The Middle Kingdom and the Promise of Growth

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The Middle Kingdom and the Promise of Growth: Assessing the Sustainability of the Chinese Economic Model

Introduction

Towards the end of the twentieth century and during the first decade of the twenty-first, the global political economy has undergone profound changes which have dramatically affected the context in which national economies operate. The dissolution of the Soviet Union and the consequent end of the Cold War paved the way for the creation of a truly global world economy, and the restructuring of production and financialization of society beginning in the post-Bretton Woods era has led to significant shifts in both function and power, altering everything from consumption habits to surveillance methods (Krippner, 2005: 174). Arguably, the most profound change has come from the rise of the new economic powers, which has laid the foundation stones for a twenty-first century increasingly characterised more by multi-polarity than unilateral hegemony (Armijo, 2007:11).

Amongst these new powers, China stands out as the most eminent and potentially transformative. Since its departure from Communism and the liberalization of its economy, China has experienced extremely high economic growth rates, raised hundreds of millions of people out of poverty, and has become a central component of the global economy due to its high degree of integration and essential role in the supply chain (Sachs, 2005, 165-169).

China has transformed itself from a poverty-stricken Communist nation into the second largest economy in the world by pursuing an export-driven growth strategy which, although undoubtedly successful, has also created significant problems for both China and the global economy as a whole (Kaplan, 2005: 1182), (Economic Report of the President, 2011: 92).

There are doubts about the sustainability of this economic model, and the questions arising on financial instability, political legitimacy and therefore governmental stability will be discussed further in the dissertation (Goldstein and Lardy, 2004: 2).

The central dilemma faced by China is the rectification of the global imbalance which China has significantly contributed to, through the restructuring of the Chinese domestic economic model. The export-oriented model of development pursued by China has created a gargantuan trade imbalance in the world economy which poses a systemic threat, evidenced by the recent global financial crisis, which was largely caused by factors relating to the imbalance (Ferguson and Schularick, 2007: 228). Although this external pressure is undoubtedly the primary incentive for reform, this issue is part of the broader question of the restructuring of the Chinese economy.

The Chinese economic model used for developmental purposes has been extremely successful, but it has produced a host of corrosive consequences, both within China and on the world economy, that have led to a consensus on the need for comprehensive restructuring, posing a problem for the continued growth and developmental prospects of China (Frieden, 2009: 1). The process of reform, and the implications of that reform, occupies a position of unparalleled importance. This topic is hugely important to the future stability of the global economy, on which billions of livelihoods depend.

Whilst being mindful of the external circumstances and the broader context of readjustment, this dissertation will focus largely on the internal and domestic implications of the Chinese system and the restructuring effort, attempting to ascertain the obstacles involved in the continuance of the developmental process.

The specific problem to be solved, and the issues to be analysed relating to it, centre around the reform of the Chinese political economy viewed as a totality. Given the existence of a consensus on the issue in both international and Chinese economic, political and academic circles, the reform towards a more domestically-oriented economy can be conceptualised as an inevitability. The focus of this dissertation will be to empirically and analytically study the Chinese economic model and assess the progress and implications of the ongoing efforts to reform it, and to estimate – on the basis of this analysis – future prospects for socio-economic and political stability in China.

The dissertation will begin with a review of the literature, presenting and discussing the canonical academic texts relating to the Chinese model and reform process and conducting an assessment of their strengths and weaknesses. The purpose of this section, within the broader scope of the dissertation, comes in identifying which school of thought I am contributing to – my contribution comes to the 'hard-landing' school which posits that many significant obstacles do and will continue to confront the Chinese economy in the coming years.

Subsequently, the dissertation will construct an analytical and theoretical framework which allows the reader to properly conceptualise the issue and argument. This will include a bipartite typological classification of the various types of financial system a country adheres to, and the consequences of employing either system, as well as a conceptualisation of social contract theory.

The penultimate section of the dissertation is the analysis and argument itself. The process of the argument begins with a descriptive analysis of the financial system of China, decisively showing how it constitutes a financially repressive and bank-dominated system, in spite of recent efforts towards reform, and exploring the key implications this evidence has for economic efficiency and capital allocation. It is then argued that the financially repressive economic system produces three factors that threaten systemic stability; these three factors, defined as the persistent presence of non-performing loans, overcapacity, and risk of asset bubbles, are said to have been exacerbated by the recent stimulus package implemented by the Chinese government.

The argument is made that this trinity of difficulties will lead to a systemic economic breakdown, as opposed to a manageable scenario. It is then hypothesised that this will constitute a violation of the social contract. Therefore, a delegitimization of the Chinese Communist Party will occur, unleashing the potential for socio-political instability.

Literature Review

The Sustainability School

The first of strain of thought, the sustainability school, uses a systemic and structural approach to reach an essentially optimistic conclusion on the capacity of China to surmount the economic obstacles before it. Although there are a number of contributors to the discussion, the primary stream of thought is exemplified by the work of David Folkerts-Landau, Michael Dooley and Peter Garber, in particular their working paper *'An Essay on the Revived Bretton Woods System'*.

They begin with the ontological view that the global economy has inherently cyclical and hierarchical characteristics, and should be viewed as a singular dynamic system rather than defined by the borders of different nation states, which are deemed to be categorically irrelevant (Folkerts-Landau, Dooley, Garber, 2003: 3). On this basis, they construct the theory that economic characteristics necessitate categorisation based on regions, rather than on individual states.

In a Wallersteinian, world-systemic approach, it is argued that shared economic characteristics can be used to classify different economies and regions into the categories of core and periphery (Bordo, Flandeau, 2003: 6).The core is said to consist of developed market economies, such as the United States, Europe and Japan, and the periphery comprised of developing economies, such as China. In defining an archetypal periphery economy, they identify characteristics that are associated with the Chinese development model: "undervaluing the exchange rate, managing sizeable foreign exchange interventions, imposing controls, accumulating reserves, and encouraging export-led growth by sending goods to the competitive sector economies." (Folkerts-Landau, Dooley, Garber, 2003:4).

Peripheral economies, such as China, are said to adopt such policies simply because they constitute the most feasible and practical strategy for swift economic development, and once they reach a certain stage of development – a precise definition is elusive – they organically "graduate" into the core. Therefore, as long as there is uneven development within the global economy, *some* form of Bretton Woods will always exist, even if it is not in its original institutionalised form (Folkerts-Landau, Dooley, Garber,2003: 6).

Given that this essentially 'outside-in' approach posits that it is the systemic characteristics and structural constraints of the international economy that determine the sustainability of internal state policies, the prolonging of the Chinese model indefinitely – or at least until 'graduation' into the core- is well within the realm of theoretical and actual feasibility, and can be conceptualised as an inevitable and organic result. Provided there is no change in the structural incentives that create the system, there will be no internal problems in China.

The principal contributors to the field, in a recent work, respond to accusations that the global financial crisis undermines their case. They argue that the severity of the crisis itself was overestimated, that it was caused primarily by moral hazard, and did not undermine – but actually reinforced – the structural characteristics of the system, and therefore decisively demonstrates its durability (Folkerts-Landau, Dooley, Garber, 2009:304).

Despite its comprehensive approach, there are many drawbacks to this school of thought. The first comes from the ontological perspective used by its proponents, which lacks in detail what it adds in breadth, leading to a major analytical failure and a poverty of prediction. The focus on external, systemic structure leads them to neglect important functional details of individual national economies that often result in economic failure and could lead to a derailing of the 'inevitable' process of integration into the core. A quintessential example here is the case of planned capital allocation, which is assumed to be a basic element of the periphery's development model, yet often results in inefficient investments and threatens the stability of the economy as a whole, a consequence entirely neglected by this model (La Porta, Lopez-De-Silanes, Shleifer, 2000: 23).

It is also highly charitable to describe the current international monetary order as a coherent system, since it lacks the rigidity of the gold standard, is not contractual, and lacks its predecessor's global scale (Diyalnas, Auerback, 2007:4). In conclusion, this train of thought falls short of analytical acuity and sufficient specificity through excessive breadth, ignoring crucial differences between Bretton Woods and its supposed successor.

A Soft Landing?

The second school of thought is the soft landing school. Its proponents have a far less optimistic view of the prospects of the Chinese economy and the international environment in which it operates, but view the resourcefulness of the Chinese government as sufficient to mitigate a disaster and continue on a developmental path with some potentially painful, yet manageable, adjustments. This school is primarily identified with the authors Goldstein, Prasad, and Lardy. Eswar Prasad has produced the canonical journal article titled *Is the Chinese Growth Miracle Built to Last?'* Proponents of this school argue that, given the unique characteristics of the Chinese economic model, China cannot be placed into the same category as other developmental states (Naughton, 2007:2).

In contrast to the conventional wisdom, China's closed capital account and savings-funded domestic investment, as well as the expanding private sector, are viewed as the sources of sustainability for the model as a whole (Prasad, 2009: 9). Contributors to this tradition also argue that, despite the deficiencies of this form of economic operation, it has been empirically shown that the Chinese government is capable of sterilising risks prior to problems emerging, and that there is no reason why this should not continue indefinitely – on the crucial condition that as long as growth, which serves a remedial purpose, continues. (Goldstein, Lardy, 2004: 2)

The sheer scale of China's integration into the global economy is said to produce a heightened vulnerability to economic 'shocks' – external and internal scenarios which could potentially detrimentally affect growth (Khose, Prasad, Rogoff, Wei, 2006: 11). Examples include a massive collapse of external demand, depreciation of the dollar and asset bubbles.

Given the structural constraints of China's *modus operandi*, there is a distinct lack of response capability available should a 'shock' hit the economy (Prasad, 2009: 15). An example given is the lack of flexibility in monetary policy due to the pegged exchange rate (Goldstein, 2006:4). The Chinese government must, therefore, use this period of high growth as a window of opportunity to deal with the structural problems that plague it, and engage in a shift towards a consumption-oriented economy, which although a painful landing process, is manageable should it be carried out during a period of high growth (Goldstein, 2006: 10).

Although this school of thought does include some positive aspects, it does not provide a comprehensive enough analysis to present a sufficiently realistic view of the Chinese economy, overestimating certain functional characteristics of the economy to the extent where they unjustifiably support the initial thesis of sustainability. The flaws in the argument's logic come from two sources – faith in the capacity of the state to sterilise non-performing loans (NPLs) and therefore maintain growth, and the belief that continued growth will create an environment where the state is capable of reforming the economy towards consumerism without significant problems.

Despite Prasad explicitly identifying the loss of confidence in the banking system as a risk scenario, the school considers the primary threat to be from a gradual opening of the capital account, not from the more tangible risk of capital misallocation (Prasad, 2009: 12). Consequently, they do not consider the latter in enough detail, and it is the neglect of crucial details that contributes to the analytical deficiency of this approach and, ultimately, to the unjustified view that a moderate restructuring process will suffice.

Hard Landings and Political Seatbelts

The hard-landing school of thought postulates that the Chinese economy is operating in a hostile external environment and possesses endemic structural features which necessitate a painful, and potentially fatal, restructuring and economic collapse. In particular, this school of thought is chiefly associated with Nouriel Roubini, Brad Setser, Barry Eichengreen, and a key report by the major investment firm Societe Generale.

Viewed externally, the international monetary system on which China relies for continued growth is said to be ultimately unsustainable. It is argued that China faces an intolerably high level of external opposition to its economic model, most notably from the United States, whose policy-makers consistently disapprove of China's economic system, notably its fixed exchange rate (Roubini and Setser, 2005: 3).

It is also argued that the institutional structures supporting the original Bretton Woods were sufficiently strong to maintain it, whereas in this incarnation there are no formal institutions at all – if they exist at all, they rely on current conditions, which in a dynamic global economy are subject to perpetual change and have actually pushed the system to its limits (Eichengreen, 2008: 5).

With regard to the Chinese domestic model, proponents of this tradition are equally pessimistic, and it is this that is central to their apocalyptic predictions. For instance, Roubini explicitly identifies the *model* as the problem, stating:

"This economic and financial model is leading to excessive monetary credit growth, asset bubbles in stock markets, housing markets and other financial markets that will eventually lead to the build-up of financial vulnerabilities – like the capital inflows and bubbles the [sic] preceded the Asian crisis of 1997 in a region of semi-fixed exchange rate –that could trigger a financial crisis different from that of 1997-1998 but that could potentially be more severe" (Roubini, 2005: 83).

Roubini then proceeds to offer two extra reasons for this: "reliance on an economic growth model based on rising growth of net external demand and domestic investment aimed at rising capacity for such exports; low reliance on domestic demand and production for domestic markets", identifying the problems facing the domestic model as purely structural in origin (Roubini, 2005: 88).

The tradition therefore posits that China finds itself in the paradoxical position of being highly strong externally, but incredibly vulnerable through its internal structural characteristics, internal deficiencies which are sufficient to cause a major crisis. (Setser, 2006:3). It is this school of thought, with its balanced focus and structural emphasis, which holds the greatest predictive and analytical capability. Consequently, this dissertation as a whole identifies its argument within this strain of thought.

Theory and Framing

The Contractarian Bargain

The following analysis and argumentation rests upon a set of core theoretical assumptions, which, while providing a foundational basis for the argument, also insert necessary contextual features in order to frame the argument in a relevant way. The first of these falls into the category of political philosophy and jurisprudential theory. The theory of social contractarianism provides a conceptual framework for the analysis of the issues at hand, and specifically, those components of the argument that relate directly to the legitimacy of governing relationships.

In its essential form, social contract theory states that the fundamental fabric of a society and the legitimacy of the government to stand at the pinnacle of that society is rooted in a contract between the people and their rulers (Kliemt, 2004: 174-177). The people, considered as a collective entity, enter into a negotiation with their rulers – either actual or prospective – and agree to behavioural terms on which the government is to operate, establishing a contractual basis for governance (Dunleavy, O'Leary, 1987: 84).

This contract is articulated predominantly in terms of rights and obligations, outlining the duties of both the people, and the state. It is this harmonization and agreement of terms that is directly facilitative of the legitimacy of the governing class. Governmental legitimacy is taken as a fundamental prerequisite of the sustainability of the maintenance of rule itself (A Levine, 2002: 18). Although the field it is dominated by liberal thinkers, the actual theory itself is not constrained within ideological boundaries, given the flexibility of the terms on which a contract, by definition, can function.

This means that a wide variety of political and economic systems can be incorporated into its conceptual framework, from the divine right of kings ruling through theological legitimacy, to the majoritarian mandate of a modern democracy – all are characterised by a substantive contractual agreement between the governing class and its people.

This agreement also does not have to be explicitly formulated, as in the case of the American Revolution, for example, but can evolve gradually over time, influenced by circumstances and context and having as its primary terms and conditions of agreement any form of rights and obligations, from economic to theological (Dunleavy, O'Leary, 1987: 84). The fundamental component of the theory, as applied to this dissertation, is the proposition that legitimacy stems from this contractual basis and that if it is broken in any form, the legitimacy of the government is negated.

Control and Efficiency: Bank-Based versus Market-Based Systems

Another core conceptual component of the dissertation is the binary typology of financial architecture, and the respective impact each has on the broader economy. In economic theory and financial practice, there are two types of financial systems, with each generally relative to the level of economic development reached by a particular state.

In the first type of system, broadly categorised as the bank-based system, banks occupy a central position within the financial architecture of the economy, and are used essentially as mediums of resource allocation by the government (R Levine, 2002: 11). The process of this often involves utilising savings of the wider population and distributing them towards state-mandated projects and sectors of the economy at lower-than-market interest rates. In emerging markets, this encourages growth by directing capital to sectors lacking in investment (R Levine, 2002: 15).

The bank-based financial system is inclusive of both negative and positive characteristics. Bank-based systems generally perform tasks pertaining to the imperatives of development far more efficiently, being better at maintaining corporate authority, allocating capital towards obviously necessary projects and utilizing savings drawn from the population at large (Allen and Lane, 1999). Bank-based systems ensure the stability of nascent industries due to their capacity to commit to long-term development of a particular industry or sector of the economy (La Porta, Lopez-De-Silanes, Shleifer, 2000: 23) .

They are often comprised of relatively few large banking institutions, and there is evidence that large, powerful banks in developing economies can lead to firms providing higher quality information than in a market-based system (Stiglitz, 1985: 133-152). Ostensibly, this is due to the increased capacity of financial institutions to ascertain risk through personalised bank-client relations, facilitating the informal development of a reputation-based relationship (Raviv, 2008: 308). In underdeveloped economies, bank-based systems also lead to rapid private sector growth (Gercshenkron, 1962: 354).

However, the central deficiency of this system comes in the fact that capital is allocated and distributed for reasons other than economic necessity and efficiency, and depending on the broader economic context (level of development), has a higher likelihood of resulting in significant levels of waste (Rajan, 1992: 1372). Theoretically speaking, misallocation of capital is a direct consequence of banking systems that meet this criterion (Weinstein and Yafeh, 1998: 642).

The second type of system, classified as market-based, is characterised by autonomy in corporate governance, increased shareholder participation, and the facilitation of capital allocation through the medium of the market (R Levine, 2000: 10). In this system, dominant in the English-speaking world, banks have a far greater degree of independence from the political authorities, and the oversight that does exist is generally intended to assist, not direct, their activities.

The market is crucial in this system due to being the primary medium through which the allocation of capital from banks is distributed. In its pure form, risk is borne primarily by investors in the banks, and therefore systemic moral hazard – at least to a certain extent – is avoided. Another positive feature of this form of financial system is efficiency in long-term capital allocation through the market response mechanisms, a tendency to swiftly eliminate poor investments, and capital formation (Levine and Zervos, 1998: 23). Negative features of this form of operation include greater risk of instability due to market fluctuations, a weaker degree of corporate control, and structural incentives towards short-term investment (R Levine, 2000: 13).

Argument and Analysis

Political Allocation, Financial Repression and the Bank-Based System

Under the aforementioned definition, there are three criteria which indicate a bank-based and therefore financially repressive financial system. The first condition is that the banks must hold a position of centrality within the financial architecture of the Chinese economy, to the extent where they function as the primary agents through which capital is allocated, occupying a dominant market share and accounting for a majority of corporate funding. The second of these conditions is that the politico-legal structures which facilitate the allocation of capital politically must be empirically definable and observable.

Banking institutions in China must be tangibly linked to the actual structures of political power to a considerable degree; the political and legal apparatus must be capable of facilitating political intervention and the structures of corporate governance and alternative investment opportunities must be correspondingly underdeveloped. Thirdly, financially repressive measures affecting both the household and commercial sector must be identified. These three factors, crucial to the argument as a whole, must be validated statistically and supplemented by the statements of policy-makers and other relevant empirical data.

The Chinese financial system is dominated by four state-run commercial banks, which hold a dominant market share and are central to financial intermediation in China, acting as the primary agents of resource allocation in the economy (Berger, Hasan, Zhou, 2009:11). These banks, the Bank of China, China Construction Bank, the Agricultural Bank of China, and the Industrial and Commercial Bank of China occupy a central position in the Chinese economy. For example, in 2006, these 'big four' banks held 66% of the commercial market share in terms of assets, dominating the financial landscape (Almanac of China's Finance and Banking, 2006).

The commercial banking sector in China is highly concentrated and capital markets are correspondingly underdeveloped, suggesting a politically conditioned banking sector. This market is considered to be an oligopolistic, as evidenced by the sector's low score on the Herfindahl-Hirschman index (Herroro, Gavila, Santaba, 2006: 306). These four banks are the principal medium through which enterprises obtain the capital necessary for their creation and maintenance, illuminated by the fact that capital markets are extremely weak in comparison to the banking sector (Herroro, Gavila, Santaba, 2006: 306).

As recently as 2007, for instance, bank loans accounted the vast majority of all corporate funding evidencing the structural centrality of banks in the financial system and the corresponding weakness of other forms of investment. Chinese policy officials agree with this assessment of the financial system, with senior supervisors at the China Banking and Regulatory Commission stating that "At the present, banks continue to dominate China's financial landscape as such indirect financing remains the main channel of financing for business companies in China." (Ping, China Regulatory and Banking Commission, 2003).

These banks are also legally and institutionally linked to the political apparatus of the Chinese state to a considerable degree, suggesting that they function essentially as political mechanisms of capital allocation. In the case of the policy banks, the tie to the state is self evident – they were created explicitly for the purpose of funding mostly infrastructural development projects, and remain under the direct jurisdiction of the State Council, the central administrative organ of the Chinese state and are themselves headed by a government minister (Agricultural Development Bank of China, 2005) (China Development Bank, 2005) (Export and Import Bank, 2010).

The commercial banks are also linked to the state in a direct and ascertainable way. Although reform efforts have been undertaken, with the introduction of boards of directors and shareholders councils, the banks are still ultimately responsible to the state and have minimal disclosure requirements. In fact, it is the State Council that holds ultimate power over their interest rates (Lardy, 2008: 1). These banks are nominally responsible to the external supervisory board, but this has no role in the functional process of overseeing the management and governance of the bank.

The commercial banks are influenced by local governments and state-controlled enterprises due to their extensive interaction with them, and also their management is drawn from the ministerial system (Boyreau-Debray, 2005: 3). In addition, the regulatory system is lax and does not disrupt the operations of the banks; the regulatory bodies and the central bank are also directly dependent on the party. (Herroro, Gavila, Santaba, P8). Given this information, the dominant banks in the financial system do not have adequate corporate governance structures – lacking the basic attributes of truly commercial banks – and are linked to various levels of the government and Communist Party (Prasad, Rajan, 2005: 9).

Although the above data indicates the potential and actual exertion of political influence on the banking sector, it must be decisively shown that it affects both commercial banking and households independently and in an interrelated fashion – from this it can be ascertained that the bank-based system in China corresponds with the technical definition of financial repression, thereby increasing the probability of destructive economic consequences occurring. Financial repression is defined by Roubini and Salai-Martin as "the presence of laws, regulations, and other nonmarket restrictions on commercial banks and other financial intermediaries that impairs these institutions from operating at their full capacity" (Roubini, Sala-i Martin, 1995: 5).

Under the aforementioned definition, logic dictates that the higher the *reserve requirement* of the central bank and the *lower the rate of return* on those reserves, the greater the degree of financial repression – since the function of commercial banking is to allocate funding to profitable and/or productive investments, the higher the degree of reserves allocated to the central bank essentially represents a tax on financial intermediation on the commercial banking sector since the rate of return in the central bank is inevitably lower than market rate (Goddard, 2010: 15).

The People's Bank of China has a fixed interest rate since 2002 on required reserves of 1.89%, and a market rate-of-return of 8.72%, a major discrepancy of 6.83% (Lardy, 2008: 1). This is a significant cost to the commercial banking sector, and represents a tax on financial intermediation and a direct transfer to the state, implying financial repression for purposes of fiscal resource allocation.

With regard to households, two measures of financial repression can be detected. Firstly, households must be full participants in the growth strategy, saving a significant amount of their income in state-owned banks. In China, 90% of household saving – an enormously large sum given the extremely high savings ratio – is deposited in state-owned banks, with the government maintaining a near-total savings capture (Lal, 2011: 1). Also, the People's Bank of China fixed the rate-of-return on commercial deposits at 0.72% (Lardy, 2008: 2).

Given that this is below inflation, which has increased since 2002, the real interest rate in 2008 was 7.28% in 2008 (Lardy, 2008: 2). Consequently, returns on household saving are actually negative, strongly suggesting that the structural constraints of the banking system remove all other depository avenues for investors, effectively forcing them to contribute to the state's development strategy through an implicit tax – a tax that amounts to 255 million RMB (23.9 million pound), almost three times the amount of the formal personal income tax. (Lardy*,* 2008:2)

The Unholy Trinity: Consequences of Financial Repression and the Political Allocation of Capital

The financial repression that the Chinese state is engaged in, within the systemic context of an undervalued exchange rate regime fuelling a growth strategy that is still largely dependent on exports, poses a huge risk to the stability of the economy and society in a number of ways. Using the historical precedent of Japan, which during the 1980s had an economy with both internal structural characteristics remarkably similar to China and externally was in an economic relationship with the United States resembling that of China presently, it can be argued that the Chinese system is breeding a host of economic problems that could lead to serious social and political difficulties in the future (Ito, 2009: 297).

Among the most serious of the problems resulting from financial repression is inefficient capital allocation, leading to the proliferation of non-performing loans that threaten the stability of and the confidence in the financial system as a whole. Other serious difficulties include a high risk overcapacity resulting from excess in fixed investment, and the collapse of the real estate market.

The Chinese banking sector is used to allocate capital to state-owned or preferenced firms and sectors at below market interest rates (Xu, Cull, 2005: P121). This has been a persistent problem in China (Breslin, 2000: 16)T. Under these circumstances, profitability, defined in its conventional usage, becomes irrelevant – the overriding aim is to construct, produce and create in order to sustain employment and growth (Roubini, 2005:5). The prioritisation of systemic self-renewal and continued development therefore prevents growth from conferring beneficial economic effects. For instance, Lau summarises the problem and its origins with reference to the Chinese model:

"The fact that the loans become 'nonperforming' is not in general a surprise to either the lenders of the borrowers – most of the lenders do not expect the loans to be collectible even at the time they are first made and most of the borrowers know full well at the time that they will not be able to repay these loans. The truth of the matter is that most of these loans are actually government subsidies for loss-making SOEs disbursed in the form of bank loans. These are, in fact, policy loans." (Lau, 1999:74)

The central problem stemming from this is therefore a significant percentage of non-performing loans, ultimately resulting in a systemic banking crisis with the potential to initiate widespread detriment across all sectors of the economy. The present extent of non-performing loans in the economy is disputed, with varying statistics given by the government and independent analysts. In attempting to portray its reform efforts as eminently successful, the Chinese government, well known for manipulating economic data, has argued that a significant reduction has occurred (Chow, 2006: 401).

For instance, in its lowest recent estimate, the China Regulatory and Banking Commission stated that the percentage of non-performing loans of the commercial banking sector in 2009 was 1.59%, an extremely low figure and down from 7.64% in 2006 (China Regulatory and Banking Commission [B], 2009).

However, reputable independent analysts, come to a different conclusion. The rating agency Fitch, in its recent decision to downgrade China, argued that “more conservative” estimates would put the present ratio of commercial banks non-performing loans at 6.0% – already going beyond the loss-making capacity of the banks – and that the ratio was likely to rise to 15-30% in the coming few years (The China Post, 2011). Also, given the financial crisis and the Chinese response to it, there is ample evidence to show that these loans would have proliferated despite any efforts on behalf of the government.

The stimulus package has exacerbated the non-performing loan problem and created the conditions for the two other detrimental factors to arise too. The measure consisted of a massive stimulus, amounting to an injection of 4 trillion renminbi (roughly 586 billion American dollars) into certain strategic sectors of the economy, intended to reduce reliance on exports as demand slackened in major foreign markets (Lardy, 2010: 2).

Although the intention of the Chinese government was to reassure the United States, and other deficit nations, that it was making efforts to reduce the imbalance, the package did not address the central problem of domestic consumption. For example, the effect of the recession led to a drop in exports of 20.1% in the first quarter of 2009 compared with the previous year (Assche, Ma, 2009: 11).

The consumer base of China, accounting for only 37 percent of GDP in 2008, rose slightly, but the primary effect of the stimulus was to massively increase fixed investment (IMF, 2010: 3). It is this increase in fixed investment that accounts for China’s relative insulation from the detrimental effects of the global financial crisis (European Chamber, 2009: 12). Aside from a slight decline in the annual growth rate, which has now returned to pre-crisis levels, the Chinese economy has not suffered in any tangible form from the financial crisis (IMF, 2010: 3). This excessive reliance on fixed investment, while protecting the economy from a downturn in the short-term, will inevitably lead to the trilemma of interlinked problems of overcapacity, an asset bubble and an exacerbation of the non-performing loan problem.

Although a significant amount of fixed investment in physical infrastructure was present prior to the crisis, the stimulus has boosted it to dangerous levels. The fixed investment share of GDP rose from 42 percent of GDP in the pre-crisis era to 47 percent during 2008-2009. In 2010-2011, the share increased to 50% of GDP. (Roubini, 2011). The primary dilemma resulting from this is that the Chinese economy – in fact, no economy in history – has ever reached productivity levels high enough to sustain this level of physical investment (Roubini, 2011).

The Chinese economy in particular, with its high growth rates but low growth profitability and high levels of waste, cannot fulfil this role. This is evidenced by the massive public and private projects which are under-used or not used at all in China – brand new empty airports, highways to nowhere, millions of new and unoccupied buildings and residences – that serve as manifest evidence of both overcapacity and inefficient allocation of capital (Roubini, 2011). Millions of commercial residential apartments remain empty while China suffers a shortage in housing (Societe Generale, 2011: 5).

From this evidence, it can be deduced that the economy is at a significant risk of a dangerous bubble in property markets. Most of the fixed investment, channelled through the state-owned commercial banks, has been concentrated in the property or real estate sector. This is due to the Chinese financial system, where households are effectively denied investment opportunities outside of those provided by the state-run banks. There has been a progressive rise in real estate investment, rising as a percentage of GDP from 2 percent in 2000 to 11 percent in 2011 (Societe Generale, 2011: 18).

The concentration in real estate lending investment has effectively halted the government's effort to provide affordable housing, with property prices rising 140% from 2007 to 2011 and 800% over the same period in Beijing (Jacobs, 2011). Cultural and demographic factors also add to this pressure – given the skewed gender ratio in China, where men vastly outnumber women, Chinese women are in a powerful position when deciding on a partner, and statistically prefer property-owning men – leading to a powerful reproductive incentive to *own* property, resulting in greater real estate investment (Jacobs, 2011).

The probability that China is on the verge of a major real estate bubble is increased by the fact that the stimulus package is to be extended and heavy physical investment is to continue. For instance, Xie Xuren, head of the Chinese Ministry of Finance, stated that expansionary policies remain on the agenda: "Active fiscal policies will continue, and this means we cannot weaken the intensity of fiscal support for economic development, avoiding the losses to our achievements that would come from an excessively early exit" (Reuters, 2010).

This is happening despite concerns about macroeconomic stability resulting from the already relatively advanced bubble that has developed. The major international credit rating agency, Moodys, which has a significant and increasing degree of control over the credit-worthiness of national economies, recently downgraded the Chinese property market, expressing fears that the government is not effectively managing the flow of credit to the sector: "Ordinary commercial housing prices are still far away from the target of government controls and the expectation of the general public. Local governments are not forcefully implementing the central government's macro control measures"(Reuters, 2011).

Prominent policy-makers have also expressed fears, with central bank governor Zhou Xiaochuan stating that "Macroeconomic risks linked to excessive liquidity, inflation, asset bubbles and a cyclical rise in bad bank loans are rising significantly." (Forbes, 2010) These fears are recognition that the Chinese economy will reach a hard landing soon.

There is also the potential problem of overcapacity resulting from this fixed investment. The problem of overcapacity has been a perpetual problem in China, due to the structure of the financial system and the development model in general, but it is arguably reaching dangerous proportions at the present moment in time due to the collapse of external demand (European Chamber, 2009: 2). The fixed investment remedy to the issue of lower global demand is not equivalent to boosting the consumptive fundamentals, and results in productive capacity without a market to consume it, given the sustained decline in external demand.

There is simply no purpose for many of the infrastructural developments that have resulted from the stimulus package and the Chinese economic model more broadly. For example, the State Council has identified six industries which are acutely suffering from the problem of overcapacity. It is estimated that the excess productive capacity in steel alone is between 15 and 30 percent (European Chamber, 2009: 20-21).

Given that demand is not likely to grow to the extent to satisfy the increased productive capacity, and domestic demand cannot be cultivated in such a short period of time and without a major structural reorientation, the current situation is unsustainable. The primary problem resulting from the overcapacity dilemma is a likely slowdown in growth due to the decreased profitability of productive enterprises, contributing to systemic collapse.

Confronted with this trinity of difficulties, the Chinese government has a number of possible remedial responses, all of which are insufficient to solve the problems facing the economy due to the structural constraints of the bank-based financial system. When faced with financial and economic problems, the Chinese government instinctively resorts to administrative solutions, mostly due to the fact that its fixed exchange rate denies the central bank flexibility in monetary policy (Prasad, 2009: 8).

For example, one potential action to alleviate the problem of overcapacity and real estate bubbles would be simply to direct banks to limit or make conditional lending to fixed investment projects, and to focus on increasing consumer spending. However, the structural impediments of the financial system do not facilitate the efficient allocation of capital, and an administrative decree to lend a certain amount of RMB in a certain direction assumes that the state has *all* of the sufficient information to allocate capita where it is needed – a patently untrue assertion, as the trinity of problems are themselves produced by the inefficient allocation of capital through administrative measures. Administrative measures are therefore inappropriate for correcting what are essentially structural problems, ultimately requiring a comprehensive, long-term reform effort that radically alters the structural fundamentals of the Chinese economic system.

The Chinese government can therefore only resolve these problems by implementing a trinity of structural reforms which will place extreme stress on the economy and society at large. These reforms are the correction of imbalances, the restructuring of the financial system towards a market-based system, and the shift towards domestic consumption. The financial system, however, is the primary determinant of these problems, and therefore warrants the most attention. Although the Chinese government understands this, they have been reluctant to engage in any serious reform effort, preferring to use short-term, investment-oriented economic stimulation to maintain high growth rates, rather than potentially disturb the growth miracle in the short-term.

This is evident in the Communist party's latest five year plan, released in 2011. At least rhetorically, the plan, like those that preceded it, concentrated on strategic industrial development and increasing domestic consumption, prescribing some moderate redistributionary policies to aid it, but did not focus on the core structural problems which inhibit consumers from spending (BBC News, 2011). For instance, policies such as increased healthcare and lower taxes were advocated, but significant structural reforms were notably absent (BBC News, 2011).

These are positive steps to ensure increased consumption, but they must come *after* the more foundational reform of the bank-based financial system and the fixed currency that are more urgently required. Both scenarios – the long-term structural reform or the likely maintenance of the present system – will result in the imposition of fiscal discipline which is likely to lead to a hard landing for China.

The Political Repercussions of Economic Crisis

The economic slowdown, ensuing from the interlinked effects of the three factors above, will constitute an actual violation of the social contract between the Chinese people and their government, with many negative implications. The unique form of social contract in China has resulted from evolving historical conditions as opposed to explicit formulation and agreement, in contrast to the United States, for example (Shirk, 2007:8).

The demise of Communism amongst the populace has left the government without an ideological current through which the people can be mobilised; despite the resurgence of Chinese ethnocentrism and nationalism, it does not form a solid basis for governmental legitimacy in a globalised world, and represents nothing more than the public manifestation of an embedded societal current.

In the place of Communism, and in the absence of a democratic mandate, the social contract between the Chinese people and its government is based solely on continued prosperity and growth (Shirk, 2007:29). When growth slows, as is inevitable under any economic system – the post-war examples of Japan and Germany are illuminating – the fundamental bond of governmental authority breaks down, and the governing legitimacy of the Communist Party is weakened (Ferguson and Schularick, 2009: 22).

This is evidenced by the large and increasing numbers of protest incidents occurring in China, the higher degree of repressive and authoritarian measures the government is resorting to, and repeated acknowledgements of their weak position by the government themselves. Since embarking on liberalisation and integration into the world economy, the Communist party has watched the disintegration of numerous former Communist and authoritarian regimes that have embraced capitalism, most notably in the former Soviet Union. In fact, 30 countries have democratized since China's opening to the world under Deng Xiaoping in 1972 (U.S. Department of State, 2007).

Consequently, China's leaders are acutely aware of their vulnerability, and have been for some time, with a 2004 Communist Party report stating that "The painful lesson of the loss of power by the Communist parties of the Soviet Union and Eastern Europe is that it is not easy for a proletarian political party to gain power, and even harder to exercise political power well, especially when it is held for a long time, and a party's status in power does not necessarily last as long as the party does, nor is it something that once achieved is never lost"(Shirk, 2007: 4).

These fears are buttressed by the fact that protests have been increasing on a yearly basis. Popular discontent has grown throughout China's liberalization process, and if it continues, especially within the context of an economic crisis, serious threats to the regime are likely to ensue. Between 1993 and 2005, as China's economy became more capitalist and globally integrated, incidents rose tenfold, from 8709 in 1993 to 87,000 in 2005 (Yu, Jianrong, 2007). This trend has been exacerbated by external events in the Arab world, where, for economic reasons, regimes have been overthrown and democratic governments instated (Pulham and Bright, 2011).

In 2011, protests swept through China, occurring in over a dozen major cities. The movement was explicit in its pro-democracy message, and also identified economic concerns as a primary motivating factor, suggesting a popular acknowledgement that the social contract between the government and its people is disintegrating and that nationalism alone is an insufficient legitimating ideology (Ramzy, 2011).

In its official responses, the government also acknowledged the economic undertones of this civil unrest. Premier Wen Jiabou, the second most powerful government official, in response to the protests stated that "Without political reform, economic reform cannot succeed, and the achievements we have made may be lost," and "It is only with reform that the party and the country will enjoy continuous vigour and vitality" indicating that the only permanent solution to civil unrest is political liberalization and a renewal of the social contract (South China Morning Post, 2011).

Foreign leaders also saw the unrest as crucial to the political future of China, with U.S. Secretary of State Hilary Clinton stating that "Chinese government… are trying to stop history, which is a fool's errand. They cannot do it." a statement that emphasizes the inevitability of political liberalization (Goldberg, 2011). In the case of a severe economic slowdown, such as the one likely to occur as a result of the factors already described, it is highly probable that uprisings will become more widespread and the Communist party, which already acknowledges the inevitably of reform, will cede its grip on power and take measures towards establishing a democratic system.

Conclusion

In conclusion, the suitable prescription for the Chinese economy is an extensive structural reorientation to balance the domestic and international economies; the measures currently being pursued are insufficient. As this dissertation has argued, an economic slowdown in China would constitute a violation of the social contract between the Chinese people and their government, a fragile relationship as seen in rising rates of mass protest. The likelihood of social and political turmoil following a likely economic crisis is extremely high, and the possibility of regime change is also correspondingly great.

When placed in a wider context, these findings have a broader significance for the global political economy as a whole. In terms of politics and governance, two important insights can be derived from the results. In an age of universal capitalism and an integrated global economy, traditional sources of authority and governance are rapidly losing their capacity to legitimate the wielding of power. The instability and inevitable tendency towards crisis in a capitalist economy is an established fact of modern economic life. If the authority of the state rests on no more than its role as an executive committee for economic management, then when faced with shocks, it loses its capacity to justify its authority.

It is clear that, in Gramscian phraseology, *some* form of powerful legitimating ideology must exist for the continuous sustenance of the modern state, and within the context of a modern global economy, that ideology must be capable of withstanding the inevitable fluctuations of capitalism. So far, the democratic mechanism has proved to the most effective structure of mitigating capitalism, but the possibility remains open that others will evolve. The results also grant an insight into the global consequences of economic and social disruption in China.

Now a central engine of the world economy, the reverberations of a systemic crisis would be global in scale, and therefore all states have a vested and immediate interest in ensuring stability in China. As this dissertation illuminated, stability begins and ends with the creation of an efficient and sustainable financial system, and also with a legitimating ideology for governance. The global community, in particular the Western world, would be wise to acknowledge that the consequences of a Chinese slowdown would greatly exceed those of its ascendancy.

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