wildau 2015).

And rising demand for improved public services has exceeded the country's ability to deliver them across the board. Supplying these services will represent a major claim on government resources in the future.

Further, according to Ma and Adams (2014), the same escalation in demand for public services will spill over into increased demands for personal and political freedoms. Beyond delivering on the economic front, if the CPC cannot fulfill these demands for social benefits and political freedoms, then the people are likely to want

to have more to say in governing themselves. This is what occurred in the Soviet Union and the former Soviet bloc as well as in Taiwan, South Korea, and other countries where firm totalitarian regimes were displaced through peaceful political actions, however unpredictable these actions may have seemed to be before they occurred.

The Chinese Financial System

China depends on 4 very large and closely controlled banks, 10 "second-tier" banks, and 140 or so other regional commercial banks that are not publicly traded. And various nonbank financial companies perform intermediary functions.

Chinese households are required to save their money in banks because of a lack of credit availability for capital items and to assure retirement income. Like Japan in the early years, the household savings rate is very high, higher than 25 percent (Chamon, Liu, and Prasad 2011), but deposit interest rates are low, providing a cushion for banks but denying Chinese individuals an adequate real return on their investment, which has led some of them to invest in riskier opportunities such as the real estate or stock markets.

In China, the large banks were recapitalized by capital infusions from the government before they went public. Banks lend to SOEs, corporations, municipalities and their many associated enterprises, and other financial intermediaries.

The government directly issues only modest amounts of debt, but nongovernment borrowings, reflecting the debt held by SOEs, other corporations, municipalities, financial institutions, and households, has grown rapidly to levels among the highest in the world. A McKinsey Global Institute report for 2014 indicated total debt in China to be $28 trillion, almost three times the country's annual economic output. Of this amount, however, nongovernment debt was 227 percent of GDP, up from 116 percent in 2007 (Nicholachi da Costa 2015). As in Japan's developmental years, considerable leverage is applied to the economy through the banking system.

Leverage, however, comes with the risk of nonperforming loans, which are designated by a bank's management and approved by its regulators. In all countries, what is or is not a nonperforming loan can be a negotiated matter in many cases. Troubled companies that are unable to pay interest on loans can sometimes persuade banks to lend them the interest due, which thus avoids default and enables the loan to continue to be considered as a performing loan.

Despite a substantial increase in total bank loans during a time of slowing growth, Chinese banks have reported that their nonperforming loans have declined rather than increased as a percentage of total assets ("Storing Up Trouble" 2012). There was a slight increase in the ratio to 1.14 percent from 1.03 percent during 2014, but the ratio was 12.5 percent in 2005. Bank officials have not explained how this large decrease happened, but smaller banks in particular have repackaged much of their riskier loans and sold them as "wealth-management products" to ordinary depositors looking for higher yields (Zu 2014).

The largest Chinese banks are publicly traded, must report their financial positions in accordance with international accounting standards, and are subject to Basel III capital adequacy standards. Some fudging of the numbers on nonperforming loans may be possible if nothing happens to aggravate the banks' financial position, but if it does, then disclosures of the true situation may threaten the banks' ability to function, as they did in Japan after 1989 when large quantities of previously undisclosed nonperforming loans were revealed (R. Smith 1993).

In 2014, Chinese banks began an effort to raise additional capital through the sales of preferred stock and Basel III bonds designed to absorb losses in the event of a crisis. Concerns about rising real-estate prices and bank-credit exposures caused the government to curtail some lending by the larger banks.

This curtailment, however, only transferred credit demands to the larger number of smaller banks that are not publicly traded. These smaller banks and some nonbank financial companies make up the Chinese "shadow-banking" sector, which has expanded rapidly. Economists at Barclays Bank estimated the size of this shadow-banking system in 2013 to be about $6.2 trillion, or one-third of all the assets in the banking sector.

About half of the shadow-banking assets relate to the more than ten thousand "local government financing vehicles" set up to borrow money for growth-enhancing local public-works and real-estate projects. The official estimate for these vehicles' total borrowings in mid-2013 was $2.9 trillion, or 31 percent of GDP (Anderlini 2014b). Nonperforming and "special-mention" loans in this sector increased to 3.5 percent of assets in the first quarter of 2015, up from 2.5 percent a year earlier. These loans are reported to be about 2 percent for the large, publicly traded banks, but the market is skeptical of the data—the banks' shares are priced as if bad loans were 5 to 10 percent of assets ("Small Is Ugly" 2015).

This shift of credit risk into the less-visible portion of the market also happened in Japan, where a Bank of Japan study in 1991 showed that bad loans held by thousands of small leasing, housing, and consumer finance companies were about equal to the total amount of bad loans carried by the banks. The banks had financed the finance companies, so the latter's failures had to be absorbed by the banks, adding to the carnage in the banking system once the true story came to be known (R. Smith 1993, 252).

Enter Mr. Xi

In late 2012, China's ten-year leadership cycle turned over, and Xi Jinping, the son of a former "Long March" high Communist official, became general secretary of the CPC Central Committee. He subsequently also became president of the People's Republic of China and chairman of the Central Military Committee.

Xi's government promised at the start to commit itself to opposing official corruption, strengthening China's international role and asserting its claims in the

South China Sea, and effecting major economic reforms to enable market forces to play a "decisive role." All of these measures appeared to be popular.

However, in August 2013 CPC cadres filled meeting halls around China to hear an important, somber message from their new chief. Power could be lost, they were told in a memo referred to as "Document No. 9," unless the party eliminated seven subversive currents in contemporary Chinese society. These perils included the notion of "Western constitutional democracy," "universal values" of human rights, Western-inspired ideas of media independence and civic participation, pro-market "neoliberalism," and "nihilist" criticisms of the CPC's traumatic past. This document was an early announcement by the Xi administration that, whatever may be said about reforms and liberalization, the CPC would protect its non-Western, authoritarian system of government and defend its political power (Buckley 2013).

The anticorruption campaign has already resulted in a number of high-profile arrests, and the assertion of sovereignty over large parts of the South China Sea has encouraged national pride, though it also has become a serious concern to China's neighbors and the United States.

A year after taking office, Xi gave details of a sweeping plan of economic reforms that included opening the financial sector to more competition, allowing the prices of natural resources to be reflected in local markets, and transferring more of the country's income to the rural sector (Davis, Silk, and McMahon 2013).

These economic reforms extended to allowing bank-funding costs to be more market based, providing deposit insurance that would impose some discipline on the system and limit amounts to be paid, and relaxing capital controls. New efforts would be made to ease the debt burden on municipalities by enabling them to issue bonds to repay debt and to swap bank loans for bonds that could be used as collateral for borrowing from the central bank. There was also to be "bureaucratic reforms" to improve conditions in labor markets at SOEs ("Coming Down to Earth" 2015).

There was some uncertainty as to when and how these programs would be implemented, but the general view was that Xi had done more to liberalize the Chinese economy in two years than his predecessor had done in ten. China's growth rate, however, was still declining. It was 7.4 percent in 2014 and 6.9 percent in 2015, the lowest in twenty-five years. Some of the slowdown, it was thought, was the continuing effect of the deflation of the earlier real-estate bubble that reduced fixed-investment in China considerably after 2011.

Reacting to Declining Growth

Xi's government was reluctant at first to provide another stimulus round because of concerns about bad bank loans, a fueling of inflation or an asset bubble, and a general need for reforms to tighten up the financial system. But the slowing of the growth rate to minimum levels and that low growth's threat to political stability left the government little choice. It would have to intervene to take stimulative actions and

then manage the consequences as best it could. Thus, reforms would have to wait ("Don't Say Stimulus" 2014).

Declining growth also puts a great deal of pressure on the less-efficient, unmodernized SOEs. These SOEs still employ a large number of workers and represent a substantial investment for the country, so the government is protective of them. The government can direct SOEs to increase production, lower prices, or accept receivables from questionable customers in order to boost growth. However, such directives—reminiscent of the Soviet-style command economy—can result in excess capacity, employment, and inventories and thus can destroy the profitability of the enterprises and adversely affect their ability to repay bank loans, turning some into "zombies."

A comparable difficulty exists at local-government levels, where officials were evaluated on the growth-creating activities they undertook on their own or in partnership with private companies. Fearful that these efforts might get out of hand, Beijing restricted direct borrowing by local governments but (unable to deny some powerful local officials) allowed these governments to get around the rules by establishing financing vehicles that borrow on behalf of the municipality. Governance of these activities is ambiguous and can involve political conflicts between the central authorities in Beijing and powerful local officials. Though Beijing has been concerned about excesses in the local financing vehicles, worries over slowing growth have caused it to relax its opposition to them. In May 2015, it went further and banned banks from cutting off or delaying funding to any local-government projects undertaken before the end of 2014 and from not refinancing any municipality that was having trouble meeting payments (Anderlini 2015).

The stimulus efforts undertaken in 2014 helped to increase prices and activity in the secondary market for real estate, but it also directed speculative capital back into the stock market, which had languished since the last bubble in 2006. Investing in stocks was made more attractive by four successive interest-rate cuts by the central bank, a significant reduction in bank reserves, and, in particular, an effort to stimulate investments in equities (as a new source of capital to enable debt reduction) through easier terms for margin loans (Wildau and Mitchell 2015). This effort seemingly was made without any regard for the financial losses that might be incurred by margin borrowers or for whether margin investing was an appropriate risk for the investors to take.

Margin lending reached a peak of about $380 billion in June 2015, according to official sources. It amounted to about 3.5 percent of market capitalization, having increased thirtyfold since 2012. Some other reports suggest that margin lending on all the exchanges, through formal and informal or nonregulated sources, actually has pushed the total amount of margin loans to an amount near $2 trillion, or 20 percent of market capitalization (see, e.g., Durden 2015).

Thus, China's second stock-market bubble in a decade began to form in late 2014. The Shanghai market index rose 150 percent from November 2014 to a cyclical high of 5,166 in June 2015, before the bubble began to leak, dropping the

index by 43 percent to a low of 2,927 in just a few weeks. About $3.5 trillion in market capitalization was lost, but the index was still about 15 percent higher than a year earlier. China's other stock markets in Hong Kong and Shenzhen as well as the ChiNext Market (established in 2009 as a separate exchange in Shenzhen for high-tech start-ups) suffered similar declines. All of the markets had price-to-earnings ratios reminiscent of Japan's in the late 1980s.

As sharp as the mid-2015 correction was, however, its effect on China's economy was relatively modest. The free-float (tradable) portion of the Chinese markets is only about one-third of GDP (compared to about 100 percent in most developed countries). Less than 15 percent of China's household financial assets are invested in stocks ("China Embraces the Markets" 2015). However, the losses were concentrated among approximately 90 million individual investors who owned 80 percent of Chinese shares. These investors, predominantly from the urban middle class, are mainly speculators whose unsophisticated trading practices contribute to the markets' very high trading volume and volatility (Sharma 2015).

Overcompensating

In July 2015, Chinese authorities suddenly announced several powerful initiatives to intervene in the stock markets to "uphold market stability." These initiatives included halting the flow of initial public offerings of start-up companies; suspending trading in as many as 50 percent of the 2,800 companies listed on Chinese exchanges; stopping short-selling; directing sovereign wealth and pension funds to purchase shares; and providing $480 billion, or 5 percent of GDP, to China Securities Finance, a government agency, to purchase shares and provide liquidity to the market. It also encouraged twenty-one willing brokers to create a $20 billion market stabilization fund and to agree not to sell any stocks until the Shanghai Index returned to 4,500 (Sharma 2015; Verhage 2015).

The free fall was halted almost immediately. The actions taken were sufficiently powerful and credible to halt the panic that had set in. Their brute force simply overwhelmed the markets' ability to apply the laws of supply and demand.

Many foreign observers, however, wondered why the government felt such extreme actions were necessary. True, the Chinese market structure is weak, and a stock-market collapse was possible, but even then the collapse's effect on the real economy was expected to be modest. The government did not intervene in 2006 when the Shanghai market plunged from 6,000 to about 2,000, so why did it intervene this time?

One explanation is that Chinese officials have since Deng Xiaoping been accustomed to controlling outcomes and saw little reason not to control the outcome in this situation. Unlike in most other countries, in China government officials have the resources, the authority, and the mechanisms to manage economic events and markets, so why not do so? Interventions of this sort remind everyone that the Chinese

government can either allow or deny market forces whenever it wants, so it remains the ultimate economic power.

Another explanation, however, is that the overheated market was a direct consequence of stimulus efforts undertaken by the Xi administration, and a collapse would be a politically embarrassing event that had to be prevented from occurring.

An unintended consequence of the intervention, however, may be that the flagrant demonstration of disregard for market forces (and for the reforms that would empower these forces to play the "decisive role" promised by Xi) may shatter confidence that the reforms will ever happen. Ironically, the massive market intervention occurred just at a time when a portion of a report by the World Bank that urged China to accelerate reforms in its state-dominated financial sector was withdrawn after objections from the Chinese.

The World Bank report had warned that "wasteful investment, overindebtedness and a weakly regulated shadow banking system" had to be addressed for China's broader reform objectives to succeed. The report also warned that the weaknesses could end "three decades of stellar performance" for the world's second-largest economy (qtd. in Magnier 2015).

Vulnerabilities

Nevertheless, Xi survived the intervention looking strong, decisive, and able to get his way. The episode, however, may not yet be over. Stock prices continued to sag even after the government's intervention efforts. Indeed, the interventions may have harmed the long-term appeal of Chinese stock markets: they demonstrated that liquidity can be withdrawn without notice and that prices may be subject to continuous manipulation if the government gets used to intervening for nonsystemic or political reasons. As trading was fully resumed, many investors chose to use the opportunity to get out altogether.

Indeed, in the first few months after Japan's market collapse in December 1989, the government attempted to halt the collapse after a 40 percent drop with a series of similar intervention measures. These measures worked in the short run, but two years later the Nikkei market index dropped an additional 25 percent, from which it fell some more to a low of 5,000 in 2003, thereafter only slowly recovering to the 20,000 level, still only half the peak of nearly 40,000 achieved twenty-six years earlier.

The Shanghai Composite index, which was buoyed to 3,053 in October 2015 after the governments various intervention efforts, continued to sag after the immediate support was withdrawn and was 2,938 in June 2016.

The Chinese stimulus also had the effect of increasing credit to marginal borrowers, such as SOEs, local governments, shadow banks, and some households. In a slowing-growth environment, many of these entities will become distressed. Efforts to support the stock market may yet spread to supporting weakened credit markets, further removing market forces from credit allocation.

Japan had such a problem with credit markets after its stock-market collapse. Loans that had been secured by stocks or real estate immediately became significantly undercollateralized. To protect themselves, banks had to ration credit sharply, denying it to small enterprises and threatening the financing ability of "zombie" corporations that had been kept afloat only by bank forbearance. With the forbearance withdrawn, record levels of bankruptcies ensued, and doubts spread about the banks themselves, which then had to be assisted by government actions.

In fact, Japan's economy and financial markets were in the process of significant (though gradual) liberalization and reform when the collapse occurred in December 1989. In many ways, they were only about halfway toward the open-market system utilized in the United States and the United Kingdom, where stock-market reforms had been completed in 1975 and 1986, respectively. After its market crash, Japan greatly slowed its reform efforts, leaving the transition to a globalized market economy substantially incomplete. Japan's reluctance to change itself in effect ended its aspirations for superpower status.

An Existential Moment

China has now arrived at an existential moment after nearly forty years of extraordinary economic progress. To get to where it is today, China has allowed market forces to play a significant (if not decisive or controlling) role in its economic development and has liberalized many of its social policies. To become and remain an economic superpower, however, it must move much further to adopt reforms that allow the country to be shaped meaningfully by market forces in the future. (The notion that allocation of investment capital be based on free markets, not on political factors, has been sacred to most Western economists since Adam Smith.)

Henry Paulson, former U.S. Treasury secretary with extensive experience of China from his days as chief executive of Goldman Sachs, is a notable China well-wisher, but he also believes that "no advanced economy has achieved high income status—something to which China aspires—with a closed financial system that misallocates and misprices capital." China knows what it has to do, Paulson says (2015), and how to do it, but it so far has lacked the will to complete the reforms. The market interventions of 2015 (from China's point of view successful at containing unruly, dangerous market forces) may be a further setback to completing such reforms.

Many observers of China's development have pointed out that the CPC may not accept Adam Smith's idea of capital allocation because such allocation could risk the party's hold on power. Document No. 9 seems to confirm this concern. But the CPC's power is formidable, so that hold could be relaxed gradually to aid development, as it has been in the past. How much relaxation and how gradually and effectively it is applied may be the key questions.

Indeed, Xi's promised reforms are meant to occur during his ten-year term of office, not necessarily right away. Xi can justify intervention to avoid a growth-affecting

market crash in the same way that Paulson did (as Treasury secretary) in 2008. Unlike Paulson and his European contemporaries, Xi seems actually to have the power he needs to shape events in China.

Deferring the reforms too long, however, continues to tie the country's future to the ability of a cadre of political officials to micromanage the outcome and expectations of China's vast, increasingly complex, and troubled economic and social system with all its scarcities. This management will be much more difficult if the cadre contains powerful rivals with different views about the CPC's willingness to share power with markets. The Soviet Union was not able to complete the reforms intended by Mikhail Gorbachev so that it could remain a superpower, nor was Russia's Communist Party able to hang on to power—two historical lessons well understood by the CPC.

By the time of the four-day meeting of the Central Committee in October 2015 to consider the broad outlines of its next Five-Year Plan (approved in the spring of 2016), a number of events had occurred that reflect an understanding of the need for continued reforms and realistic thinking about China's economic outlook and global position. The central bank reduced interest rates further but also said it would allow banks to set deposit rates based on market conditions. Two large banks were permitted to issue bonds denominated in renminbi in the Euromarket, bringing the total Chinese overseas bond issues in 2015 to $90 billion, up from $10 billion five years ago (Hale 2015). The one-child policy was also abolished, and the first China–Taiwan meeting of political leaders since 1949 was announced.

Most important perhaps was President Xi's announcement in November 2015 that the government had set a 6.5 percent growth target for the period of the forthcoming Five-Year Plan. This is the minimum rate necessary for China's GDP and per capita income in 2020 to be double what they were in 2010, an important goal for the CPC. Xi's announcement included goals to expand the domestic consumption portion of the Chinese economy, to have the renminbi included in the IMF's basket of currencies, to attract more foreign inward investment, and to encourage overseas investment by Chinese companies (Wong 2015).

In China, much will depend on what the growth rate is over the next few years. If it declines to levels more typical of the global economy (as some Chinese and other officials have predicted), how will China handle pressures that may increase unrest and political opposition? Will it be able to transfer growth in employment and prosperity from the export to the domestic economy? Will this transfer require additional stimulus measures, which in turn will further increase debt outstanding and credit risk? Will the government be able to manage strong public demands for expensive programs to improve health care, environmental quality, education, and pensions? Will rising income inequality become a political issue?

Xi certainly expects to face these important challenges. He has fortified his personal power base to be able to do so, but in the end these challenges may be a test of whether a "Red State" superpower, with all its vulnerabilities, can be made to succeed and endure.

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