Refusing to brake, because you still want to win the race:
Unbridled Chinese credit growth in a political economy analysis.

Thesis Max de Lange, s1564099
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Chapter 1. - Introduction

Back in 2008, when China was the prodigy of the world economy, and the US was busy swallowing up the consequences that come with the near meltdown of one's financial system, all was well in the Middle Kingdom. China was growing at a rate that made other developing countries' governments salivate, and it's status as a future contender for the position of economic hegemon seemed almost inevitable. Cut back to now, when after many years of (foreign) newspapers and (foreign) economists writing about a very serious build up in bad debts, a considerable number of Chinese banks are at risk of defaulting, for the first time since 2001. This is visible in the current blind spot in Chinese banks, which is making investors in China pull out their hairs. This blind spot (some 647$ billion), is the latest news coming out of China about its banking system, and the hidden faulty debts that might pull it down.[1] Unlike in the US in 2008, when regulators did not do their jobs, when the president of the Federal Reserve did not see the crisis coming, and only a handful of economists and investors were crying out like Cassandra, China has been aware of its debt problem for a while. Whether the current mood will swing into a full blown debt crisis of course remains to be seen, but it is interesting to wonder how China, a country which has been touted as an example of effective governance and durable long term policy views, has let it come to this.

In fact, the first academic research about the misuse of Chinese credit, and the unhealthy trend of stockpiling debt at worrying rates, comes from 2008. During the 11 years that lie in between, the trend has spiralled out of control to such an extent, that even anonymous official sources (believed to be close advisers to Chinese president Xi Jinping), have made headlines by pointing out the problem, which in China has been dubbed as the need for "supply side structural reform", in regime mouthpieces like the People's Daily.[2] Meaning that the most powerful parts of the CCP, up to the top, were getting worried about the debt build up. This was and is quite understandable, seeing that across the economic board, Chinese debt was growing at a considerably faster rate than GDP. This means that the ability of the Chinese economy as a whole to repay the newly incurred debts, was diminishing at a rapid rate. And that is without considering the notion that perhaps some banks had much more bad debts already on the books, than other banks. The median is only a number, it does not show particular cases accurately.

Now what interests this paper, is the following question: why, despite the early diagnosis of growing debt levels being an issue in China, and the continued and heightened attention towards the issue from a wide range of sources (most importantly the highest echelons of the

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[1] Don Weinland, "Investors face $647bn banking blind spot", last accessed on 27-06-2019, https://www.ft.com/content/99801ab6-8743-11e9-a028-86cea8523dc2

[2] People's Daily, "Q&A with an 'authoritative insider' on China's supply side structural reform", last accessed on 27-06-2019, http://en.people.cn/n3/2016/0104/c98649-8998970.html

Chinese Communist Party(CCP) itself), no action has been taken to tackle it in a sufficient manner? This is a question of collective action problems, of vested interests, of shadow banking, of patronage networks, of a party hoarding power, of the intricacies of credit creation, and its immense importance for any capitalist country. The end answer, will be as intricate as the question posed. As this paper will argue that the CCP is intent on increasing its power to a much greater extent than has been seen since Deng Xiaopeng left Chinese politics for good. The CCP, and Xi Jinping in particular, feel the need to do this, because in order to have economic and social stability in China, they cannot have to much internal opposition to the reforms they need to make. The proposed reforms, while lowering Chinese debt levels to less risky standards, will also reform the Chinese economy in very big ways. Pushing China from an 'investment growth model' into a 'consumption growth model', has opened some deep divisions between parties who want to profit from the current system as long as possible, and those who see the need for reform so that China does not fall into a banking and/or debt crisis.

These arguments, will come forth first through a discussion of the creation of credit, and specifically how debt bubbles form. This will be part of the literature review, as will be a discussion of the previous research on the Chinese credit bubble. The next chapter, discusses the larger underlying reasons for the Chinese credit bubble, by taking a more top view position that the CCP would most likely take. The following chapter deals with what would need to be done to save China from a debt/banking crisis, and considers the Chinese political system, and its (absence of) ability to push through the necessary reforms. Then, there is an analysis of the information gathered through a framework developed by Susan Strange, which lays bare the balance of power between the state (central CCP) and the market (vested interests and Local Governments in this case). The end result, as reiterated in the conclusion, will show that Xi Jinping and the central CCP powers, are hoarding structural power to increase their ability to successfully reform China.

Chapter 2. - Literature review

This chapter will first discuss general theories and differing views on the creation of credit, credit bubbles, and the consequences of such bubbles. Following, there will be a view on the role of the Chinese state in the Chinese economy, and after that an overview and discussion of the particular traits that together form the Chinese credit bubble. Most importantly: the role of the housing market, private companies and State Owned Companies (SOEs), local governments, and shadow banks.

2.1 - The wonderous world of credit, credit bubbles, and credit crises.

Capitalist economies are fuelled by credit; it is the very lifeblood which keeps the economy running. Without the continuous extension of credit, many companies will be forced to close as they cannot pay their employees, buy inventory, acquire raw materials for processing, and most other things. Furthermore, capitalist financial systems are reliant upon hourly balancings of the books of banks. They do this by lending to and lending from other banks in their financial systems. This way, they are able to spread the risks of their investments; like those in the stock market and the real economy. When a financial system as a whole is at risk of coming to a standstill, banks stop lending to each other out of fear that new debt incurred will be riskier than previously expected. The fragility of the financial system is sometimes compared to that of a house of cards: pulling away one card has the ability to destroy the entire house.[3]

Naturally, a credit bubble is always accompanied by a growing amount of debt. When credit is extended, there is also a creation of debt that goes along with it. This is not a negative aspect in and of itself, as the persons/companies who receive the credit will be able to create more wealth than without the credit. This is the main reason why credit is so easily extended, and why almost all people who make a large purchase, like buying a house or a car, are indebted to a lender in some respect. Still, it is common knowledge that a person, company, or even a country cannot keep on lending forever. However good a promise of future profit might be, there is generally a point at which a party will find it hard to keep on lending more money if they are having trouble paying back the older debts. This is usually when a company/person will go bankrupt, will be forced to sell assets to pay off debts, or find another way to be considered creditworthy again by its creditors. This is not a huge problem when it is just one person, or even one major company. But, when an entire financial system is fuelled by finding new credit to pay

[3] See the great movie “Margin Call”, on how a financial system based on continues trust can collapse when trust between banks is gone.

off old debts, the system as a whole stands at risk. This is what is often referred to as a 'credit crisis', or 'debt crisis'. There has been a move to in academia to confidently diagnose a credit bubble before it can become a crisis. The most used at the moment, is the rational asset bubble theory.

The rational asset bubble theory can be used for explaining unreasonably large growth in asset markets. Strictly speaking, a rational asset bubble is when the price of an asset is above the 'fundamental value', or the value of future dividend payments from the asset. what will be referred to here as 'speculation'.[4] There are several issues with this definition, the most important of which is its vagueness. Some assets, like Amazon stock, rarely pay out dividends, yet Amazon has one of the most expensive stocks in the world. Still, the rational asset bubble theory has been found useful for research pertaining to the housing market, among other things. But, as a definition, it proves to be of little use for this paper, since it requires the need to consider a fundamental value for assets. To say which value is correct and which is incorrect is something economists normally leave to markets. Still, Stiglitz does refer to the 'fundamental' value in his definition of bubbles. He considers a price increase a bubble when investors buy an asset not because of its 'fundamental value', but because they believe the price of the asset will be higher tomorrow.[5] A good behavioral explanation of how a bubble is formed comes from Shiller. Shiller argues that: "rising prices encourage them to expect, at some level of consciousness, more price increases. A feedback develops—as people become more and more attracted, there are more and more price increases … the amplification mechanisms that make a bubble grow strong are just that price increases beget more price increases, through human psychology".[6]

When a bubble is diagnosed in an asset market, this can make it easier to see how a credit bubble is formed. This is because the money not only needs to be available for investment, but there also needs to be a market where this money can be invested in. In some newly liberalizing economies for instance, not every part of the economy is open for investment from parties other than the central authorities. If an economy is as liberalized as the US, there is also still the issue of speculative markets offering such high dividends compared to other investment opportunities that it acts as a centrifugal force. Pulling investment from other, often safer, markets into the speculative market, creating the possibility of a bubble. The emphasis is on possibility here, because a market labeled as being a bubble, does not always 'pop'. It is entirely possible that the investors do not pull out even as dividends seem less forthcoming than promised, and the

[4] Jan Werner, "Rational asset pricing bubbles and debt constraints", *Journal of Mathematical Economics* 53 (2014): 145

[5] Joseph E. Stiglitz, "Symposium on Bubbles," *Journal of Economic Perspectives* 4, No. 2 (1990): 13–18.

[6] Robert J Shiller, "*Diverse Views on Asset Bubbles*," in Asset Price Bubbles: The Implications for Monetary, Regulatory and International Policies, edited by William Hunter, George Kaufman, and Michael Pomerlano (Cambridge, MA: MIT Press, 2003), p.35

particular asset market recovers after a few months, or years, when real profits from the asset catch up.[7]

One frequent commentator on Monetary theory, Ray Dalio (founder of the massive investment firm Bridgewater Associates), lays the blame for big debt crises with governments being too easy in their extension of credit. Dalio's book, which contains at least 51 case studies of debt crises, lays out how a credit boom can lead to a debt crisis. As he puts it: "Lending naturally creates self-reinforcing upward movements that eventually reverse to create self-reinforcing downward movements that must reverse in turn".[8] When such an upswing is happening, lending increases spending and investment, which then increases incomes and the prices of assets. The increasing incomes and asset prices then allow more borrowing to take place, leading to more expenditure on financial assets and goods and services. The expansion in borrowing activities allows the parts of society who have access to easy credit, to increase their incomes faster than actual productivity growth. As the peak of the credit curve is nearing, lending is still taking place on a grand scale, as there is an expectation that the 'above-trend growth' will continue as it has since the curve started moving up. However, this is unreasonable. At a certain point, income will undoubtedly fall below the costs of lending, even if the costs have decreased dramatically. At that point, the credit curve will go down until enough debt has been serviced so that creditors will want to lend again. Much of how far the credit cycle will go, depends on the role of governments in expanding and tightening the extension of credit.

Dalio's reasoning is that for governments the promises of more growth play a big role in their decisions not to tighten credit extension. The possible negative effects of a credit bubble, namely a debt crisis and the accompanying possibility of a full blown economic crisis, are difficult to imagine when the economy is booming. He also points out that the tolerability of bad debt for a society is based on two things: whether the denominated currency of the bad debt is controlled by the respective country, and whether the policy makers can influence how the creditors and debtors behave with each other. These factors can allow a government to make society as a whole bear the burden of bad debt, and spread out the costs among decades. If this is not done, big companies will go broke, many people risk losing all their savings, and an economy as a whole might contract more than society can bear in a relatively short time span.

One stream in the credit bubble discussion is the one often heard from Keynesian economists and policy makers. They suggest that the capitalist system is indeed at the moment at risk of its own credit creation, while also arguing that such a crisis is entirely preventable while maintaining a capitalist global economy. Their argument is best explained by Ann Pettifor. She writes that money should not actually be seen as a commodity with scarcity values, like grain or steel. This is the way most neo-classical and liberal economists consider money. If the money supply increases or decreases, this is due to the supply-demand workings of money. When such a

[7] Brad Jones, IMF working paper, "Identifying speculative bubbles: a two pillar framework", https://www.imf.org/external/pubs/ft/wp/2014/wp14208.pdf

[8] Ray Dalio, "*Principles for navigating big debt crises*" (Westport: Bridgewater, 2018): 11

consideration of money is taken for a fact, it is easily forgotten that governments and banks are the ones creating money. In this money creation, around 95% of the money is created by private banks, not public ones. It is therefore rather strange, Pettifor says, that when these private banks let loose their own control over money creation (and thus the extension of credit), they are not reigned in on this. There are almost no constraints on the amount of money that can be created and its purpose, except for making banks more accountable. The feeling is that the incentives not to fall go bankrupt will keep banks from creating too much credit, which is understandable. Pettifor makes the argument here, like Keynes long before her, that the banks do not have to be handled like this. Like they have an inherent right to self-management and as if they will do what is best for an economy as a whole. Instead, she points out that governments can create rules that will enforce a more moderate trend in credit creation, where risks are kept lower. Most importantly, she argues that governments can demand the creation of credit to be in favour of the real economy. That way, the debt incurred does not go to waste as the credit is traded around the world in financial assets. Instead, it can be used for projects benefiting the real economy.

The focus on the lack of investment in the real economy in favour of financial products, is one new argument in the credit bubble debate. While acknowledging the Marxian explanation of overaccumulation as in their view correct in explaining credit bubbles, which will be touched upon in short notice, they point to trends of widespread financialization as a new source of instability in this regard.[9] The process of financialization started to pick up in the 1970s and 1980s. Rules surrounding financial sectors were made less stringent, allowing financial sectors to start moving faster than the real economy, instead of in tandem with it. Now, profits could be created out of thin air by simply trading paper value. These higher profits consequently seduced parts of the real economy to financialize as well. Hospitals start trading in stocks, and companies like General Electric, Toyota, General Motors, and most other global manufacturing giants develop their own financial vehicles to sell and profit from. What all this creates, some authors argue, is a much more unstable financial system. Now when a bank collapses, it also manages to pull down with it companies used to be perfectly capable of surviving an economic meltdown by cutting costs in terms of capital and labour. As more and more parts of modern capitalist economies are fine with carrying higher debts so that they do not have to make radical changes, the downturn in the next financial crisis will only by greater.[10] It is thus not only the rules society sets for the process of money creation that are important, but also what we allow to become financialized and monetized. If there is already an inherent risk of failure in a system, why allow that system more power of other parts of an economy?

[9] Stephen Resnick, and Richard Wolff, “The economic crisis: a Marxian interpretation”, *Rethinking Marxism* 22, no.2 (2010)

[10] Ismael Hossein-Zadeh, “Marx on financial bubbles: Much keener insights than contemporary economists”, last accessed on 15-04-2019, https://www.counterpunch.org/2016/07/01/marx-on-financial-bubbles-much-keener-insights-than-contemporary-economists/print/

Maybe a credit bubble is unavoidable?

While (neo)liberal and classical views on the causes of credit bubbles and subsequent debt crises are mainly focused on how they can be managed within the systems where they occur, there are also authors who look at the system as a whole. The best known example of this view, is Marx's theory of overaccumulation and modern interpretations and adaptations of that theory. In short, his theory focuses on the falling rate of profit in any economy. In Marx's view, the tendency of a falling rate of profit is by far the most important law that should be grasped in the study of political economy.[11] It explains business cycles, and is widely used in modern economics. For Marx, the natural state in a capitalist economy is one where the maximization of profit and the always continued expansion of production reign supreme. Simply put, a company can only invest so much capital for any type of production, as eventually a market will be satisfied. This is because markets are not ever expanding, they rely on humans to buy and sell things.

For people who want the global economy to grow at maximum speed, the unsatisfying reality is that humanity is not (yet) ever expanding. The species is for now bound to a single earth, which can be inhabited by a limited number of people who for the most part have a point at which they are satisfied with their level of consumption. One person can only consume a certain quantity of stuff. As this is bound to happen for any person, its effects can be seen on a grand scale in any reasonably developed economy. With markets becoming satisfied, and competition being at peak levels where profit margins have been reduced to almost nothing, capital starts accumulating as there are not enough areas of reasonably profitable investment. Also, at this point there is a growing surplus of labour that seemingly has no reasonable area where it can be productively used (so there is growing unemployment) , and there are goods on the market that cannot be sold at the real market price without the sellers incurring (unbearable) losses. This is generally the moment at which an economy begins to shrink. Bad debts have to be written off the books before banks are willing and able to lend again. Companies go bankrupt, taking bad debt with them, and partly wiping clean the tumors that had been growing inside the economy in question.

Before an economy arrives at this crucial point of overaccumulation in Marxian thought, there are several pathways where the excess capital could go to prevent an economic downturn. Apart from of course not investing the excess capital at all, which almost no one will want to do, there is the option of moving the excess capital to another market (country) where goods can be sold without incurring losses, cheaper labour can be found, and investments generally still have higher profit margins. This is called the 'spatio-temporal fix', as it simply means moving the capital to new (temporal) place (spatio) which is able to absorb the excess labour and/or capital.[12] However, this does not always happen, nor does it always work. When excess capital cannot be

[11] Lefteris Tsoulfidis, "Falling rate of profit and overaccumulation in Marx and Keynes", *Political Economy Quarterly* 43, no.3 (2006)

[12] David Harvey, "The new imperialism: accumulation by dispossession", *Socialist Register* 40, (2004):64

invested wisely, it will be invested unwisely. This is where we come back to the origins of credit bubbles. When there are no safe spaces of investment, and investors have a lot of excess cash, banks and other financial institutions will (without thorough regulation being in place to prevent it) create new financial vehicles which can absorb the excess capital internally. These financial vehicles can come in many forms, but what they all seem to have in common is that people at a certain point trade in them not because their investments are so good, but because the price keeps rising. A credit bubble then expands, as more and more capital is needed to keep the bubble in tact, and it is hard for people to watch someone else make money by doing almost nothing. Since their own money is sitting idly by, being unproductive.

2.2 - Particular traits of the Chinese credit bubble.

The Chinese state in the Chinese economy.
Before elaborating on the Chinese credit bubble, it is wise to first categorize the role of the Chinese state in the Chinese economy. Normally when the extent of government control in a capitalist country is discussed, there are not many options to choose from. There is the 'liberal' version, where a state chooses to intervene as little as possible in an economy through measures like spending more or less. A liberal state will prefer to steer the direction of its respective economy through the creation or amendment of the laws governing the nation. To some extent it will see the need for public funding in basic research and other project lacking immediate economic value, but the amount invested is almost always quite low. If possible, such a state will seek to co-fund research in tandem with local companies. Apart from policy on keeping inflation in check and protecting industries that are important for national security, such a state is quite limited in its role in the national economy.

Generally more to the left on the political spectrum of state involvement, there is the 'Keynesian' state. In such a state, the government will use its ability to increase or diminish spending much more in its attempt to create favourable economic times. Apart from the 'normal' jobs that a state has, it will have full control over infrastructure, education, and water and energy services. It is very unlike a Keynesian state to delegate these sectors to private companies. There is often some kind of social safety net for citizens in hard times. Pensions, national healthcare, unemployment benefits, and other such stabilizers are almost always found in Keynesian states. Most importantly however, these state are well aware to in economically hard times, they have the ability to increase their spending to a great degree in the real economy. Thereby diminishing the severity of a crisis. Lastly, one of the aspects sometimes overlooked or differently interpreted, is that a Keynesian state will recognize that it can use its own resources to create new industries, or protect old ones. In states like France, Italy, the Netherlands, and Germany this is still visible. France for instance, has a history of using state funding to protect its car, steel, and

the aviation industry.[13] There are of course many more variations of the extent to which a state is involved in an economy, even in capitalist countries, but to discuss all those would be tiring to say the least.

When looking at how and to what extent the Chinese state is involved in its own economy, contradictions quickly arise. For one, China is officially still on the path to 'Socialism with Chinese Characteristics', so capitalism is in that manner just a temporary phase. [14] Also, China is seriously attempting to create an economy that is based increasingly on the rule of law. But, at the same time there is also a massive amount of funding still going to State Owned Enterprises, or National Champions. The first of these is self explanatory, but the latter is not. A state champion will be chosen on a provincial or national level by the state, after which it will be given almost a monopoly position in the domestic economy. This is through preferential access to state contracts, the bending of rules for these companies, and most importantly easy access to cheap loans to expand the company.[15] All this is done to make these respective companies world players able to compete in their respective sectors. The Chinese state understands that this manner of using state resources, if done right, can create or keep a great amount of jobs. At the same time, if China is to ever become a high-income country, it will need to be able to compete on a very high level in almost every type of industry or business. The extent to which the Chinese state is willing to use state resources is much greater than most other countries.

For instance, the construction boom which has driven Chinese growth since the global financial crisis, has been in large part funded by Chinese banks because the state told them to.[16] Unlike most capitalist economies, the Chinese state will ask companies to do things for them like build a new factory here, invest more money there, or hire people they do not necessarily need somewhere. Most importantly for the global economy, it has directed a number of companies to transform from manufacturing to a more technology driven business model[17] This quite opaque manner of state control is widespread and can likely take place in almost every part of the economy. The government is able to ask such things, because it still has much arbitrary power to destroy a business by changing legal interpretations on its own will. It is unclear how often the state asks/demands such things from businesses, as research into these actions are almost impossible to carry out.

These are just some examples of the power of the Chinese state in the economy. Showing that when China is discussed, it should always be kept in mind that the Chinese economy is essentially a capitalist economy run by a dictatorial state with theoretical full control. It is

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[13] Jonah D. Levy, "The return of the state? France's response to the financial and economic crisis", *Comparative European Politics* 4, no.15 (2017): 608
[14] Theodor Tudoroiu, "The Neo-Communist Regime of Present-Day China", *Journal of Chinese Political Science* 16 (2011): 422
[15] Thomas A Hemphill, George O White III, "China's National Champions: The evolution of a national industrial policy - or a new era of economic protectionism?", *Thunderbird International Business Review* 55, no.2 (2013): 196
[16] McMahon, 64-64
[17] Douglas B. Fuller, *Paper Tigers, Hidden Dragons* (Oxford: Oxford University Press, 2016): 65

sometimes very liberal in the discretion it allows businesses to operate and expand, while being very Keynesian how it can spur an economy to whatever ends it pleases. In some ironic way for readers of Hegel, the Chinese state is the synthesis of the twentieth century's political economies in this regard. One party Leninist communism is mixed with liberal business practices, together with a regulatory state and huge public investments funded by private companies under end control of the government. China does not fit any one category, which is why it is so incredibly interesting.

Credit means growth

About ten years ago, Chen published a groundbreaking study on the possibility of a Chinese credit bubble formation. In that study, Chen is adamant on the effects that excess liquidity are having, and will have on the Chinese housing market. His basic argument is that from 2000 to 2007, China had undergone one of the highest economic growths in recorded economic history, which had been underpinned by a wave of excess liquidity from the Chinese banking system.[18] However, this excess liquidity had not sufficiently reached some smaller banks and businesses, which could not get access to loans as much as they wanted. Especially parts of the agriculture sector, the social security sector, and SMEs were often blocked when trying to get access to the excess liquidity. Chen's description and prediction of how cheap money is able to fuel a housing bubble, is based in part on researching the 1997 Asian financial crisis. This crisis was in part caused by an extensive liberalization of the respective banking sectors in Thailand, Indonesia, and Malaysia, which by itself had given rise to housing bubbles. After an economic downturn had made housing prices to start falling, the housing bubble splashed. Since much new debts in these countries had been based on the continuing rise of housing prices, banks were stuck with much bad debt, they had to be bailed out by their respective governments and the IMF (which had been one of the main drivers behind the liberalization in the first place), and economic growth in the region was stifled for sometimes a decade. Now, why the Chinese credit bubble has been developing in its particular manner, is explained by another author some years later.

Zhao, basing his assumption of the rational asset bubble theory, discovered proof for a housing bubble in China. Now what should be kept in mind when studying the Chinese housing market, is that many people are indeed looking for places to live in cities where such space is hard to find. Hong Kong, Shanghai, and Beijing are among the cities where there is a very serious crisis in the housing market. In Beijing, for instance, it is not rare that people live in basements, due to high rents. In contrast to this, a number of 'ghost cities' exist in China. Shepard identifies these cities as: "a new development that is running at significantly under capacity, a place with drastically fewer people and businesses than there is an available place

[18] Yuanquan Chen, "Chinese economy and excess liquidity", *China & World economy* 16, no.5 (2008), p.63-65

for." [19]. One geographical study, discovered about 30 ghost cities in China out of 654 cities in total.[20] While housing units are more often than not sold by in these cities, they are also very likely to stay unused (no occupants) after being sold. In Zhao's words, that is because the Chinese population is starting to look at this process as 'brick and mortar savings'.[21] Zhao explains that people sometimes do not acquire a house/apartment to use or rent out. Instead, they are a pure 'store of value' for a great number of Chinse house owners. This has created a paradoxical housing market where millions of homes which are unused, are still not rented out to the millions of people who would probably rent these units.

In Zhao's view, the origins of the extensive use of 'brick and mortar savings' in China, can be traced to rules making it difficult for citizens to invest their money in the real economy. Large monetary rivers of this excess liquidity then flow into the housing market. Another factor is the constant rise of housing prices in China ever since it first started liberalization. Therefore, a house is always seen as a safe investment. One study on ghost cities even found that it is not rare for a single family to be in ownership of more than one apartment, with some families even having a dozen or more. This last fact, can be in part explained by the act of developers selling apartments for cheap when they are in need of liquid assets.[22] In one study, the authors even concluded that "in theory… China should have already experienced a real-estate and financial crisis." [23].

The Chinese housing market and bubble are not very similar to what the housing market in the US had experienced in 2007-2008. In the US, mortgages were handed out to people who should not have been able to acquire them in the first place, they were simply unable to pay off their loans. When it eventually became clear to everyone that more and much more mortgages were about to default or had already defaulted than had previously been thought to be true, the bubble popped. Housing prices dropped like irons, banks had to write of billions in debt, and two of the biggest banks in the world had to close down. This in time created the second largest US financial crisis in US history, and pulled most of the world into a recession. Not to be confused with China, where bad debts originate from companies and local governments, rather than from consumers.

Companies and local governments in debt.

That local governments are pushed to develop land in their respective jurisdictions is not due to their own will. It is a consequence of budgeting rules, forged in Beijing. It is mainly intertwined

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[19] Wade Shepard, *Ghost Cities of China : The Story of Cities Without People in the World's Most Populated Country* (London: Zed Books, 2015) p.40

[20] Xiaobin Jin et al., "Evaluating cities' vitality and identifying ghost cities in China with emerging geographical data". *Cities* 63 (2017), p.107

[21] Bo Zhao, "Rational Housing Bubble", Econ Theory 60 (2015) p.168-169

[22] Yanpeng Yiang et al. , "Sorting through Neoliberal Variations of Ghost Cities in China", *Land Use Policy* 96 (2017) p.445-446

[23] Simon X.B. Zhao et al. "How big is China's real estate bubble and why hasn't it burst yet?", *Land Use Policy* 64 (2017), p.160

with the manner in which the national government collects revenue. For one, local governments have to hand over a disproportionately large part of their revenue to the national government compared to what they have to spend. There is in fact a history of local government budgets being under pressure in China. While the Chinese economy was being gradually liberalized on many fronts in the 1980s and early 1990s, the Chinese government found that government revenue as a share of GDP falling from 31 to just 12 percent in 1978 and 1992 respectively.[24] In the central government's case, its share in the total revenue collection fell from 40 to 22 percent in 1884 and 1993 respectively. In more general terms, the government as a whole was finding it harder to find revenue, and the central government was losing control over that stream. Which in turn meant that it was losing control over one of the central instruments it used to control China, next to its security forces. There had already been put in place a fiscal system meant to incentivize local governments to grow their economy. However, local governments quickly found ways in which they could cheat the new system, and government revenue as a share of GDP kept falling. So, from 1994 onwards, the central government centralized the tax system to a much greater degree. Revenue was split on some taxes, a new universal tax code was introduced, and a new tax bureau was put in place. Before that, tax bureaus were local and often worked together with local officials, which now made largely impossible. The new tax bureau fell completely under the control of the central government for staffing, management, and funding.[25]

This mismatch in revenue and spending on the local level, is still a problem for local governments. In fact, it became still bigger as the central government has given the local governments more and more mandates that they have to fulfill with their relatively smaller budgets. They gradually had to pay for: most public transport, infrastructure, some social security like pensions and healthcare, clean water, immunization, and education. In order to be able to afford this, local governments focus economic activity to areas where they are returned most or all of the revenues. This used to mainly be promoting economic growth and wealth rises, since they shared the largest shares in those revenues with the central government. While this was no longer the case, the central government continually increased its own share in tax revenues. So as the fiscal burden of its mandates kept growing, local governments were forced to find new revenue which they could keep just for themselves.

Local governments in China can keep all income from land sales. Meaning, that when a local government is in need of revenue, they have historically turned to land sales as a reliable revenue source. One key facet if the housing market in China, is that the government only leases out land for a period of 70 years.[26] This land will in theory be handed back to the state after the 70 years are up. Not that this policy does not work for the most part. Indeed, the very manner in

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[24] Fubing Su et al., "Local Officials' Incentives and China's Economic Growth: Tournament Thesis Reexamined and Alternative Explanatory Framework", *China & World Economy* 20, no.4 (2012): 11
[25] Fubing Su et al.,: 12
[26] Library of Congress, "China: real property law", last accessed on 19-12-18, https://www.loc.gov/law/help/real-property-law/china.php

which budgeting rules, revenue returns, and other such policies are designed, have the purpose of incentivizing local governments into a much more efficient profitable straight jacket. This can be seen in local government tendencies in regards to infrastructure projects. These projects are most often funded by large short-term borrowing, which then places financial pressure on the LGs when the time comes to pay them off. This being, because often the revenue from such projects only really start to materialize years after the loans should have been paid off. Thereby increasing the debt burden even further, while at the same time creating no new significant revenue streams to pay them off with.

In western countries, and indeed in most countries around the world, growth targets are often set by national governments, but they do not have to be 'filled in' by state, provincial, or local governments. They are indeed more of a want than a must. Which stands in stark contrast to the ostensibly liberalized economy of China, where growth targets are set as an imperative for most levels of government by party officials and bureaucrats in Beijing. As renowned China scholar Michael Pettis argues: "GDP growth in China is really a political number, not an economic number. So if the government wants it to be 6.2 it will be 6.2. If they want it to be 7.2 it'll be 7.2. Not because they are cheating on the numbers, but because the local governments are asked or encouraged to create as much economic activity as is necessary to achieve the target".[27] For a while there was even talk that something called a 'tournament thesis' made provincial officials more eager to achieve these targets, because that would get them promoted faster.[28] This has however been debunked as a coding error by another study.[29] What was found, was that officials are scored based on what their predecessors in the same position did, not what other officials in the region are getting done. This creates an incentive to strive further than one's predecessor, which is hard when that predecessor heavily indebted his province to meet previous targets. When a debt crisis then takes place, because the local government has continually overextended its budget, the central government will 'swoop in' too quickly provide financial support. Since the CCP recognizes that the need for social stability exceeds the need for budgetary conservatism.

Shadow banking

The practices of shadow banking have creeped into almost every part of Chinese local governments when it comes to funding large development and infrastructure projects. Since many local governments are somewhat consistently in need of cash for infrastructure and development projects, and it is illegal in China for banks to finance local governments, loopholes have been found by Chinese banks. There are quite a number of loopholes, but the most

[27] "Michael Pettis: Real growth in China is less than half of reported growth", Youtube Video, 5:14, "AmChang Shanghai", March 6, 2019, https://www.youtube.com/watch?v=4rdh6zf-9OY
[28] Chen et al. "Relative performance evaluation and the turnover of provincial leaders in China", *Economic letters* 88, no.3 (2005): 421-425
[29] Fubing Su et al., :16

prevalent ones are found in the form of trusts. These trusts basically exists as investment platforms wherein citizens can invest their money more profitably than normally possible for them. One particular version, Local Financial Platforms (LFP), also sometimes referred to as Local Government Financial Platforms (LGFP), is so prevalent in government infrastructure projects that its role in reshaping the Chinese landscape has been referred to as the "financialization of urbanisation".[30] A working paper from the IMF on this financial product even warned that in a worst case scenario: "LGFPs may create potential contagion between the financial sector and the sovereign due to the close linkages between the public sector and banks". [31] Combined with the relatively immature Chinese capital markets handling these flows of money, poses a significant risk to Chinese domestic financial stability. These new financial products are all part of the shadow banking sector in China.

The shadow banking sector has become hugely important in the Chinese economy, as the rather immature Chinese financial system has not been allowed to service much demand for credit. The CCP, while trying to keep control over financing in its economy, has thereby (accidentally) spurred the growth of shadow banking. Any type of business that engages in bank-like activity, and whose activities are not covered by deposits, can be called a shadow bank. Even traditional commercial banks have created entities who engage in shadow banking. Shadow banking is thus not necessarily an illegal or unregulated activity, although it very well might be. Or as Wei puts it: "Financing through non-core liabilities, in contrast to regular banks' core financing through deposit-taking-and-lending, is the defining feature of shadow banking regardless of the entities (either banks or non-bank institutions) that carry it out.".[32]

Despite the fact that economist Paul McCully only coined the term 'shadow banking' in 2007, a lot has been written on its Chinese variant.[33] What all these studies have in common, is their focus on the risks paired with the growth of shadow banking. One study argued that even when a shadow banking entity is part of a normal commercial bank, it will be less risk-averse than other parts of that same bank who, contrary to the 'shadow bank' entity, engage in the before mentioned core-financing.[34] Several studies warned that the shadow banking sector is becoming, or has become, larger in terms of credit extension than the 'normal' banking sector. The size of shadow banking, one study argued, is especially worrisome when paired with the larger than normal risks this sector has because of poor regulation, a general lack of oversight by

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[30] Fenghua Pan et al., "Developing by borrowing? Interjurisdictional competition, land finance, and local debt accumulation in China", Urban Studies 54, no.4 (2017)p. 898-900

[31] Yinqiu Lu, and Tao Sun, "Local Government Financing Platforms in China: A Fortune or Misfortune?", IMF working paper, accessed on 19-12-2018, p.14, https://www-elibrary-imf-org.ezproxy.leidenuniv.nl:2443/doc/IMF001/20966-9781475599671/20966-9781475599671/Other_formats/Source_PDF/20966-9781484301159.pdf

[32] Shen Wei, *Shadow Banking in China* (Cheltenham: Edward Elgar Publishing, 2016), p.5

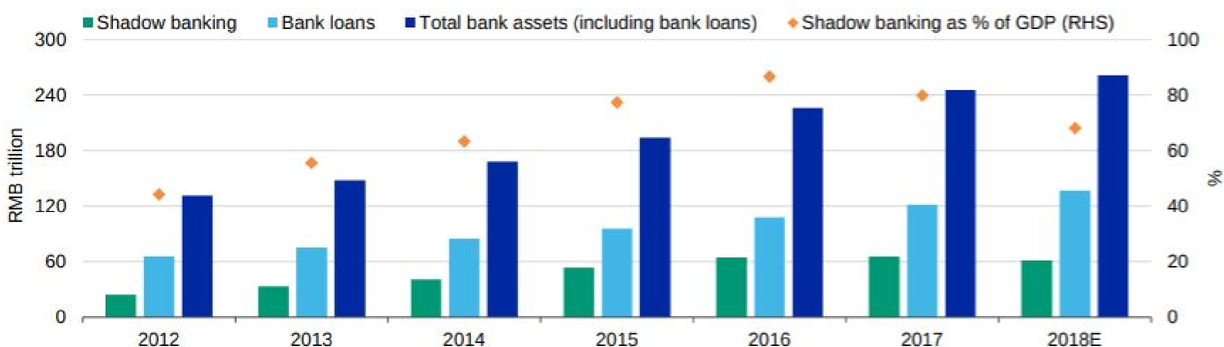
[33] Paul A. McCulley, "Teton reflections (2007)", last accessed on 17-04-2019, https://www.pimco.com/insights/economic-and-market-commentary/global-central-bank-focus/teton-reflections

[34] Meng Wen-Chu, and Chung Hua Shen, "Effects of shadow banking on bank risks from the view of capital adequacy", *International Review of Economics and Finance* (october 2018): 20-21

those regulatory bodies, and the relatively high default rates of shadow banking entities.[35] Another study stressed the importance of understanding the (unrealistically) high faith in shadow banking by the Chinese populace. As normal Chinese bank deposits are guaranteed by the Chinese state, they seem to expect that other forms of finance are also guaranteed. This is not the case though, at least not in terms of official policy. Therefore any risk taking by shadow banks should be added by the risks that Chinese citizens take when they invest in shadow banking practices, thinking that the risks are much lower than they actually are.[36]

As to the exact size of shadow banking in China, there is some contention. This is due to the very nature of shadow banking, and its poor regulation, but also because China is not known for its exact nature when it gives out data on its economy. Also, the definition of what constitutes shadow banking varies in width of applicability across publications and institutions. In showing the importance of SOE's in China today, almost all the loans generally pointed to as shadow banking by financial commentators are issued by state backed. While only being in existence for some 16 years since 2002, when it was worth some $80 billion, shadow banking was worth $700 billion in 2007.[37] After that, growth kept increasing. With the shadow banking sector meeting its peak around 2017 with it being worth some RMB 61 trillion, or around $10 trillion. Or about 84% of GDP. Since then, growth has slowed in the shadow banking sector relative to GDP growth, and in late 2018 the sector had stabilized at some 68% of GDP, which is still RMB 60 trillion, or nearly $10 trillion.[38] The figure provided below (constructed by Moody's), illustrates the trend described above.

Figure 1



Source: Moody's, "Quarterly China Shadow Banking Monitor (march 2019)", last accessed on 04-06-2019, https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1166068

[35] Yunlin Lu et al., "Shadow banking and firm financing in China", *International review of economics and finance* 36 (2015): 52

[36] Jianjun Li, and Sara Hsu, and Yanzhi Qin, *China economic Review* 30 (2014): 126-127

[37] George Magnus, *Red Flags: Why Xi's China is in Jeopardy*, (Yale University Press: New Haven, 2018): 84

[38] Source: Moody's, "Quarterly China Shadow Banking Monitor (march 2019)", last accessed on 04-06-2019, https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1166068

Chapter 3. - Political reasoning in relation to the credit bubble.

This chapter elaborates on the political reasoning that has made the credit bubble creation possible. In particular, it discusses Chinese monetary policy and its effectiveness. Before moving into the realm of developmental economics, by looking at the growth model China is using, and its long term viability.

3.1 - Chinese monetary policy

One much noted aspect of the Chinese economy, has been the manner in which the Chinese government uses the handing out of cheap credit as a way to grow the economy both in times of recession and in times of growth.[39] The use of monetary easing in times of relaxation, has been labelled by at least one study as 'pushing on a string'. What the study discovered, is how the effects of monetary easing are very different in China compared to other large industrial economies like the G7 and OECD members. In a 'normal' economy, the positive effects of monetary easing will be less than the negative effects of monetary tightening. However in China, it works the other way around. Since State Owned Companies (SOEs), make up such a large part of the economy, handing out easy credit to them will have a larger positive effect on the economy than in a 'normal' capitalist economy. These companies, after all, do not require their books to be healthy, and will thus not use easy credit for balancing, instead they use to spur their directly measurable economic activity like acquisitions, salary payments, building new factories, etc. Thus, understanding how SOEs work, helps to explain why the Chinese government has repeatedly pumped massive amounts of money into the economy. It is simply more efficient on a short time scale if growth is all that matters. This model however, seems to be running out of time, and the Chinese state agrees.

Eventually in 2017, the Chinese state decided that its debt to GDP levels had indeed become too great. This is visible in figure 1, where the shadow banking sector stops growing at around that time. The deleveraging drive that was started in 2017 had some positive effect on the debt levels. Corporate debt declined to less high numbers, promising a healthier long term financial future for China. Where the risk of over the top debt levels creating a crisis was smaller. However, as the US-China trade dispute has escalated since 2018, the Chinese state has frantically been trying to repair the damage from that event, with new monetary easing practices. The People's Bank of China (PBoC) has provided new cheap liquidity for banks so they can open new lines of credit with the private sector, and the PBoC has also repeatedly cut reserve rates for banks so the new lending drive does not stop before the trade dispute has ended.[40] This

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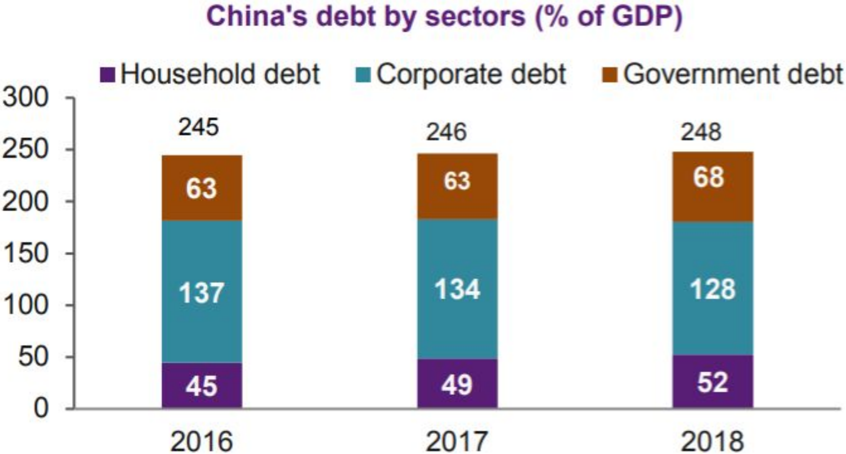
40 Yawen Chen, Kevin Yao, "China gives modest boost to economy with RRR cut amid renewed trade tensions", last accessed on 04-06-2019, https://www.reuters.com/article/us-china-economy/china-gives-modest-boost-to-economy-with-rrr-cut-amid-renewed-trade-tensions-idUSKCN1SC02D

is good for the private sector (especially SMEs) and thus Chinese economic and social stability in the short term, as it provides struggling companies with new credit. On the long-term though, this move allows these companies to leverage their old debt. Meaning that these private companies already having trouble paying off debt, will become even less likely to pay their creditors. Thus, the debt bubble starts growing again, which should be considered aside the now slowing down of economic growth in China. In theory, falling growth and still rising total debt (figure 2) means that paying off debts will become even harder for many companies and thus also for households.

Figure 2.



Source: Alicia Garcia Herrero et al., "China Hot Topics, March 2019", last accessed on 06-06-2019, https://www.research.natixis.com/GlobalResearchWeb/Main/GlobalResearch/DownloadDocument/ZIc6Ql7kh8OQg8pIsY-IRg%3D%3D

One startling piece of evidence that money is just a poster for value determined by a society at large, is an IMF paper concerning the falling effectiveness of new credit in the Chinese

economy.[41] Through measuring how much credit was needed in order to raise GDP with 5 trillion RMB. In 2007-2008 6.5 trillion RMB was needed to raise GDP with 5 trillion RMB, while in 2015-2016, the same raise in GDP required close to 20 trillion RMB![42] Now why is money turning so much more inefficient in China? Part of the issue could be that the industrial sector, and mostly SOEs, are ignoring their own inefficiencies, because they have access to cheap liquidity. Instead of cutting costs, they are able to borrow cheaply and thereby push the due date on their business models's viability forward (temporarily). This is only pushing the problem forward, because there is very little chance that without some serious efficiencizing these companies will become profitable again, especially the SOEs. The underlying reason for this, is not only the cheap money that these companies have access to, but also a more general lack of consequences for companies that go bankrupt.

Throughout China, it is felt that when a company goes bankrupt or has to default on its loans, either the central government, or the respective provincial government will step in to bail them out. This societally felt reassurance for bankruptcies, does not incentivize especially the larger companies to turn more efficient. In fact, it does the opposite. Since the job that SOEs have traditionally been doing is more that of reaching general employment figures, and maintaining quota for the goal of industrializing China. The cutting of costs, efficiencizing, and reaching financial self reliance are not at all their top priorities. SOEs are most often not judged on their value to the real Chinese economy, nor on their long term strategies, or actual productiveness. The feeling that one's financial future is being guaranteed by the party at large, is actual felt throughout large parts of the Chinese population. Shepard tells the story of a man he met who had invested quite seriously in empty apartment buildings, and who noted that the Chinese housing market was a bubble. After Shepard then asked him why he had not yet sold his investments since he knew it was a bubble, which would surely 'pop' sooner or later, the investor told him: "The government will take care of it. The government will lose a lot of money but we will be fine".[43]

3.2 - The Chinese growth model.

In macroeconomics, large countries who want to grow their economies have essentially only two tools in their toolkits. A domestic consumption based growth model, and an investment based growth model. One of the two growth models can be attributed to almost every economic 'miracle' that has taken place in the history of capitalism. Japan and South-Korea grew their economies immensely through the precise and effective allocation of capital resources in certain industries and in infrastructure, while at the same time gradually opening up their respective economies to the global economy. Such a model of gradual liberalization, combined with

[41] Sally Chen, and Joon Sikh Kang, "Credit Booms - is China different?", p.4, https://www.imf.org/~/media/Files/Publications/WP/2018/wp1802.ashx, last accessed on 11-11-2018
[42] Idem
[43] Shepard, *Ghost Cities of China*, p.64

directed public investment is what China did until 2008-2009. When in the 1970s, China began to 'open up', there was much low hanging fruit that would boost economic growth. Agricultural productivity shot upwards by allowing agricultural communities to form Town and Village Enterprises (TVE's) which could keep part of their profits, allowing hundreds of millions of people to start moving to urban areas in search of work. SOEs were also allowed to keep part of their profits, which were boosted in part by their efficiency gains and in part by the government keeping prices for raw materials low. In the 1990s, China turned to an export-oriented growth model, which worked so great that its export surpluses grew dangerously large. I say dangerously, because an economy relying on large trade surpluses can and will be hit harder than most countries is the global economy, and thus its exports, collapse.[44]

This is exactly what happened from 2008-2009 onwards, when the global economic and financial crisis, which was ignited by the world's largest economy (the US) swept around the world. Suddenly, a China which was not at all ready to stop growing needed a new engine of growth as global demand for its exports was falling rapidly. The proportion of exports to GDP dropped from 34.6% to 18.6%, the contribution of net export growth to GDP dropped from 10.6% to -6.8%, and year by year growth of FDI went from 18.6% to -0.2%.[45] All in the 2007-2016 period. This quite serious stagnation of what had at first been the engine of growth in China, exports and FDI growth, prompted the Chinese state to seek another growth model. This was achieved in the short term (a little more than a decade) through a massive stimulus package, aimed at construction, infrastructure, and heavy and chemical industries. These investments, while bringing jobs and reigniting the double digit GDP growth for a while, has been at a cost to household income, and to efficient capital allocation. This is because the stimulus package, 4 trillion RMB (or 586$ billion) was just the first step.[46] After depleting the stimulus package, new investments were increasingly funded through private, public, or private/public investment, taken from Chinese savings. How these savings have grown so much, is to some extent up for debate.

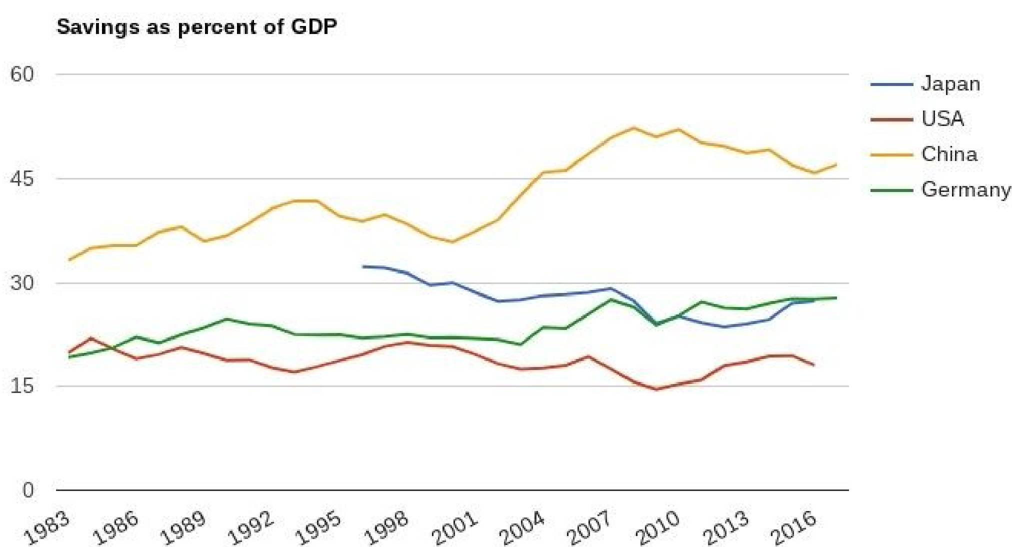
The basic manner in which savings in an economy work and is usually explained, is that consumers and companies earn money from their economic activities. A portion of this money will be saved, a portion will be taxed by their respective governments, and a portion will be used for investments. In the case of consumers investing, they might start their own business, buy a larger house, have children, move to another city, put their money in the stock market through an investment fund, or simply allow interest to build up their savings account etc. A company that invests, might use the spare money to acquire better production technology, hire more people, open a new factory or store, fund research for new product lines etc. When a company or person

[44] Yang Zhigang, JUlien Verceil, and Robert Boyer, "A growth model with Chinese Characteristics", *Revue de la régulation* 21, (2017)

[45] The World Bank, "Exports of goods and services (% of GDP)", last accessed on 20-06-2019, https://data.worldbank.org/indicator/NE.EXP.GNFS.ZS; The World Bank, "Foreign direct investment, net inflows (% of GDP)", last accessed on 20-06-2019, https://data.worldbank.org/indicator/BX.KLT.DINV.WD.GD.ZS?locations=CN

[46] Barry Naughton, "Understanding the stimulus package", *China Leadership Monitor* 28, (2008): 2

does not have enough spare money, they can go to a bank to take out a loan for their respective project. This is already much easier for companies than for persons, as people oftentimes want to buy things just for themselves, and not because it will necessarily make them a 'profit'. It is therefore not unsurprising that private persons can loan the largest sums of money when they want to buy a house. Houses generally appreciate in value over time, making them a generally safe bet for banks and people alike. In China, it is even more difficult for private persons to get money from banks, as these banks are 'directed' by the Chinese government to invest in SOEs, construction, and other projects earmarked as valuable for economic growth. Together with other factors such as an inadequate government safety net in things like health care, child care, and unemployment benefits, this has led the Chinese population into having a very high savings rate. At least, that is the story which is most often told.[47] However, there are some alternate theories. Figure 3.



Source: The World Bank, "Gross savings (% of GDP)", last accessed on 21-05-2019, https://data.worldbank.org/indicator/NY.GNS.ICTR.ZS?locations=CN

One argumentation, put forward by Michael Pettis, does not point to the Chinese population very willingly having such a high savings rate. Rather, it points to the Chinese state as having wanted, and having achieved that savings rate for its own purpose. For this to make sense, it is important to think about how a developing country, where the savings rate is almost always quite low, can 'develop' its economy. Essentially, when an economy is trying to grow, investment is needed in almost every part of that economy. New roads need to be built, dams constructed for much needed energy, ports need to be deepened for huge ocean farers to access

[47] Lonmei Zhang et al., "China's high savings: Drivers, prospects, and policies", WP/18/277, last accessed on 18-06-2019, https://www.imf.org/en/Publications/WP/Issues/2018/12/11/Chinas-High-Savings-Drivers-Prospects-and-Policies-46437

it. All these projects require a considerable amount of money, which is hard to find when a country's savings rate is low. Also, those savings are generally already invested in non-productive assets like gold and silver. So, as a state wanting to grow your economy through centrally guided investment, you are therefore in need of new capital. Now, what could have been done, was to get foreign capital to invest in China, and use that to make the essential investments. However, foreign capital is quick to move to another country when times seem bad. During the asian financial crisis for instance, it became clear that when too much (foreign) capital flees a country in a short time, banks fall over as they are suddenly unable to find enough liquid assets.[48] In the case of China, where the investments required on a long term basis were so large, that it would have to drain considerable FDI inflows from other countries around the world to do so. Not to mention that the CCP has generally been wary of making domestic stability depend on foreign powers.

Thus, China wanted to increase its savings rate, so that it could fund the projects it wanted to fund. There are a number of ways to increase the share of savings, but by far the simplest manner is to lower the share of household consumption in the economy. Since in the most simple model, where government spending (which would not be lowered anyway) and the international sector (which China did not want to rely on) are left out, Real GDP (Y) is Consumption (C) plus Savings (S). Thus, when $Y = C + S$, bringing down the value of C in relation to S, will increase the Savings rate in the economy. In GDP measurement, almost all consumption is done by households. Therefore, in order to bring down C while not cutting massively in government spending (which makes up a small share of C), the household income share of GDP should be brought down. Pettis argues that this is exactly what happened in China, through what he calls a "hidden tax on household savings".[49] In short, by keeping interest rates several percentages below inflation, any depositor would indeed gain some money through interest rates, but when taking in the value of that money, it would have become worth less. Thus, a transfer occurred from net savers to net borrowers. Which means that essentially, depositors are taxed to cover borrowing costs for economic development projects.

Two other important techniques by which China has managed to keep down the consumption share of GDP, are an undervalued currency, and slow wage growth. An undervalued currency might be good for exporters (companies), as their goods are cheaper in relation to other currencies, but it's not good for consumers (households). This is because pretty much all households, if they are not subsistence farmers, in some way consume imported goods. When these goods cost more than they have to, because the currency is undervalued, this puts the cost on consumers, while companies profit. This might all be fine if then wages go up with

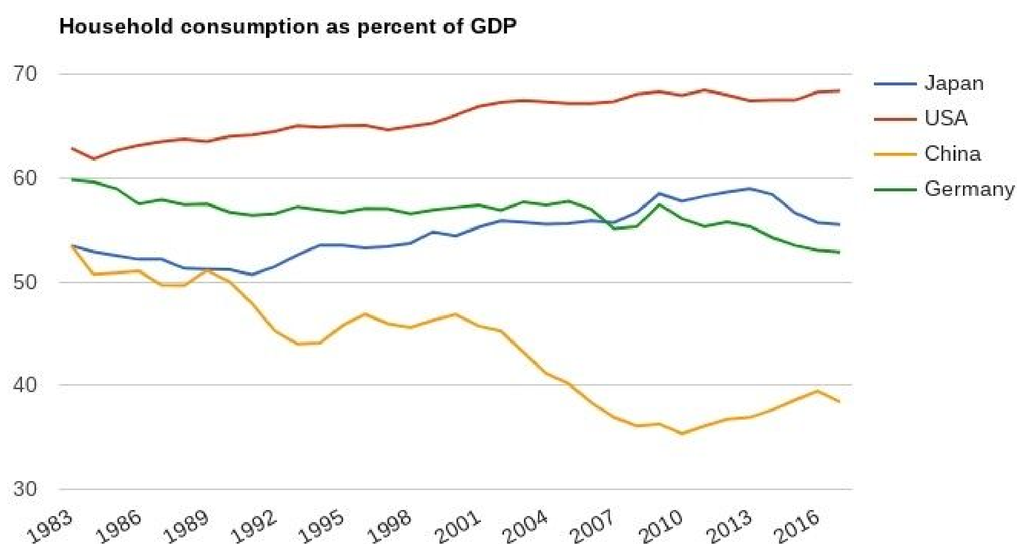
[48] Stephen Haggard, and Andrew Macintyre, "Theme Section: Models and crisis: turbulence in Asian economies - The political economy of the Asian economic crisis", *Review of International Political Economy* 5, no.3 (1998): 383-385

[49] J Steven Landefield, "Taking the Pulse of the Economy: Measuring GDP", *Journal of Economic Perspectives* 22, no.2 (2008): 197

increased exports, but this has historically never been the case. Wages almost always lag significantly behind economic growth. This is also the case in China, where wage growth has been much slower than economic growth, although it has been rising much more equally than in any other country in the world since 2018. Therefore, the household income share of GDP has grown slower in the long run than the rest of the economy, effectively reducing its share in GDP over time.[50]

Without these 'hidden taxes', where consumption is kept down to increase the share of savings in the economy, there wouldn't be enough money to lend out.[51] This, Pettis argues, is what is currently driving the Chinese economy higher onto its debt mountain. Because the only way to decrease the share of savings, is to increase consumption. But to do that, interest rates have to be higher than they are now. And when interest rates are higher, bad debt will rise up to the top, as lenders will be unable to service their debt with new lending, as the interest rates are too high. If this is really the central issue driving the core debt pile up, then how can it be fixed?

Figure 4.



Source: The World Bank, "Households and NPISHs final consumption expenditure (% of GDP)", last accessed on 21-06-2019, https://data.worldbank.org/indicator/NE.CON.PRVT.ZS?locations=CN

[50] "And Now for the Hard Part: China's Economic Adjustment After Three Miracle Decades - Michael Pettis", 51:00, "Institute for Advanced Studies", February 3, 2016, https://www.youtube.com/watch?v=zU7GdX57NOw
[51] Michael Pettis, "Avoiding the fall: China's economic restructuring", (Brookings Institution Press: Washington D.C., 2013): 104

Chapter 4. - What is to be done?

The issues described in the previous section, coincide with several other problematic trends in the Chinese economy that have been previously discussed. One of the most important indicators here being, that the effect of investment on economic growth has been dwindling. More and more money is needed for the same value of GDP growth. Meaning that the current growth model (based on investment), is losing effectiveness. Which, if the money invested does not create sufficient wealth to pay the newly incurred debt, is actually destroying wealth. It is not as if the Chinese state is not aware of this, since 2007, when the then premier Wen Jibao announced the need for rebalancing the economy in favour of households, and away from companies and local governments. So, there will now be a small section dedicated to what China could feasibly do to address the debt issue, who will benefit from those changes, and who will be harmed by them.

4.1 - Cui bono, qui leaditur?

Many economists, pointing to Chinese debt rising three times faster than debt servicing capacity, predict either a crash or very slow growth as a result of this debt pile. China could in theory grow very fast to rise out of its debt, but this has never successfully happened for a large country in history.[52] Growth relying on exports is already not an option anymore, as China and its debt have become too large for it to rely on the (at the moment weak) global economy. Thus, it will either have to default on its debt, rely on high inflation to lessen the debt burden, or use stocked up wealth somewhere in the economy to lessen the debt burden.

This, not surprisingly I might add, is perhaps why China has until now not sufficiently addressed the debt burden in the policy area. High inflation or defaulting are not an option for the CCP. Since both would seriously undermine the legitimacy of the CCP's mandate to power. Also, bringing down the rise in debt servicing costs, would require China to stop investing in so many non-productive assets. Which would in itself be a major problem, because that is how the CCP is keeping GDP growth at such high levels. Millions of workers would lose their jobs practically overnight, and GDP would most likely fall several percentages. In Michael Pettis's view, the only way China can feasibly grow while servicing its debt away, is by increasing household consumption. There are historically two ways to do this: increasing household debt, or household income. In the last couple of years, household debt has already risen very fast, so that short term option is off the table. Leaving only a larger rise in household income, compared to real GDP growth, as a possible growth model. The only way that is possible, is by growing the share of household income in the economy. While simultaneously paying down the debt burden. Another option like restructuring the debt, which essentially means that the creditors will receive less of the money owed than they had previously agreed to, is not really an option because many

[52] Carmen M Reinhardt, and Kenneth S Rogoff, "Growth in a Time of Debt", *American Economic Review: Papers & Proceedings* 100 (May 2010), 577

of the big creditors are a critical part of Chinese society (big pensions funds, banks, insurance companies). If they ‘fall over’, the ripple effect of such a shock could very likely have a large negative effect on the Chinese economy and society.

The vague outline of a possible growth model that China could adopt while simultaneously driving down its debt burden, has actually already been on the table in Chinese politics since the third plenum in 2013. Ever since then, the calls for addressing the high inequality levels in China, and for a “comprehensive deepening of economic reform”, have been the spearpoint of China’s economic future.[53] This might not sound like a big deal, but it basically entails what will need to be done to simultaneously drive down the debt burden, and switch to a new growth model that brings up the consumption share in the economy. This will require a transfer of wealth (and a little power) to households. Which in turn will be possible by making local governments sell their shares in SOEs and other companies to pay for the debt pile up, by lowering or removing a number of taxes on households, and by increasing or creating (hidden) taxes on (very) high incomes or large private assets. So basically, the groups bearing the burden will be the local governments and local elites. Who often go hand in hand. These groups, will probably not give up easily, as their current wealth comes from the investment led growth model. The Chinese state is well aware of this, which is why it has been on a public campaign to make its populace aware of who is the new internal enemy in China.[54] Their name: the vested interests. [55]

4.2 - The Chinese political system in a mangle

Ever since government mouthpieces like the People’s Daily and China Daily started their attack on ‘vested interests’ through op-eds by anonymous government officials, the Chinese government has been trying, and succeeding, to increasingly centralize power. This is because it is believed that without the massive reallocation of powers to the center (Xi Jinping and his allies), China will be unable to successively reform its system in order to successfully manage the two central issues (debt and where to find new growth) facing China’s economy. These, then, are issues of political power. Therefore, it is good to discuss how the Chinese political system works at the moment, how policies are (not) implemented, and how dethroning the ‘vested interests’ can be very hard.

Political power is in China not something that everybody or anyone can achieve. Indeed, even within the Chinese Communist Party, the only party with any actual political authority in the Chinese political system. Even within the CCP (roughly 88 million members), political

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[53] Barry Naughton, “After the Third Plenum: Economic Reform Revival Moves toward Implementation”, *China Leadership Monitor* 43 (2014)

[54] Anonymous, “China's reform of Party, state institutions revolutionary: senior official”, last accessed on 20-06-2010, http://en.people.cn/n3/2018/0313/c90000-9436601.html

[55] Hannay Richards, “Deepening reform to curb vested interests”, (12-10-2016), last accessed on 18-06-2019, http://www.chinadaily.com.cn/opinion/2016-12/10/content_27629415.htm

decision making is the sole responsibility for a very small margin of the upper echelons within the Party. In the CCP, there are some 650.000 'leading cadres' who fulfill, a range of essential control mechanisms on practically every level of governance in China.[56] From the county to the national level, and in a wide range of state owned-companies, mass-organizations, big newspapers, and various other types of socioeconomic organizations. The 'leading cadres' are there to ensure that the Party authority, legitimacy, and ideology are not harmed or in any other way threatened by these organizations. They are the mouths and eyes of the CCP, unless they themselves fall out of grace within the Party. Which has become a much more regular event since the massive anti-corruption and ideological tightening campaign, initiated in 2012, began.

The policies and ideology that the leading cadres are meant to carry out and supervise, come from the central Party and government organs (which are also controlled by the Party). Formal Party power is centralized at the Politburo (25 members from the most important Party organizations around the country) and is approved by the Politburo Standing Committee (7 members). The standing committee is basically a cabinet of ministers and the president, who represent the highest level of decision making in China. The 7 standing members together control the most important party organs, the most important government councils/committees/and Leading Small Groups (LSGs), the military and security apparatus, and the propaganda system.

Heilmann has argued that there are roughly two modes of decision making that decide how these members, and effectively the Party come to a decision. In the 'normal mode', they set objectives and guidelines for national policies. After which, different government bodies and departments, together with academics and other experts approved or from the party, come to a decision on the regulations and actions required. The politburo/standing committee come these decisions in a manner of consensus, so not purely on a majority basis. Also, they rarely use their authority to push something through, preferring to rely on the consensus within the committees and various party and government organs they chair. The extent to which the central government can then supervise and control the local and provincial governments who have to carry out these new rules or objectives, is very limited. Local and provincial governments can operate according to their own discretion and knowledge of particular conditions in their jurisdiction. Then, there is the crisis mode. In such a mode, power is "abruptly centralized across the party hierarchy", and ruling on consensus is no longer a prerogative in the view of the central party headquarters; personalization of leading figures and of ideology is used to strengthen Party standing, disciplinary and security organs are upgraded to carry more political weight, and a fall-back to militant mobilization rhetoric is visible in propaganda organs.[57]

According to Heilmann, China's political leadership has moved to the 'crisis mode' since Xi Jinping to office. Since such a mode has only been 'engaged' in times where the party felt that stability (and thus its rule) was in some way threatened. Good examples are: big natural

[56] Sebastian Heilmann, *China's political system* (Rowman & Littlefield: Lanham, 2017): 153
[57] Sebastian Heilmann, *China's political system* (Rowman & Littlefield: Lanham, 2017): 161

disasters, economic crises, big scandals, and big societal tensions like Tiananmen square in 1989, and inter party decision making crises. Through various means, Xi Jinping has centralized power over the military, economic reform, big foreign policy events, and the security apparatus in a huge way. Xi is however still held back from more complete control, by forces from within the party. These are the informal networks which play a very big role in Chinese society, just like they do in the CCP. In fact, it is very hard to climb the political ladder in the CCP, purely through being a good cadre.

Where the formation of factions is and has always been strictly forbidden for even the highest CCP members, patronage networks, which according to Fukuyama generally only creates a less effective bureaucracy/government, are encouraged by the CCP. It is common knowledge that if someone wishes to reach to the top of the CCP, they first need to find a top cadre who is "willing to pave the way for him/her and who expects absolute loyalty in return".[58] However, where self-enrichment of the patron and his network was previously ignored, this has also been forbidden in recent years (which does not mean that corruption is not a problem anymore). This still leaves the patron-network relationship that exists between top cadres and anyone currying their favour. Especially in the case of SOEs and their chairmen (who do not attain the position without the right contacts within the CCP), and local governments (where alliances between SOEs and local leading cadres are often the backbone of local economic development), there is a definite pressure being put upon Beijing through interpersonal networks. Even without the lack of data on such networks, there has been a lot of evidence to support this claim.[59] That these networks can hold back policies they deem unfavourable to them, has been a public secret in China for decades. This is why the Chinese system has been categorized as 'fragmented authoritarianism' by many. However, despite the new surveillance systems being put in place across China almost certainly having an effect on local and provincial cadres at some point, it remains to be seen how far the CCP central leaders will be able to go in their push for extensive economic reforms that target SOEs and local governments.

What is clear from any political science view, is that in order for reform to be pushed through, the state's capacity in regards to policy implementation needs to cross a certain threshold. This threshold is not just an arbitrary line, but represents a point at which 'vested interests' can be sufficiently undermined by either the formation of a new coalition of interests who would want to see the intended reforms pushed through, or through a crisis that makes the model no longer viable for continuation (even in the eyes of a large enough part that makes up the interest groups).

[58] Heilmann, 184

[59] Yu Zheng, "Privatization with 'vested interests' in China", *Socio-economic review* 0, (2017): 21

Chapter 5. - Analysis

What has become clear in the previous chapters is that the issue, a growing debt burden, it's dangerous nature for China, and the CCP's unwillingness to sufficiently address it with the necessary reforms, is at the base a power struggle of some kind. The CCP is well aware of the issue, it has years ago announced plans and policies to do something about it, but these policy plans have not had the required effect, since most were not even implemented at all. Now, in order to make it more clear how and why this has and is happening, a framework will be used to show in a more concentrated picture how this has an effect on, and is affected by, the four primary structures of power in China. Therefore, a short introduction into the workings of the framework is necessary first, for clarity's sake.

5. 1 - The framework, and the four structures of power.

For the framework, four structures of power are normally used to identify where the balance of power is influencing or causing something that is being researched. These structures are the security structure, the production structure, the financial structure, and the knowledge structure. Normally changes in each of these structures, are then lined up against the market, the state, and the balance between the two. However, since a large part of the issue here is actually the power struggle between the central and local/provincial powers within the CCP, there will be a division within the two. Susan Strange herself, said that the framework can and should be adapted to whatever is being researched, not the other way around. So, if the nature of the state is that it is for the issue of debt, and financing in general, essentially divided in two, then the framework will show that division. Before attending to that part though, a short explanation of what exactly falls under each of the four power structures, will be necessary.

The security structure,is the first of the four fundamental structures of power. It means asking who provides security to whom and against what threat, and what the price of that security is. In the case of China, security is provided by the CCP against foreign actors (through its military), against internal political instability (through censorship, propaganda, and repression of political freedom in general), and against corruption and the abuse of power by politicians and businesses (through large anti-corruption schemes and the setting of strict ideological rules for its leading cadres). The price of these securities, is that the CCP basically has a monopoly on political power, and thus on the making of all rules and regulations, all laws in general, and important security services like the military, the (secret) police, and intelligence services. This will be visible in the framework as well, as the military and police services are under strict control of the central CCP, and Xi Jinping in particular.[60]

[60] Susan Strange, *States and Markets* (Bloomsbury Publishing: London, 2015): 49-51

The production structure entail what is produced in general, by whom it is produced, for whom it is produced, under what terms, and through what kind of method. The wealth that is created and to whom it then largely belongs, influences the other structures in allowing them more or less room for movement. In China, the commanding heights of the production structures are many sectors are under the control of the CCP and its private partners. Multinational companies originating from China have CCP members on their boards, and obey to demands from the CCP for certain actions like creating employment through their control over the creation of wealth. Especially SOEs, owned by the state, are used as tools by the state in the economy to create economic growth in places where it deems them necessary. The control of the CCP over the production structure used to be total, but it has traded a large part of this control to private companies and SOEs, because it realized that less control over the goals and means meant that more wealth would be created for the economy as a whole. Currently, the CCP is tied up the issue of wanting to create more wealth through liberalization/privatization of underperforming and inefficient SOEs, and its need for end control over the economy. For this paper, the most important production function issue is that of needing to grow the consumption share in GDP over investment. If consumption is gonna grow more than the investment share in the economy, large companies and local governments will suffer, because they are the ones benefiting most from the current allocation of production power.[61]

The financial structure is where the crux lies in this paper. It's ability to create and hand out credit is immensely important, and has been the main driver of Chinese economic growth since the global financial crisis of 2007-2008. The liberalization of the financial sector, and the growth of the shadow banking sector, are the main causes of the giant debt burden now weighing down on China. It allowed the CCP a way to give back control over certain parts of the production function, by increasing its hold on who can acquire credit. This tactic diminished the share of consumption in the economy (through the previously discussed 'hidden taxes on household savings'), thereby creating cheap money for the privileged parts of the production structure (local governments and SOEs). Through this system, China has managed to fund the biggest construction (both housing and infrastructure) boom in world history, and has allowed SOEs and privileged 'private' companies access to much more liquidity than they needed. Many SMEs and private households though, have very little or no access at all to the official financial structure. This need for funding from SMEs, the unproductive nature of private bank account interests, and the CCPs willingness to 'look the other way' until it has found a solution that fits its mandate and ideology, has created a massive shadow banking sector. Which has driven a rise in shadow banking debt. This sector has allowed local governments to borrow from private banks through shadow constructs. These shadow constructs are funded largely by households, as they search for higher interest rates in opaque and high-risk financial products. If the financial structure was to be changed, in favour of a growing consumption share of economic growth, this

[61] Strange, 68

will hurt other parts of the economy. Undoubtedly, many patronage networks, large interest groups, and others who benefit from the current distribution of power in the financial structure, are in opposition to such a change. Not to speak of how many businesses/local governments will default on (parts) of their current debts because they are suddenly unable to acquire cheap liquid assets. The state will also be unable to push through reforms, unless the trade conflict with the US is over. Otherwise, it has no room for adjustment.[62]

Lastly, the knowledge structure contains, in China, the power of being able to decide what knowledge is and is not given out to the general public. What is known, and what is not. The importance of such a power should not be overlooked, as it dictates how people consider the CCP, and perhaps even more importantly, what the CCP knows about its citizens. In recent years, the CCPs grip on the knowledge structure in China has risen to a very high level. The ideological tightening of the Chinese media in favour of Xi Jinping and central CCP policy, gives central CCP orders more authority than before. While assessing the precize goal of these current trends is not given by the CCP, the similarities with Mao cannot be missed. When Mao was the leader of China, his authority over the knowledge structure was so great that he was able to direct China in every direction (mostly chaos) he wanted. This is probably also the goal of Xi Jinping and other powerful CCP leaders under him. As strengthening their control over the knowledge structure, will enable them to use that new power for the control over other power structures. Examples are: interest groups, local governments, resistant patronage networks, corrupt CCP members, secret societies, public protest groups etc. All in all, managing resistance is much easier once it is known where it is located, and who are leading it.[63] Finally, it is time to look at the framework that has just been described, as can be seen in figure 5.1.

[62] Strange, 99
[63] Strange, 131

5.2 - The final framework, and its findings.

Authority/Market Change China	Security	Production	Financial	Knowledge
State	Central CCP is very powerful in this area. New Surveillance systems allow more control over possibly every part of China with an internet connection.	Wants to change growth model due to debt and long term growth prospects. Has found it difficult to do in face of interest group lobbying.	State controls interest rates in favour borrowers. Wants to change in favour of consumers. Has little oversight over SB sector. Cannot adjust until trade conflict with US is over.	Beijing controls the media, most of the internet, and can mold public opinion. Is doing that in order to build large (nationalist) coalition under population for reforms.
Markets /LGs	Very little power in this regard, when compared to the state.	Lucrative ties between private companies, SOEs, and LGs, ensure local coalitions against many reforms. Are funded through cheap liquidity.	Immature financial system has free reign in creating risky financial products. Debtors have increasing difficulty to pay debt burdens.	Very little power in comparison with the state.
Balance	Very much in favour of the Central CCP (state). Will become even more attuned to Beijing, as surveillance systems progress.	Tie between the two. Beijing wants reforms, but is not able to push through due to budget constraints, interest groups, and little control.	In favour of Markets for now, until Beijing finds fiscal room to push through reforms.	Was already very much in favour of the state. State wants more power here, to increase its power in other structures.

Structural Change in China's economy

Figure 5.1: Structural power balance between Markets/LGs, and Beijing on the issue of debt reform.

What now becomes visible in the matrix. Is that since Beijing is wary of creating any kind of crisis, it is stockpiling power in every structural sector before it begins to push through major reforms. This is in line with Heilmann's argument that Beijing is in crisis mode, and Pettis's argument that Beijing needs much more control over every part of society and the economy before it can sufficiently address a change of growth model, and is then able to lower the debt burden. It also concurs with Hirschman's theory on why some developing countries have found it easier to engage in necessary economic reforms than others. His basic argument is that if vested interests are sufficiently aware of the negative consequences that a reformist policy might have on them, they will very likely campaign, lobby, and protest against such a reform. This is perhaps the reversed version of Hirschman's principle of the hiding hand. Which hides the risks of developmentally oriented projects, since these are unknown unknowns (to speak in Rumsfeldian terms), that allow people/groups who are generally oriented towards risk-aversion, to miss hidden costs in a project. Thereby making them think the risks will be within an acceptable range when they really are not. This is the opposite of what we can see in China.

Vested interests are very much aware of what will happen if they join the necessary political and business coalition which the CCP needs for its reforms. They will face serious change, that could very well impact them and their partners negatively. It is therefore that the CCP has sought to push the proverbial balance in their own favour, in the other power structures. Since, for China to keep its domestic and foreign image of a unified country under a unified one party rule, only a limited amount of dissent is allowable.

Chapter 6. - Conclusion

This paper started with the question of why China so far has not sufficiently addressed it debt issue, despite the CCP leadership, and Xi Jinping in particular, being aware of the debt, and its consequences? Through a better understanding of how credit, credit bubbles, and credit crises work, it was made clear that similar country cases have either crashed their economies as a consequence of such debt crises, or experienced long term economic stagnation. It was also pointed out that some authors, most notably Marx, have argued that capitalism and the way it handles credit will always end up crashing as a consequence. The way that capital accumulates, and over time becomes less effective in finding productive investment opportunities, will cause a build up in debt in a sector. This can translate into the formation of a bubble which will only deflate when investors start to ask for their money in such large terms, that lack of healthy assets becomes visible, investor confidence falls, and the market crashes. Then, the very wide and deep role of the CCP and the Chinese state in choosing economic policy and making sure companies follow that was uncovered. After which, the role of debt was discussed in the Chinese housing market, where houses are seen as 'brick and mortar savings', and there is widespread belief that the Chinese state is the guarantor for all financial investments of such kind. This belief, together with the realisation that the Chinese financial sector and its regulators are still immature for the amount of money they are dealing with, gave signs of a massive and very quick build up in debt held by shadow banking practices. The very risky and often short term nature of these investment products like WMPs, had not stopped the Chinese populace to invest in it en masse. Its size, some $10 trillion in 2018 (equal to 70% of GDP), is worrying to say the least, when the risks buried in such investments is taken into account.

Then, through a discussion of the Chinese growth model, who it does and does not benefit, and the realisation that it needs to change to avert a debt disaster, the primary power struggle within the CCP and among its allies was laid bare. In order to sufficiently address the debt issue, the central CCP leaders had to invert their growth model so that consumers would benefit more from economic growth than investors had done in the last twenty odd years. However, for this to happen, it needed to take away many assets from local governments by privatizing SOEs to pay of enough debts before turning the interest rates up further on bank account. Otherwise, the new higher interest rate, would make many debts unpayable, laying a possibly unbearable burden of basically dead assets on the banks who had extended these loans. Not surprisingly, the SOEs and Local Governments who were currently benefiting so much from the 'old' growth model, have formed powerful interest groups on the ground and in Beijing, all in order to make them not have to pay for this change. The central CCP leaders, being aware of the domestic forces in opposition to the planned reforms, have centralized much power in the standing politburo and under president Xi Jinping than since Deng Xiaopeng. This being, because the current leaders do not have the authority Deng had, so they need more formal power

to push through their reforms quickly. This being, because the CCP does not want to uncover opposition structures in China, as they believe that would harm their credibility and mandate to rule. In the framework that was used to make it easier to understand how such a balance of power works, in this case, in the Chinese political economy, the increasingly centralized power of the CCP was easy to see. Through increasing centralization in the security structure, a never before seen Orwellian surveillance system affecting the knowledge and security structures, the CCP is tightening its grip on every part of Chinese society, including its own cadres. Together with an increasingly nationalist and anti-foreign rhetoric, Xi Jinping and other CCP leaders, are painting vested interest groups and a volatile and risk taking financial system as enemies of a prosperous China. And now, with the US-China trade dispute that Trump single handedly created, the CCP has even less financial room to move its economy into another growth model. This has temporarily halted the promising beginnings of financial system and overall debt reform, and has made China's central bank push more money into the financial system for now. Thus, vested interests, an obsession with stability and the mandate to rule, and a decades long addiction to cheap liquidity have kept China from addressing the growing risk of a credit and debt crisis, despite being very aware of its existence and dangers.

It remains to be seen what will happen with China under Xi Jinping. Will China do what needs to be done so that it does not stagnate in growth, under the burden of so much debt? One could say that it does not really have a choice, at least if it wants to completely reform its economy to a zero-emission output to address the existential danger of climate change. If it wants to compete the likely new economically charged space race that will decide who holds most power in our solar system. The same goes for the CCPs wishes to dictate new global rules, make the Renminbi into a widely used global currency, skip the middle-income trap, and become a high-income country. All these objectives it has set for itself, and more, will be much harder and more difficult if China does not bite through this sour apple, if I may put it such understated terms.

What has been learned from this paper, has been that credit is too often overlooked in its role in the economy. That governments have and do use powers to manipulate that credit creation. That financial systems, if given cheap liquidity and denied strong regulations, will find numerous ways to make money by selling persons or companies credit. That too much money will make a sector inefficient, and that the scarcity principle in making an economy more productive seems to be true at least in this case. It shows that capitalism will thrive even in sectors, even when it is denied access to it. This paper also show what effects historical experiences can have on a ruling party, and that the need for coalitions is very real, even in an authoritarian one-party dictatorship like China.

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