Carl Walter and Fraser Howie, *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise*
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PAPER-TIGER FINANCE?

After more than thirty years of capitalist transition, and with most of its economic activities driven by the pursuit of profit, few would dispute that the Chinese economy is fully capitalist now. Yet perhaps that label alone is insufficient to capture the many twists and turns of the PRC's post-Mao development. Huang Yasheng, for example, distinguished two stages in his acclaimed *Capitalism with Chinese Characteristics* (discussed in these pages by Joel Andreas, with a reply from Huang). First had come the entrepreneurial capitalism of the 1980s, when growth was driven by the dynamism of rural private enterprise, as well as by collective firms, many of which were private ones in disguise. This had been followed from the early 1990s by a turn to state-led capitalism, with large, urban state-owned enterprises displacing and subjugating the private sector. The SOEs, no less driven by profit motives, benefited from fiscal, financial and policy advantages offered by the CCP; yet their monopoly status, across sectors from telecommunications to banking, rendered them less efficient than the competitive private sector, Huang argued.

This periodization of the post-Mao era is important, as it shows that many of the features that have intrigued critical political economists in search of progressive alternatives to Anglo-Saxon capitalism have been transient, their reproduction far from guaranteed. One such feature was the early salience of decentralized rural industries, which led Cui Zhiyuan to see a living model of Proudhonian socialism in China; while Giovanni Arrighi suggested it could be fostering a less exploitative, non-capitalist 'market society'. Over the past decade, especially since Hu Jintao and Wen Jiabao came to power, some have celebrated and others lamented an apparent reversal of economic liberalization, with increasingly discriminatory policies against private and foreign companies. Is China experiencing yet another shift of development path?

The answer is 'Yes' for Carl Walter and Fraser Howie, whose *Red Capitalism* details the institutional arrangements underlying China's vertiginous growth from the 1990s to the present day. The authors are veteran investment bankers (Morgan Stanley, JP Morgan) with years of experience in China helping to float major SOEs in overseas stock markets; both are fluent in Mandarin. In an earlier book, *Privatizing China* (2003), they charted the development of a national, then international, Chinese stock market, from its origins in local 'street-level' trading in the 1980s. It is unsurprising that their analysis is coloured by a belief that American-style capitalism, as epitomized by giant private corporations, should be the goal of China's capitalist transition. This bias need not prevent others benefiting from the authors' intimate knowledge of the operation and evolution of China's financial system, which has been central to its economic rise. Walter's and Howie's depiction of Deng China in the 1980s does not differ much from Huang's account: market reforms created a successful small-scale private sector which was efficient, export-oriented and open to foreign direct investment. In the 1990s, Jiang Zemin and Zhu Rongji—members of the 'internationalist elite from the great city of Shanghai'—decided that the moribund domestic-oriented SOEs and state banks that had remained untouched in the 1980s needed to be reconstructed into profitable, internationally competitive corporations. To revamp the state sector, the Jiang–Zhu regime invited US investment banks to restructure some of the biggest state companies along the lines of American corporations. They then floated these restructured firms on the new Chinese stock markets and on those of Hong Kong, London and New York. In the authors' words, 'Goldman Sachs and Morgan Stanley made China's state-owned corporate sector what it is today.'

Red Capitalism's detailed account of the 'creation' of China Mobile illustrates what SOE reform in the Jiang–Zhu era was about. The country's fragmented telecommunications facilities had initially been provided by provincial governments. In the early 1990s Goldman Sachs 'aggressively lobbied Beijing' to create a national telecommunications corporation. Under the auspices of international bankers, accountants and corporate lawyers, China Mobile was formed as a new company from the provinces' industrial assets. After years of American bankers' efforts to build its international image, China Mobile's IPO raised a historic $4.2bn in Hong Kong and New York in 1997, despite the Asian financial crisis. As the authors point out, China Mobile's valuation was not based on an 'existing company with a proven management team in place with a strategic plan to expand operations', but on projected estimates of the future profitability of the consolidated provincial assets, as compared to existing national telecom firms elsewhere in the world. International financiers, as minority stakeholders, and China's central government, as its owner, made a fortune by creating a 'paper company'.

To be sure, these paper companies would turn real once they floated in the stock market. The scale of market capitalization has grown exponentially over the last twenty years, especially since China's entry into the WTO. China Mobile is now among the 'National Champions' of central-government-run enterprises and features on the *Fortune* Global 500 list. SOEs of this stratum are investors themselves, and were responsible for Shanghai's stock-market bubble in 2007. The regulatory commission permitted these firms to buy blocks of each other's shares at their issue price, prior to the formal launch of deals. Hike-ups were guaranteed, with prices set low while demand was high. Walter and Howie reckon that up to 20 per cent of corporate profits came from stock trading that year. These National Champions get to retain the bulk of their earnings rather than pay dividends to the government.

Red Capitalism does not provide much information about the actual performance of these SOEs, but even the official data consistently show that they have been trailing the private sector in profitability, despite all the financial and policy advantages they enjoy. In 2004 the average profit rate for SOEs was 2.4 per cent, compared to 6.7 per cent for private enterprises; by 2009 the respective figures were 2.9 and 10.6 per cent. Since the 1990s, favoured SOEs have expanded on the basis of virtually unlimited financial resources from the giant state banks, which have themselves undergone the same remodelling after the style of US corporations, but have remained tightly under the grip of the CCP. The Achilles heel of this financial structure is that the Party 'can tell the banks to loan to the SOEs, but it seems unable to tell the SOEs to *repay the loans*'. Lax lending to unprofitable SOEs led to a surge of non-performing loans in the late 1990s, when the fever of debt-financed investment by local governments and SOEs ignited by Deng's 1992 Southern Tour had cooled—partly as a result of government efforts to contain inflation and partly due to the Asian financial crisis, which hit China's export sector hard. The pile-up of bad debts eventually exploded on the books of the major state banks. In 1999 the situation was resolved by a government bailout, based on the creation of 'bad banks' in the form of four Asset Management Companies, which took on most of the problem loans from the four leading state banks, which thereby became 'good banks' again, and eventually floated in international markets at good prices.

But the Asset Management Companies were not as well capitalized by the government as many assumed. While the Ministry of Finance had contributed RMB40 bn, the other RMB858 bn of their capitalization came from

10-year maturity bonds, issued to the rescued Big Four. The banks' continued exposure to the non-performing loans, in the form of these bonds, meant that the bailout was in fact little more than creative accounting to postpone an NPL-induced financial crisis for another ten years. That was supposed to buy time for the reforms of banks and SOEs to march ahead. The idea was that the Big Four would improve their transparency, risk-valuation and accountability following their flotation on international financial markets; meanwhile SOE reform was supposed to deepen, so that the big firms would finally become profitable and capable of repaying most of their old loans, which had been transferred to the Asset Management Companies.

But rather than following this plan, Walter and Howie suggest, SOE and state-bank reform started to lose momentum after 2003, when the Jiang–Zhu regime was replaced by the new leadership of Hu Jintao and Wen Jiabao, and had petered out completely by 2005, when they consolidated their power. The authors attribute this to Hu's and Wen's 'weak grasp of finance and economics', as well as their ideological unease with an American-style corporate capitalism that placed profit before employment and workers' well-being. But despite Hu's and Wen's apparently more left-leaning ideology, the termination of SOE reform did not revive the system of socialist enterprises which had guaranteed full employment and workers' welfare. Instead, the state sector was 'caught somewhere between its Soviet past' and its presumably 'capitalist future'. The SOEs grew 'fat, wealthy and untouchable as they developed China's own domestic markets and always with the unquestioning support of a complaisant financial system'. They became 'cash machines' of the oligarchic CCP families, today's ruling elite. Heads of the largest SOEs are equal in rank to provincial governors and ministers of state; many are members or alternates on the Party's Central Committee.

Nor has this elite been shy about squeezing resources from these companies, which became increasingly unable or unwilling to repay their lingering loans. As of 2006, the Asset Management Companies had only been able to recover about 20 per cent of the non-performing loans, and the cash thus generated could barely pay the interest on the 10-year bonds held by the major state banks. In 2009, it became clear that the Asset Management Companies would not be able to repay their maturing bonds, which constituted up to half the capital of the Big Four. As a remedy, the government extended the AMC bonds' maturity for another ten years. This is no more than a further postponement of the crisis. Indeed by 2019 China's financial system will be far more vulnerable: many of the massive loans from the emergency 'Great Leap Forward Lending' in response to the 2008 global financial crisis will deteriorate into a new wave of non-performing loans, much larger than that of the 1990s.

Two central chapters of *Red Capitalism* are dedicated to the bond markets, or lack thereof. To the extent that a market for bonds exists, it functions as a clearing house to move money from one arm of the state to another, resembling a pyramid scheme with household savers at its base. Rather than raise new capital, Walter and Howie argue, these disguised loans essentially compensate for weak tax collection. The 2009 stimulus package required municipalities to come up with two-thirds of project spending, so they leveraged utilities, infrastructure and assets to borrow from banks and then issue bonds. Still, the bond bonanza was geographically limited to the prosperous coastal regions: three-quarters of the money raised was in Greater Shanghai, Beijing and Guangdong; while Henan, one of the most populous provinces, accounted for a mere 3 per cent. Walter and Howie point to the cyclical nature of the financial system: 'The first decade of the twenty-first century now appears to have ended, just as each of the last three decades of the twentieth did, with China's major banks in desperate need of massive recapitalization.'

The authors suggest that China's authorities could keep sweeping bad loans under the carpet and postponing a financial crisis because of the 'heroic savings rate' of households and of enterprises based in the profitable, export-oriented private sector. But they warn that the country's large savings deposits are set to dwindle in the future, under any imaginable scenario. The savings rate will drop when depositors lose confidence in the state banks, the population ages, the export sector slows, or the government succeeds in rebalancing the economy into a consumption-driven growth model. The bad news is that all of the above are certain to happen, if not already underway. With declining savings deposits as buffers, the coming of a homegrown financial crisis is just a matter of time. *Red Capitalism* concludes with a warning about China's public debt. The authors calculate that if local-government debt, greatly increased with the stimulus package, and non-performing loans are counted along with the Ministry of Finance's debt obligations, then the figure at the end of 2009 could be at least 76 per cent of GDP (as of 2010 it was 63 per cent for the US). Such a proportion indicates a heavy interest burden, which will eventually limit the state's ability to invest in growth. Thus far the government has been leveraging China's domestic balance sheet, borrowing 'expensive RMB now to build projects' with the intention of making 'repayment at some point in the distant future using inevitably cheaper RMB'.

The book's depiction of the transformation of China's SOEs—from up-and-coming American-style corporations under Jiang and Zhu, into cash machines of rent-seeking political families under Hu and Wen—coincides with a narrative newly gaining ground within the American business community: that the PRC used to be more friendly and open to Western investors and the global economy in the 1990s, but has become increasingly protectionist and hostile to foreign companies over the last five years. The authors' account offers a convincing explanation—as well as a partisan justification—for this view. While Huang Yasheng describes a long rise of state-led capitalism, from the 1990s to the present, Walter and Howie divide this into two distinct periods. During the first, from 1992 to 2003, the PRC fostered a 'good' state capitalism, converging with a profitable corporate America. After 2003, this metamorphosed into a 'bad' state capitalism, closer to the insular, opaque, cronyist Suharto model.

Was this changing course of state-capitalist development inevitable or contingent? At points, Walter and Howie attribute the shift to differences in policy orientations and backgrounds between Jiang–Zhu and Hu–Wen. Yet they also hint that the deterioration of 'good' state capitalism into 'bad' was predestined. They note that the Party's *nomenklatura* had never intended to relinquish their grip on the state sector. 'Given the fragmented structure of the country's political system in which special interest groups co-exist within a dominant political entity, the Communist Party of China', the failure to follow through on state-sector reform may have been inevitable. This second interpretation makes more sense. Given the principle of collective leadership after the passing of Deng, as the last charismatic, first-generation revolutionary leader, it is unlikely that the course of the state sector, a complex edifice enmeshed with vast vested interests, could easily be altered by particular dispositions of individual leaders. The 'good' stage can in fact be seen as a manifestation of the weakness and fragmentation of Chinese state capital in the 1990s, when the CCP elite was dependent on global financial capital to foster the centralization and globalization of SOEs. Once state capital had been strengthened and expanded within global financial markets, the CCP elite became confident enough to ignore the preferences of foreign capital as to how their companies should be run. The demystification of American-style corporations as solidly profitable, transparent and well governed in the wake of the Enron scandal of 2001 and the financial crisis of 2008 only redoubled the Party's determination to kick away the ladder from American investment banks.

Viewed in this light, what distinguishes these two periods is not the nature of Chinese state capitalism, but its relation to global capital. Subjugated to global capital in the first stage, Chinese state capital became more independent and defiant in the second. This changing balance of forces tallies with the many recent complaints from US corporations about being bullied by the Chinese authorities and discriminated against in favour of native SOEs. It also sheds light on the recent rise of China's nationalist left, characterized by its pro-state sector and anti-Western stance, which has become increasingly vocal in certain official media outlets such as *Global Times*. Whereas the PRC's state capitalism in the 1990s was a constitutive part of the US-centred neoliberal global order, it underwent a nationalist turn in the early 2000s. The mounting economic conflicts—from US corporations' accusations of stolen patents to American complaints at the WTO about Chinese subsidies to SOEs—can therefore be understood as an incipient inter-capitalist rivalry between Chinese state capital and US global capital. Given all this, we can also understand better why US investment bankers like Walter and Howie would be so nostalgic about the Jiang–Zhu regime and so down on the Hu–Wen era.

Red Capitalism helps to illuminate three stages of Chinese capitalism, in the 1980s, the 1990s and the 2000s. What the authors pay insufficient attention to, however, is the position of private, export-oriented capital in China's political economy today. They seem to assume that the private sector was simply subordinated to the expanding state sector after 1992, asserting that private companies 'will be supported only as long as they are critical as a source of jobs (and hence, the all-important household savings), technology and foreign exchange'; the private sector 'is there to be used tactically by the Party and is not allowed to play a dominant role'.

There is plenty of evidence to support this view. The private sector's well-known difficulty in borrowing from state banks, in contrast to the SOEs' flood of easy credit, is a case in point. The picture, nevertheless, becomes more complicated if we look from another angle. In the debate about currency policy, the private export sector, together with its coastal-elite hosts, clearly wins the argument each time. Big, domestic-oriented SOEs have been futilely supporting more drastic appreciation of the renminbi, while China's coastal exporters are the key vested interests that deter Beijing from letting it rise. For example, the heads of Lenovo and Hunan Lengshuijiang Iron and Steel, two major SOEs, openly urged the Chinese government to end the dollar peg in spring 2010, as a stronger RMB would reduce their import costs and hence increase their profits; to no avail. The influence of the private export sector also explains Beijing's addiction to a ballooning trade surplus and US Treasury bonds. The political competition between China's private, export-oriented capital and its state-owned, domestic-oriented capital, therefore, is far from settled. The former's changing triangular relation with oligarchic state capital and global capital will continue to influence the debate over the PRC's development path in the years to come. All these fractions of capital, as well as their ideological representatives such as the nationalist left and the liberals, purport to act in the interests of the people. Whether, when and how China's working classes will become a key political force and assert their own independent voices in actual political struggles remains to be seen.