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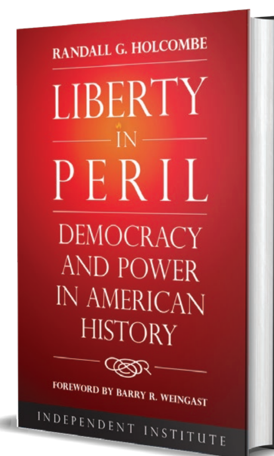

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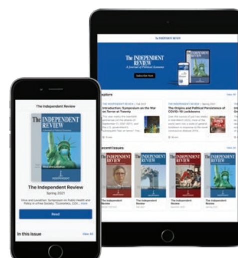

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China's Next Ten Years

Roy C. Smith

On October 24, 2017, at the Chinese Communist Party's (CCP) Nineteenth Party Congress, President Xi Jinping was elected to a second five-year term, the Central Committee was packed with his supporters, and the party's constitution was amended to include Xi's "thoughts on socialism with Chinese characteristics for a new era" as part of its essential doctrine. These actions, together with an additional honorific, "core leader," demonstrated his near total consolidation of power within the party. Of five new appointments to the seven-man Politburo Standing Committee, none is young enough to succeed Xi if the party's current retirement age (sixty-eight) is maintained. In a three-hour speech, Xi outlined his thoughts about a "two-stage development plan" that will make China "a great modern socialist country" in the "new era" between now and 2050 (China Daily 2017). Xi's term will expire in 2022, but on March 5, 2018, after the successful party congress, the CCP voted to amend its constitution to eliminate term limits on the presidency, thereby clearing the way for Xi to remain in office indefinitely.

The next ten years, however, will be crucial in determining whether China will emerge as the permanent great power in Asia and as a global superpower able to contest the United States in a bipolar world. Whether this happens or not will depend more heavily on economic and financial factors than on political ones, though of course the two are closely tied.

Much of the Western geopolitical commentariat appears to have already bought into the China-as-superpower vision—much has been written about a coming war between China and the United States and of a global power shift to the East as China asserts its broad maritime territorial interests, expands its military capacity, and benefits

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Roy C. Smith is Kenneth Langone Professor of Finance Emeritus at New York University Stern School of Business.

The Independent Review, v. 23, n. 1, Summer 2018, ISSN 1086–1653, Copyright © 2018, pp. 109–129.

from a perceived weakening in power and influence of its principal rivals in Asia, the United States, and Japan.[1]

Most of these opinions recognize that China's growing assertiveness is based on its economic success, but some also observe that the influence of the United States has decreased because of its crisis-induced sluggish economy, weariness with foreign wars and trade disputes, and refocusing of priorities on national issues at the expense of fulfilling its role as superpower. Others have observed that, in addition, Russia and India have potential to become global or regional powers, but China is the most potent of today's challengers to U.S. hegemony.

But superpowers cannot be transient things—to be one requires being able to sustain the position indefinitely, despite economic fluctuations, political missteps, and the rise of rivals. The United States has been a superpower for nearly eighty years, largely because its economy and its politics have adapted to challenges. Its economy is among the world's most open to market forces and new ideas, one of the least affected by government intervention, and therefore one of the most self-renewing. Its democracy is robust and capable of leadership changes through elections and therefore one of the most self-correcting. Its rivals may be capable of achieving a superpower designation for a time, but their ability to sustain the position for lengthy periods may ultimately depend on how self-renewing their economies are and how self-correcting their political systems are.

The Chinese commentariat does agree on one thing, however: the next ten years will demand high levels of political skill and patient diplomacy to avoid serious conflicts between a rising China eager to establish its new hegemony and a United States perhaps wearied by its superpower burdens but not at all ready to give up the role. The election of an "America First" president with little knowledge of or patience with complex and often inscrutable Asian political dynamics renders the current situation more uncertain.

China's Rise

Each of Xi's predecessors left his mark on China's movement toward superpower status. Mao Zedong (1949–76) established the CCP as China's ruling body and enabled its command structure to endure despite the enormous human costs of his regime. Deng Xiaoping (1979–92) enabled one of history's greatest internal turnarounds by adopting "Red capitalism" from a pure form of Marxist Leninism in order to avoid losing political control (as all other former Communist countries did when "transitioning" their economies to a market system). Deng was replaced by a pragmatic protégé, Jiang Zemin (1992–2002), a governor of Shanghai who aggressively promoted business and foreign investment. Jiang was succeeded by the relatively colorless Hu Jintao (2002–12), another rising star in the Deng faction who continued to encourage economic expansion while keeping a low global profile. Xi Jinping (2012–), a "princeling" son of

1. See Rachman 2016, Allison 2017, and Erzioni 2017, among others.

a former high CCP official, was thought to be a safe pair of hands to keep things moving along smoothly.

In his early days in office, Xi promised to return to traditional CCP ideals (including resistance to foreign ideas and to temptations to increase political or human rights), to eliminate corruption in the party, to rekindle national pride in China's history and achievements, and to introduce necessary reforms and give market forces a "decisive" role in the economy (Kroeber 2013).

Xi was chosen as Hu Jintao's successor when China used the 2008 Olympic Games as a platform to demonstrate its riches, accomplishments, and past glories. Since then, Xi has introduced China's somewhat baffling actions in the South China Sea and in areas of the East China Sea claimed by Japan and has embarked on an ambitious "One Belt, One Road" policy to develop overland and seaborne trading routes between China, the Middle East, and Europe (along the ancient Silk Road) to draw together the sixty or so countries along the way into an expanded China trade zone. This endeavor is to be financed by the new Chinese-formed $100 billion Asian Infrastructure Investment Bank, which fifty-six countries (not including the United States) have already joined as members. Meanwhile, Chinese state-owned enterprises (SOEs) have invested heavily around the world in raw materials and the development of new markets for exports, and other large Chinese corporations have invested hundreds of billions of dollars in acquiring businesses abroad (French 2017, 5–12) ($246 billion in 2016 alone, according to *Bloomberg* data [Sidders and Chan 2017]). In 2016, the Chinese yuan officially joined the special drawing-rights basket and became a foreign-exchange reserve currency of the International Monetary Fund (IMF), along with the U.S. dollar, the British pound, the Euro, and the Japanese yen. China has also been lobbying the IMF for a greater share of its voting power to be directed to it and other developing countries.

Xi has also moved boldly to establish his personal power and has demanded the loyalty of those in senior party positions. In 2013, he began promoting the "Chinese Dream," which some have called an embodiment of his political ideology—a vague notion of other things Chinese should be proud of, apart from economic progress, including China's ancient past and traditions, its commitment to socialism, and its independence from Western ideals and political evolution. In 2016, the CCP proclaimed Xi a "core leader," elevating his political status to the level of Deng Xiaoping and Mao Zedong, both of whom served as party chairman for more than ten years. In August and September 2017, in the run-up to the CCP's October Congress, China's state television ran a series of six 45-minute broadcasts on China's emerging great-power status and Xi's commendable "diplomatic thought."

However, beyond vague notions of the Chinese Dream and the core leader's diplomatic thoughts, Xi has not made it very clear what sort of vision he has for China or what timetable he may be on. But it may be possible, as some historians and Sinologists have suggested, to sketch out a general idea. Deep in China's psyche, some say, lie two important self-identifying historical themes that drive Chinese perceptions of themselves and what needs to be made right. First, for millennia China claimed to be the ruler

of "all under the heavens" (i.e., all the countries it came into contact with) in a system wherein those wanting to deal with China "kowtowed" to it and paid it modest tribute but otherwise were left alone. Second, the Chinese experienced the undeniable "century of humiliation" under Japanese aggression for fifty years beginning in 1895 and under British and the other European colonizers for several decades before then, for which some sort of restitution is seen to be essential (French 2017).

Xi seems to want to restore the former tribute system in some sort of modernized version—to have other countries, especially those in Asia, return to treating China as the great power that is more equal than any other, with the United States and Europe at least recognizing China as equal to them in prominence but granting special deference to its interests in Asia, much as the U.S. claimed similar rights in its hemisphere under the Monroe Doctrine.

Other Asians may have to accept such a role for China as something they are unable to prevent. The Europeans probably don't care because their role in Asia is more commercial than political. But for the United States, such a change would be significant and surely resisted. It would mean that the United States should back away in the Pacific and entrust its and its allies' interests to the Chinese to administer for the greater global good.

Apart from its direct military presence in Asia, the United States has alliances and mutual-defense treaties with almost all of the countries in the region, which see it as a buffer between themselves and a bully-boy China of the future. The United States provides a nuclear umbrella for all these countries, but, ironically, should the United States withdraw, some of the countries in the region (especially Japan, South Korea, and Vietnam) might develop their own nuclear capabilities. This outcome certainly would not be in China's interest.

China, in contrast to the United States, has only one ally in the region—North Korea, which China has allowed to provoke the United States with its nuclear weapons program, perhaps using that program as a proxy for demonstrating the limits of U.S. power in the region. But it also certainly would not be in China's interest for the situation to escalate into another, potentially catastrophic Korean War.

Whatever political tensions Xi's challenges to the United States may bring, China's economic relations with the United States are vital to its success as a rising power. The United States is China's leading trade partner ($520 billion in imports and exports in 2016), and China became the largest U.S. trade partner in 2017, displacing Canada and Mexico (U.S. Census Bureau 2017). The U.S.–China trade deficit, a source of much political anxiety in the United States, was $375 billion in 2017, or nearly half the entire U.S. global trade deficit. China, however, is also a major investor in U.S. Treasury securities ($1.1 trillion in 2017) and an important direct investor in U.S. corporations, real estate, and factories. The U.S.–China economic relationship has been under continuous negotiation since the George W. Bush administration and involves ongoing discussions about currency manipulation, theft of intellectual property, inappropriate government subsidies, the opening up of Chinese markets further to U.S. exports, and

tariffs or taxes on Chinese exports that are deemed to have been "dumped" (i.e., sold below cost) (Paulson 2015, 178–79). The Trump administration has reopened these discussions in a renewed effort to counter what it considers "unfair" trade practices.

China's obsession with past humiliations inflicted by the Japanese is seen in many different forms of anti-Japanese propaganda, literature, movies, and demonstrations that occur regularly (*Wikipedia* n.d.a). Even so, the relationship between the two countries is significant and mutually dependent, with Japan ranking as China's second-most-important trading partner ($244 billion in total trade in 2016). Much of China's economic achievement is due to its closely copying Japan's successful, highly leveraged, state-controlled concentration on exports and technology absorption (Smith 2016). China now sees Japan as politically a spent force, however, so it has not hesitated to launch an increasingly assertive effort to "recover" the Senkaku Islands off Okinawa, an ancient claim that Japan denies. Japan's adopting a docile, tributary role in the future to maintain its relations with an ever more important China would certainly please the Chinese, but Japan was never a cooperative part of the tribute system, even in the distant past, and is unlikely to become one now, especially because it has such close ties to and a mutual defense treaty with the United States.

These are the things that the geopolitical commentators comment on. But they may be entirely beside the point if China's political efforts are undermined and it is reduced to sub-great-power status by fundamental economic and financial weaknesses.

Such weaknesses are a considerable and present danger to the sort of aspirations Xi appears to have. They present a serious risk of an economic setback similar to those experienced by other rapid-growth countries, whose governance mechanisms could not keep up with asset bubbles, leverage, financial speculation, and related misadventures.

In September 2016, both the IMF and the Bank for International Settlements warned that China's rising debt levels risked another major financial crisis (Evans-Pritchard 2016). In 2017, both Moody's and Standard & Poor's downgraded China's sovereign credit rating because of its inability to get its extremely high debt ratio under control. China's total debt soared to $33 trillion, or 304 percent of gross domestic product (GDP), according to an estimate by the International Institute of Finance in May 2017 (Amaro 2017), with nongovernment debt ($28 trillion) representing 250 percent of GDP, twice what it was in 2011 (International Institute of Finance 2017).

Many academic and other studies point to the risk of a debt-based financial crisis in China. However, the question has never been just about China's wobbly financial structure, but rather about how bad it has become and whether the government will be able to manage a crisis without having to abandon or dilute its other global objectives.

So the issue for Xi seems to be: Will he get the time needed to solidify his vision of China's future and status, or will economic and financial reality capsize the effort and sink the hopes of the aspiring superpower? This concern may explain why Xi seems in such a hurry to make things happen within his window of opportunity.

Achieving superpower status will unavoidably involve facing formidable economic, demographic, and financial headwinds over the next ten years, of which there are

essentially three: (1) a deceleration in economic growth; (2) adverse demographics that compound the issues; and (3) an unbalanced financial sector weighted down by heavy debt levels, misregulated credit sources, and lack of credit transparency among large state-owned borrowers, which pose increasing risks in China's rapidly growing markets for financial instruments.

Decelerating Economic Growth

China's economic growth rate since Deng Xiaoping's turnaround in 1978 has been extraordinary, the most dynamic in history. Growth in GDP has averaged around 10 percent since 1990, lifting hundreds of millions of Chinese out of poverty into a rising middle class and enabling China to overtake the United States in 2010 as the world's largest economy in terms of purchasing-power parity (but second-largest economy otherwise). China's GDP per capita has risen to the world average (IMF 2017).

This change has been accomplished through a succession of leaders after Deng who pursued a highly leveraged, export-oriented industrialization of the country. The program required allowing foreign companies (initially entrepreneurs from Hong Kong and Taiwan, but then also large Japanese and Western corporations) into the country to organize factories and train workers and to operate the export businesses that became the base for the country's growth. To get their investments approved, these large corporations were required to bring in their most advanced technologies, which would be shared with local joint-venture partners. In a relatively short period of time, China became the workshop of the world, using imported Western technology to fabricate, assemble, and ship consumer products all over the world. This major transformation of Chinese industry occurred over a twenty-year period and cumulatively involved about $1 trillion of foreign direct investment by companies believing in the Chinese transformation, far more than any other developing country ever attracted.[2]

Financial markets were reopened in 1990, and a few years later extensive "privatization" of SOEs occurred (which involved incorporating the SOEs and selling a portion of their stock to private investors, though with the government still appointing top managers of the enterprises, who had to follow government policy directives). The reforms of this period also included allowing nongovernment enterprises to obtain financing in local and foreign markets and to flourish on their own. Enabling this segment of the economy to develop as it did was China's greatest economic reform after Deng Xiaoping. Even so, the reform came with "Chinese characteristics"—namely, that the state and its various agencies would control access to credit, resources, and licenses as well as control the freedom of individuals to access the "market for ideas," which is severely constrained. Thus, the Chinese people's creativity and capacity for innovation

2. Chinese foreign direct investment, 1997–2017, at http://www.tradingeconomics.com.

are underutilized, a factor that has significant if unmeasurable effects on growth (Wang 2017).

In mid-2017, Chinese domestic stock exchanges in Shanghai and Shenzhen, with about three thousand listed companies (both privatized and entrepreneurial), had a combined market capitalization of $7.3 trillion. (The Hong Kong Stock Exchange, with a market cap of $4.1 trillion, provides access to Chinese stocks for international investors.) By comparison, at this same time the market capitalization of stock markets in Japan was $5.5 trillion and in the United States (New York Stock Exchange and NASDAQ) $24 trillion.

Economic policy in China is administered very differently from economic policy in most other countries. Beijing sets broad policies and allocates resources—to a point. However, everything is executed and administered through powerful CCP cadres spread around the country. China has five "autonomous regions," sixty "special economic zones," twenty-two provinces, four large cities that act on their own, and other provincial or municipal authorities that get in the act. Just as in imperial times, local party mandarins far from Beijing decide who gets what, how much, and when. Because these officials command so much authority, they are very powerful, have many loyal supporters, and can command political factions that rival those of Beijing's leaders.

The CCP directly controls the military and police, the courts, the media, the banks, the SOEs, and the hodge-podge of urban, provincial, and local governing organizations and regulators of the country. Although the CCP's 89 million members compose only 7 percent of the population, they collectively rule everything. Within the hodge-podge are the factions, deal making, corruption, and other lubricants necessary to make the whole thing work as well as it does. According to the wealth-tracking *Hurun Report,* the two 3,000-member legislative bodies, the National People's Congress and the Chinese People's Political Consultative Conference, include some of China's richest men. Although membership cuts across society, 209 delegates were identified by *Hurun* in 2017 as being worth an average of $290 million, and around 100 were dollar billionaires (Yan 2017). It is widely believed that China's highest leaders and their family members have been able to accumulate sizeable fortunes from their CCP careers.

According to many observers, the CCP's main long-term interest is in preserving its control of the country with all its attendant power and privileges. But it knows this will be difficult to do. Indeed, it has witnessed the loss of this power and privilege by other, authoritarian regimes that seemed securely entrenched—the Soviet Union, the Republic of China (Taiwan), and South Korea, among others—and even Deng Xiaoping, the great reformer, understood that democratic tendencies, however natural they may be in developed economies, have to be suppressed to preserve control of developing countries such as China. But within the higher ranks of the CCP there are differences of opinion on how to steer the country through challenging conditions, and factions can be found reflecting such differences and the loyal and committed supporters of rising challengers.

All factions agree that growth is very important to the Chinese—the increase in prosperity that growth enables is seen as the benefit the CCP must provide for its unchallenged right to rule, with its suppression of personal freedoms, delivery of a low level of equality of opportunity, and maintenance of a low standard of public services. How much growth this trade-off requires is unclear, but some Chinese observers think it is in the 7–8 percent range (Yao 2013). Over the past twenty years, the country's increasing prosperity has been seen in the migration of poor people from the rural districts into the urban areas, where good jobs are available, though residential privileges take time to acquire. If the growth rate is high enough to continue this process, some say, the people will go along with the negative rest of the party program. So local CCP leaders do whatever they can to support continued growth, even if the projects they sponsor are wasteful and ultimately unsuccessful. Chinese growth accounting is based on an old socialist methodology (subject to manipulation by officials) that many observers believe overstates actual growth rates by as much as 2 percent per year (Takahashi 2006). But the rates reported by the Chinese government are the only official rates there are; they are less important in an absolute sense than in a relative one that reflects changes in the rates of growth.

Growth, however, has decelerated rapidly since 2010, when it topped 12 percent before declining to 6.9 percent in 2016. The government forecasted growth at 6.5 percent for 2017, but results for the first three quarters were a bit better than that so a rate of 6.8 percent was expected.[3] Even so, the government allowed the money supply to grow at 12–13 percent in 2016 and 2017, providing substantial credit creation in the economy, even while bank regulators attempt to rein in lending by the largest banks to reduce the risk of a financial crisis (Yao 2017).

Beginning in 2008, after the slump in China's export markets following the global financial crisis, the government undertook a $590 billion fiscal-stimulus effort (larger in terms of percentage of GDP than the similar stimulus effort in the United States) and has been doing all it can since then to encourage spending and investment to reverse the falling growth rates and their pressures on employment and wage rates.

However, according to researchers at China's National Development and Reform Commission, the stimulus measures and hyperactive construction they induced generated $6.8 trillion of "wasted investment" (*The Economist* 2014). Nearly half the total amount invested went to support entrenched steel, glass, cement, and automobile industries that 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 the investment boom (Jamil 2014). Despite all this investment, Chinese economic growth slipped into a steady decline, dropping below the important 7–8 percent threshold.

3. Accounting for growth is different in China than in Western countries. Many Western economists believe Chinese growth rates are overstated, but they tend to follow the difference in rates between periods as more reliable indicators of economic progress.

China's SOEs represent a paradoxical feature of its economic system. When Deng Xiaoping's reforms began, around 80 percent of the country's industrial output was state owned but inefficient. So Deng encouraged privatization (by selling some of the shares of SOEs to the public) to reduce the role of SOEs and to speed development of the private sector to improve efficiency and growth. Even so, the SOEs grew along with the rising level of industrial output, and many grew even larger through mergers organized by the government. Further, local governments promoted new enterprises owned and often financed by them, so the number of SOEs expanded to around 150,000, with about two-thirds of them owned by local governments and financed by local branches of state-owned banks.

Chinese data suggest that only about 20 percent of industrial output is now provided by SOEs, but the number is misleading because it excludes some very large privatized companies that are only partly owned (but still completely controlled) by local and central governments. Both levels of government actively use SOEs as instruments of their pro-growth industrial policies, but, ironically, these efforts have turned much of the sector into dead-weight, bureaucratic organizations (called "zombies" by some observers [*The Economist* 2016]) with low profit margins and high debt levels that account for a disproportionate share of national financial resources (*The Economist* 2017a). Xi, who when he came into office favored reforms that would increase the role of markets, has since then shied away from the idea, asserting that SOEs should continue to play a "dominant role in the economy" and that "the party's leadership of SOEs is a major principle, and that principle must be insisted on" (*The Economist* 2017a). About 30 percent of the increase in new loans since 2014 has gone to SOEs (Roberts 2017).

As a result, China has shifted away from Xi's policy of allowing market forces to be "decisive" in allocating resources in the economy. Indeed, the government's approach since confronting the decline in growth has been to revert aggressively to an industrial policy only slightly less directive than the old Communist command economy model. This policy has shown up in excess monetary liquidity, slack regulation, assistance to weak SOEs, subsidies to these and other favored projects, directed loan programs, market interventions, and, ultimately, assistance to financial institutions bearing the weight of an increasing inventory of nonperforming loans (*The Economist* 2016).

There have been problems, too, in the entrepreneurial sector, where large, rapidly growing multi-industry conglomerate companies have taken on so much debt as to worry regulators. These companies—which include Anbang Insurance, Fosun International, HNA Group, and Dalian Wanda, which a CCP newspaper referred to as "gray rhinoceroses" (Bradsher and Wee 2017)—are the creation of China's first generation of billionaire "oligarchs": post-Deng capitalists who have used government connections and access to cheap financing to build vast empires and more recently have invested billions in high-priced acquisitions of foreign companies. In 2017, the government in Beijing pressured the CEOs of these companies to slow things down and reduce debt levels so as not to imperil the economic stability that Xi wanted to see

maintained (Bradsher and Wee 2017). One of the rhinos, however, wasn't listening. Anbang Insurance, a conglomerate headed by Wu Xiaohui, the flashy husband of Deng Xiaoping's granddaughter (and son-in-law of Deng's powerful princeling daughter) continued attempts to make large overseas acquisitions of real estate, including a $14 billion offer for the Starwood Hotel Group. However, Anbang's offers were suddenly withdrawn without explanation, and Chinese officials arrested Wu in June 2017 and charged him with fraud and embezzlement. In February 2018, Chinese insurance regulators seized control of Anbang and its $300 billion of assets, supposedly to avoid its bankruptcy and disruption in financial markets, apparently with the intention to unwind it (Hornby and Sender 2018). Meanwhile, government officials instructed state banks to continue lending to the HNA Group, another rhino making overseas acquisitions despite concerns about its overextended financial position. This occurred after the HNA Group sent a New Year's memo to employees describing its achievements and proclaiming that HNA is "an enterprise that belongs to the people" and is "loyal to the CCP and President Xi Jinping" (Trivedi and Steinberg 2018). Two rhinos in similar trouble from aggressive activities—one benignly assisted, the other harshly taken over—promote two different messages: loyalty is rewarded, and even princelings need to be loyal.

In addition, the government has indicated that it will seek to acquire 1–2 percent stakes in China's largest technology companies, including Tencent, Weibo, and a unit of Alibaba; obtain board seats; and "have a say" in their operations (Li 2017).

Even so, the optimistic case for China's economic future is that the government is rich, powerful, and knowledgeable enough to manhandle the economy through a transition period in which growth rates decline and adjustments (which take time) are made to the economy to enable it to replace export growth with domestic consumption. Meanwhile, China's Internet technology industries are highly entrepreneurial, growing rapidly and attracting new investment. Saving rates are high, government controls are solid and effective, and officials are smart and well trained. Household consumption as a percentage of GDP, however, has been stuck at about 35 percent for several years, a level well below that of Japan and South Korea at similar stages of their development, so a significant breakthrough in future domestic consumption is assumed. China bulls believe that the government will be able to maintain growth at a 5–6 percent annual rate for the next ten years, using its considerable powers to contain any labor unrest, prop up sagging industries, and fortify banks and other financial providers (as well as manage any major market disturbances) to allow it to begin instituting the necessary economic reforms to smooth things out so a more robust domestic economy can develop (Morgan Stanley 2017).

At this stage in China's development, average growth rates lower than 10 percent are to be expected. China began its rise from a very low point, and as it catches up with its global competitors in industrialization, the cost of wages, land, natural resources, and social welfare programs will begin to rise, eliminating the comparative advantages of China's low-cost labor force. Indeed, China has already lost export markets to other

developing countries (Vietnam, Bangladesh, and Cambodia), but China's exports were still 20 percent of GDP in 2016, though down from 37 percent in 2006. Conversion of an economy the size of China's, with its unique locally supported industrial policies, to a consumer-driven one promises to be a difficult and lengthy process (Barnett, Myrvoda, and Nabar 2012).

The pessimistic case for China's future economic growth has three key components. First, credit expansion has been too fast, and the growing debt burden will reduce growth rates by about 50 percent—to something like 3 percent for the next ten years, according to Michael Pettis (2017), an American economist teaching at Peking University in Beijing. Second, China's total factor productivity growth is lagging well below what it was in the high-growth years and has now flat-lined at about zero.[4] Total factor productivity is an economy's ability to turn inputs—such as labor and capital—into output. It is driven by innovation and efficiency improvements, which in China have been set back by Xi's reemphasis on Chinese socialism, the delay in allowing market forces to be decisive, the reemphasis on SOEs, and the constraints on the free market for ideas. And third, to offset the decline in growth rates, the government has directed SOEs and other bodies to engage in excess production, inventory buildup, and a bevy of ineffective debt-financed investments directed by the central and local governments. As a consequence, there is growing evidence that China's declining growth rate is not something cyclical, based on the prolonged aftermath of the global financial crisis in 2008, but something structural that will affect China's growth over the long-term (Asian Development Bank Institute 2017).

Adverse Demographics

For many years, China's leaders believed that the key to economic development was in controlling its vast population. Deng Xiaoping imposed a one-child policy in 1979, and the policy achieved its purpose—to prevent run-away population growth from sapping any economic achievement. However, an unintended consequence was that the policy ultimately would accelerate problems stemming from an aging population: a reduction in the size of the country's labor force, which is a brake on growth, and a rising cost of pensions and health care for the elderly within population segments that are distinctly uneven in terms of their participation in the benefits of China's growth and increased economic prosperity.

Mark L. Haas points out in his article "A Geriatric Peace?" (2007) that China's problems are shared by most European Union countries, Japan, and Russia, all of which are aging faster and have less-developed support systems in place than the United States.

China's total fertility rate for the years 2000–2005 was 1.7 children born per woman, lower than the natural replacement rate. The rate was reported at 1.6 by the

4. On this subject of low productivity growth, see Wu 2014 and Nofri 2015.

World Bank in 2016 (*Wikipedia* n.d.b). This rate is a bit higher than the fertility rates in Japan, Russia, and the larger countries in Europe, but it is still well below replacement (2.1), which it dropped below in the 1990s. The government rescinded the one-child policy in 2013, but so far the fertility rate has continued to be far less than replacement. Haas estimates that the percentage of the population older than sixty-five will rise from 6.8 percent in 2000 to 23.6 percent in 2050, over which time the Chinese workforce will continually decrease at an annual rate of 3 percent. These forecasts are credible, one Chinese expert said to Haas, "because the old people of the future have already arrived" (Haas 2007, 130).

In 2000, China created the National Social Security Fund to pay off SOEs' unfunded pension liabilities, but an unfunded deficit of about $350 billion still existed in 2012 (*China Daily* 2012). The situation for the general population is much worse. Haas estimates that three-quarters of Chinese workers are without any pension coverage at all and must rely on savings when they retire. Haas reports that some independent estimates of the gap between "government obligations to the elderly" and their current savings is as much as 150 percent of GDP, or about $15 trillion. Health-care costs in China will also increase four- or fivefold, as they are expected to do in Europe, adding to the enormous fiscal burden the government will face over the next ten years. These retirees will be claiming retirement benefits just as the current workforce begins to shrink. In 2000, there were ten working-age Chinese adults for every person sixty-five years or older; the United Nations (2006) has estimated that in 2050 this ratio will drop to about 2.5.

The cost of dealing with China's aging population will also substantially squeeze funds available for military expansion and politically important demonstration projects, and the demographic changes will also limit the number of military-age adults. Haas (2007) maintains that the weight of dealing with aging problems around the world will be sufficient to prevent any rival country from overtaking the economic and military preeminence of the United States.

China's population has three segments: a growing urban affluent and middle class of about 180–200 million in 2012, which management consulting firm McKinsey & Co. expects to grow to 300 million by 2022; 250–300 million unregistered rural workers who have migrated to find work; and a generally poor rural population of about 900 million (Barton, Chen, and Jin 2013; Qi 2017). The affluent and upper middle class "is poised to become the principal engine of consumer spending over the next decade," according to the McKinsey report (Barton, Chen, and Jin 2013). This class of people, however, resides primarily in Beijing, Shanghai, and other large urban areas, where fertility rates are well below the national average. In Beijing in 2010, for example, the fertility rate dropped to 0.71, the lowest in the country (*The Economist* 2017b).

China's economic model has depended on the migration of unskilled workers from rural districts to urban areas, where they can be trained as low-cost factory employees or manual laborers. But these workers are not given residential permits to settle their families, so they struggle to survive as itinerant workers. Some of them have

in time been able to make it into the residential urban middle class. Even so, the annual growth of migrants slowed to 1.4 percent in 2014 from 4.5 percent between 2005 and 2010. According to the World Bank, China's "excess rural surplus labor," on which it built its economic performance, is nearly exhausted (Wildau 2015).

The affluent and upper-middle-class segment represents the bulk of Chinese household net worth, estimated by Barron's at $40 trillion, and owns most of the stocks and real estate held by noninstitutional investors. However, this segment represents only about 13 percent of the population, so the concentration of wealth in it has created a rapidly increasing level of income inequality that some studies suggest is considerably greater than that of the United States (Yu and Zhou 2014). For example, China, with a stock-market capitalization of only one-third that of the United States, nevertheless by 2015 had created more dollar billionaires (568) than the United States had (535) (*BBC News* 2016).

Within the next ten years, China's government may have to choose between "allowing poverty levels to grow among an exploding elderly population, or providing the resources necessary to avoid this situation" (Haas 2007, 131). In short, China is in a position unparalleled in history, "that of a newly and still very unevenly modernized country," according to Haas, "that must build a social welfare system on the backs of a rapidly declining workforce" (2007, 130). This dilemma is known as the paradox of "growing old before growing rich" (French 2017, 277).

The weakness of institutions designed to provide welfare for the elderly, the poor, and the sick leaves China distinctly in the developing-country category, despite its recent economic success, which has enabled as many as 400–500 million people to escape poverty. Other underdeveloped social institutions (the legal system, education, environmental protection, etc.) are less costly, though the health-care and mortality costs of pollution are also considered to be potentially very large. Social services have become highly important to all Chinese citizens, especially as expectations for a better life grow, as they have, along with per capita income. On the whole, a rapidly growing demand for improved public services, exacerbated by an aging population, will be a future drain on economic resources and a potential source of significant social unrest (and thus a threat to the CCP's longevity).

Unbalanced Finances

Structural weaknesses and demographic drag will place a great deal of strain on China's economic system over the next ten years. They point mainly to the end of China's high-growth era and the beginning of "normal" levels of economic activity typical of other large countries. But these conditions are further complicated by financial weaknesses brought on by excessive credit expansion, especially "shadow-banking" elements and loans to SOEs, other favored industries, and pet projects of local mandarins. These financial weaknesses are the result of the politically directed growth policies of the central and regional governments that produced one stock-market bubble and crash in

2006 and another in 2015, from which the market has still not fully recovered. Other bubbles have also appeared in real estate and in newly introduced "wealth-management" and "asset-management" products.

China's banking system consists of 4 very large banks that account for more than 40 percent of all banking assets, 10 second-tier banks, and 140 or so regional commercial banks that are not publicly traded. As of April 2017, the onshore assets of China's banking institutions, including commercial banks, policy banks, and rural credit cooperatives, climbed by 12 percent from a year earlier to $29 trillion, according to the China Banking Regulatory Commission.

The large banks are internationally active and subject to global capital-adequacy ratios and other regulations. Chinese bank loans have increased by about 30 percent since 2008. Local governments encouraging growth and weak SOEs account for most of the increased lending of the past few years, which has raised concerns about bad debts. Indeed, the Chinese estimate of nonperforming loans increased to 1.75 percent of outstanding loans, the highest ratio in eleven years, but few foreign observers take this number seriously. In September 2016, Fitch, a rating agency, estimated the ratio to be ten times larger than this, with nonperforming loans totaling as much as $2 trillion (CNBC 2016).

Some of this bad loan exposure is due to a too-rapid expansion of credit, but the Chinese system for administering credit has its special inefficiencies. A local political leader, for example, may want a particular project to go through because his supporters have set it up and generously spread ownership participations around. Officials in Beijing may think the project is uneconomic or involves too much new debt to be serviced from the project's revenues, but they may have to bow to the power of the local interests. So ways are found around central regulatory objections through various ingenious mechanisms, such as "local government finance vehicles." These vehicles and other fudging mechanisms to get deals done any way they can be done are part of the shadow-banking apparatus that is not part of the banking system and therefore not regulated in Beijing.

Bank regulators do what they can to keep the banks' lending activities under control so as to manage "systemic risks," but this control has had the effect of shifting credit creation from regulated banks to unregulated investment products set up and managed by banks and other financial institutions. Banks sold $3.7 trillion of their own long-term loans to high-yield wealth-management products, and another $1.9 trillion of loans were converted to asset-management products sold to mutual funds (Trivedi 2017). The volume of these products doubled between 2015 and 2017. Shadow-banking assets now are about $9 trillion, of which approximately 60 percent are loaned or guaranteed "off balance sheet" by the banks (Miura 2017).

Altogether, these elements of instability have caused many observers to expect a financial crash of some kind in the near future. However, the case for such a crash has been offset for many years by the understanding that the CCP controls all necessary resources (including $3.1 trillion in foreign-exchange reserves as of December 2017

and the ability to print money) to put out any fires that excess credit and the deceleration of growth may ignite. Indeed, China's central bank and other financial policy makers have attempted to micromanage financial firms and markets to rein in bank loan loss exposures, to allow (selectively) more bankruptcies, and to intervene directly in markets (including bailouts) to keep things stable and under control. Indeed, in the cases of the Anbang takeover and the HNA lending assistance, referred to earlier, the end result was the same—the government intervened to prevent any kind of panic to develop in credit markets out of fear of either entity's collapse. Neither company was large enough to be naturally considered to be too big to fail, but the government didn't want to take any chances. This pattern of government intervention, however, neutralizes market forces and compounds weaknesses in the financial system, deferring them until a later time.

Despite the efforts by banking regulators, the broader government priority for the past few years has been to boost growth even at the cost of greater financial risk, on the assumption that the government can handle a crisis if one comes along. The buy-in to this idea has been considerable, especially among geopolitical thinkers who do not consider financial risk to be an important element affecting China's future.

However, financial risk was not considered to be an important factor in assessing Japan's potential as an economic superpower in the late 1980s until a massive market crash ended such dreams once and for all. Nor was the financial crisis of 2008 expected to reduce the power and influence of the United States and the European Union for a decade and undermine confidence in democratic free-market capitalism practiced in the West, but it did (Emmott 2017, 1–7).

China is more vulnerable now than it ever has been to a similar crisis that could severely damage its future aspirations, its power, and even its political control. In the past, China has been able to tough things out by applying the formidable powers of an authoritarian state, as it did after Tiananmen Square in 1989. But things are different now.

China has enabled and encouraged financial markets that now account for about $30 trillion of tradable assets that are bought and sold (often on margin) by Chinese urban middle-class individuals, pensions, and other institutions and some foreign investors. These financial assets represent about three times China's GDP. The corporate bond market has about $10 trillion outstanding; various shadow-banking products total $9 trillion; and the Chinese stock markets are valued at approximately $7 trillion. In addition, $3.7 trillion of mortgage loans for individuals and property developers, secured by real estate properties, were outstanding in September 2016, according to the central bank, with such loans to individuals up 33 percent during the year (Reuters Financials 2016). Central and regional governments closely control China's real estate market, which periodically goes through speculative cycles to the benefit or distress of middle-class investors and intermediaries.

Markets can very rapidly transmit, accelerate, and expand financial panics and lead to crises that can severely damage the real economy of developed and developing countries alike. The bigger the aggregate market capitalization involved, the greater the potential crisis, and the greater the crisis, the more difficult it is to manage.

What we have learned from recent crises in Japan, the United States, and the European Union is that the real danger is not that weak borrowers do not pay off their loans on time but that investors in the financial assets traded in markets suddenly believe that these borrowers cannot or might not pay and so rush for the exits all at once. Once a liquidity stampede begins, market prices collapse, causing major losses among investors that can destabilize the markets.

In 1990, the sharp drop in stock prices in Japan quickly spread to the real estate and corporate debt sectors, causing serious problems for lenders, who then cut back sharply on credit granted to corporate clients, throwing the country into a prolonged recession that exacerbated the crisis. The Japanese government and central bank intervened extensively to contain the crisis, but market prices remained low, and, despite repeated bouts of fiscal stimulation, economic growth in Japan remained lower than 1 percent for decades. China is different from Japan of the 1990s, of course—its economy is larger, and its financial sector as a percentage of GDP is smaller. But its financial sector is big enough to be subject to a systemic collapse, and its financial system already shows signs of vulnerability to a crisis.

After all, financial crises don't occur just in high-growth countries with fragile financial infrastructures. In 2007, the year in which the global financial crisis began, the global market capitalization of tradable stocks, bonds, and bank debt was $245 trillion, or about 3.5 times world GDP. In the United States, such assets represented $63 trillion, about 4.5 times GDP. The U.S. subprime mortgage-backed securities market at the time was a relatively small part of the debt market, but rumors, compounded by a lack of transparency about where the risks really were, forced market prices of mortgage-backed securities into a sudden, sharp decline, which spread to other forms of corporate debt. This in turn put pressure on weaker investment institutions and intermediaries, causing some of them to fail and accelerating the drop in market prices until they reached levels as little as half the intrinsic value of the securities in question. In turn, this drop triggered margin calls that forced distressed sales at even lower prices. Then came withdrawal of money from investment funds that could not be replaced by new investors. Marking asset values to market prices (as international accounting standards require) forced financial institutions to report massive losses and capital depletion, which resulted in governments intervening with state funds to bail them out.

When this happened in Ireland, Portugal, Spain, and Greece in 2010, the burden on these governments to rescue the banks caused a loss of confidence in these countries' sovereign credit, leading to the need for other Eurozone countries to assist them. In all these cases, a "vicious cycle" that inflicted a great deal of damage on investors, financial intermediaries, and governments was set off by a sudden, unexpected loss of market liquidity, which quickly spread to all other asset classes except top-grade government bonds.

In 2008, governments in the United States, Europe, and China intervened in various ways to cushion the economic effects of the market collapse, expending vast amounts of funds in bailouts, other market interventions, economic stimulus programs,

and increased unemployment and other welfare programs. The US Congress, the Treasury, and the Federal Reserve committed more than $10 trillion in 2008–9 to stabilize markets after the crisis began. The Federal Reserve subsequently expended much more in monetary policy efforts ("quantitative easing") to lower unemployment rates until 2015.[5]

All of the countries that experienced recent financial crises (i.e., Japan, the Asian Tigers, the United States, and members of the European Union) are democracies, and all of them experienced changes in governments through elections following the events. The voters' economic well-being was disturbed, and they held their governments accountable.

Despite its authoritarian controls, China is not exempt from such market-driven crises. Indeed, in 2014, after a year of monetary easing and government pressure to grow the economy and encourage stock prices so companies could refinance loans, a major effort was made to increase margin loans, which grew, in aggregate, to as much as $2 trillion (Durden 2015). So China's second stock-market bubble in a decade began to form in 2014. The Shanghai Composite Index of stock prices rose 150 percent from November 2014 to a cyclical high of 5,166 in June 2015 before the bubble burst, dropping prices by 43 percent in a matter of a few weeks. The government intervened forcefully—requiring government-controlled investors to buy stocks and encouraging further margin buying—and the rout was halted, but the market has not fully recovered since then. Investors chose to invest in residential real estate or other assets instead, moving the speculative destination to other sectors.

The stock market, however, is relatively small in China compared to the other financial markets, but, as indicated, all tradable market assets now amount to about three times GDP. If a vicious cycle is sparked in, say, the shadow-banking sector, it is likely to spread very quickly to the real estate sector, the corporate bond market, and the banking sector, where disclosures of loan losses and off-balance-sheet obligations could require major assistance by the government. Wealth management and other mutual fund products would also take a beating and be vulnerable to failure as investors withdraw funds. And such events would instantly cause lenders to become more cautious and to cut off credit sources for weaker private enterprises and SOEs, causing some of them to fail. As they fail, unemployment will rise, as will the attendant potential for social unrest. Also, financial losses by the urban middle class, which McKinsey has called China's engine of consumption, would put the engine into reverse, slow growth further, or create a recession. All of this in a country without social welfare institutions to assist those affected could result in acute political turmoil.

5. For an in-depth discussion of these events, see Smith 2010, 391–400.

China's Existential Dilemma

For Xi's grander vision of China's future to be realized, China must continue to grow fast enough (at least 5 percent) for a long enough time to be able to cross over the bar to become a "rich country"—that is, one that has achieved a lasting economic stability and become "developed" in social-economic terms. Underdeveloped countries have never achieved superpower status. There may be no clear agreement on what being developed means, but for China it must include the ability to manage financial challenges and to meet rising public expectations for social institutions to address the country's pressing demographic needs in the future and still have resources available for military and other important demonstration projects.

But China's growth rate is already decelerating rapidly enough to question this possibility. Installing the many reforms that China's leaders know are necessary—principally, allowing market forces to be decisive, as promised at the beginning of Xi's administration—is in sharp contrast to the directed growth-improving efforts made instead by the old, regionally decentralized, command-economy apparatus. In the short run, the reforms might undo these efforts, allow bankruptcies, and perhaps trigger the financial crisis and political or social disruption that China is trying to avoid. In the end, however, the reforms are necessary to cross over the bar (Paulson 2015).

Xi is making a bet that, having consolidated his power and loyal base of supporters and having repressed dissent from within and without the CCP, he will be able to impose some of the necessary reforms to enable him to realize his plans and objectives. This could mean a period of major changes in China that some important party leaders may think are too risky or too far removed from basic CCP doctrine. This is why it was so important for Xi to get his key political alliances in place at the midpoint of his original ten-year term.

What happens next is likely to be a pragmatic Chinese accommodation of the old ways with some modernizing market-oriented reforms executed within a system as much under Beijing's control as possible. To pull this off, however, Xi will need all the ruthlessness and political skill of Deng Xiaoping. So far Xi appears to be Deng's equal, but one of Deng's important contributions was to institutionalize China's presidential powers through term limits, to prevent another all-powerful Mao Zedong from assuming dictatorial power. Xi has cast these limits aside.

To emerge and survive as a superpower, China will have to meet the formidable challenges described in this paper. To do so may mean, as some have suggested, further increasing its authoritarian practices at the expense of free-market reforms, personal freedom, and private-sector initiatives, which will ultimately undermine its economic success. China may also maneuver itself into a position in Asia that becomes hostile to the interests of the United States and its allies. This move would begin to undo China's trade surpluses and require that more resources be devoted to military capability, which could significantly affect its economic engine.

Any significant setback to China's economic engine may risk social unrest with a potential for political change. This is what brought down the Soviet Union and the Soviet bloc.

All recent U.S. presidential administrations have taken a pragmatic approach to China, one based on good mutual understanding of each country's important political and other concerns and on the idea that the more China becomes part of the world economic system, the better it will like that system and the more it will conform to the system's practices and principles. The more it does, the more welcome its rising superpower status will be by others, including the United States. China does not have to become a democracy to achieve this position, though authoritarian regimes tend to suppress market forces and the private sector as engines of growth. However, the more it moves in the direction of free markets and an open society, the closer it will come to democratizing, which is not something Xi and his CCP colleagues want to see. This is China's existential dilemma, one that will occupy much of Xi's attention over the next ten years.

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