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# FEATURE REPORT

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# China's Crisis Of Success

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## A Word From The Editor

This piece by William Overholt is fascinating — it shows how deeply Bill knows about China; his narrative on China's contemporary economic and political landscapes is both highly objective and very accurate, in my view. Bill is one of the few old "China hands" in the U.S. who began to study China many decades ago and his 1993 work, *"The Rise of China"*, is the first book predicting China's economic and geopolitical success, which won the Mainichi News/ Asian Affairs Research Center Special Book Prize. His 2018 book *"China's Crisis of Success"* lays out the many challenges facing the Chinese leadership. I trust that you will find Bill's piece highly informative and very insightful.

Bill has a long and distinguished career of being an Asia expert for both the public and private sectors. He is currently a Senior Research Fellow at John F. Kennedy School of Government's Mossavar-Rahmani Center for Business and Government, at Harvard University.

Previously, Bill spent decades working in the financial industry. He served as head of strategy and economics at Nomura Research Institute's regional headquarters in Hong Kong from 1998 to 2001. At Bankers Trust, he ran a country risk team in New York from 1980 to 1984, and was regional strategist and Asia research head based in Hong Kong from 1985 to 1998.

Bill also served as political advisor to several of Asia's major political figures and his political advising has included intense involvement in Zimbabwe's movement to independence (1979-1981), South Korean domestic conflicts in 1980, the Philippines revolution of 1986, Burma's insurgent wars of the late 1980s, and Hong Kong's transition. He served as head of the Asia Policy Task Force for the 39th President of the United States Jimmy Carter's campaign in 1976.

**Chen Zhao,**
*Chief Global Strategist*

This paper[1] provides a different view of China, and a different way of understanding China, from the conventional wisdom. China is the latecomer of a group of Asian miracle economies. Seeing China through the lens of the earlier miracles' experiences often leads to very different conclusions from our consensus images.

In the 1980s I saw that Deng Xiaoping was emulating the strategies of the earlier successes of South Korea and Taiwan. Based on that I argued that China would become the next superpower, a view eventually crystallized in my book, *The Rise of China: How Economic Reform Is Creating a New Superpower*. That argument was quite controversial. The leading review in London said, Mr. Overholt's bank must have paid him a lot of money to write such nonsense.

In the new century it was quickly clear that Hu Jintao's China was not following the playbook. I wrote an article called "Reassessing China," published in the *Washington Quarterly*.

Then it became clear that, although China is no longer following the South Korea/Taiwan model, it faces a crisis shared by all the Asian miracles, a crisis of success.

## Prerequisites Of Asian Miracles: Simplicity And Fear

The earlier Asian miracles were very simple economies and polities. The economies were landlords, peasants, roadbuilders, some manufacturers of cheap socks. Even a government could understand what that economy needed to grow.

Politics was simplified by intense fear. The Asian miracle polities were all terrified: Japan after losing World War II, Korea after the Korean War, Taiwan after losing the Chinese civil war, Singapore after a traumatic separation from Malaysia, China after more than a century of domestic and foreign debilitation and strife.

Fear of social collapse changes politics. Leaders know that they have to do great things, incurring great risks to avoid collapse. The people accept extraordinarily stressful policies because they fear civil war and the starvation of their children. With the right economic policies, Leninist politics works.

*Message to fearful Washington policymakers: This model works only under extremely constrictive circumstances. It is not a model you can spread everywhere. Chinese leaders know that.*

China's early reformers took extraordinary risks to save their country. In a population of peasants, communist political power was ensured by absolute control over the life of every peasant, through a system of communes that gave the Party control of job, income, location, marriage, clothing, haircuts. But when farmers in Anhui Province started seizing their land back in the late 1970s, threatening communist levers of power, Deng Xiaoping noticed that the economy grew much faster and the farmers were much happier. He decided to take an extraordinary risk: surrendering the most important lever of communist power in the hope

2 This is an edited text of a book talk originally given at CSIS on January 15, 2019, based on William H. Overholt, *China's Crisis of Success* (Cambridge: Cambridge University Press, 2018, available on Amazon).

that more prosperous people would support the Party. Looking back through an economist's lens that decision seems straightforward. At the time it was a terrifying political risk.

In the 1990s, Zhu Rongji and Jiang Zemin did the same things with urban industry, shedding the most important direct controls over workers' lives and giving up the direct transfer of all company revenues to the state. They bet that workers would be happier and that corporate taxes would offset the loss of direct control of revenues.

That kind of behavior, taking great risks in the belief that improving society will ultimately enhance support for the party, is the essence of being a successful vanguard party. It is the political core of the Chinese miracle. Its attenuation is the political core of China's crisis today.

## Crises Of Success

Every Asian miracle comes to a crisis of success, which is a moment in the development of a successful business or a country where continued success requires organizational transformation. Think of an entrepreneur who invents a cool widget and the business takes off, managed as the entourage of that one successful inventor. Soon the point comes where a simple business becomes complicated. It needs to list on the stock exchange. It needs very professional accounting and very professional human resources management. It needs a board of directors and a public rule book. *It requires an organizational transformation*, and its future success or failure depends on successful transformation. Call it an Elon Musk moment.

These crises of success share certain characteristics. The country finds itself overleveraged, threatened by debt, bubbles, inflation and bankruptcies. The big companies find themselves in difficulty. The 40 conglomerates belonging to Taiwan's Leninist Party went into intensive care; likewise Korea's *chaebol*. China's state enterprises can't earn back their cost of capital. And the state's autonomy finds itself challenged by powerful interest groups trying to seize control of policy, together with more demonstrations and larger scale demonstrations.

At this point leadership counts. South Korea and Taiwan faced their crises of success at the end of the 1970s through the 1980s. Taiwan was managed by Chiang Kaishek's tough, Leninist son — a member of the Soviet Communist Party, a nasty security chief who had dissidents killed, not just jailed like his counterparts on the mainland. But he was close to his society and understood the need to change. He organized a gradual transition.

In South Korea Park Chung Hee didn't get it, either economically or politically. Most of Park's favored *chaebol* (conglomerates) eventually failed financially. In October 1979 students planned a great demonstration. Park's Korean CIA head understood that society was changing and recommended liberalizing concessions. Park's bodyguards recommended stationing sharpshooters on tall buildings and shooting the student leaders. Park went with the bodyguards. Fearing social chaos, the KCIA chief, a close friend of Park's, invited the President to a dinner with two pretty girls and shot him. Thus began the ultimately successful management of crises of success in Taiwan and South Korea.

## How Has China's Crisis Of Success Emerged?

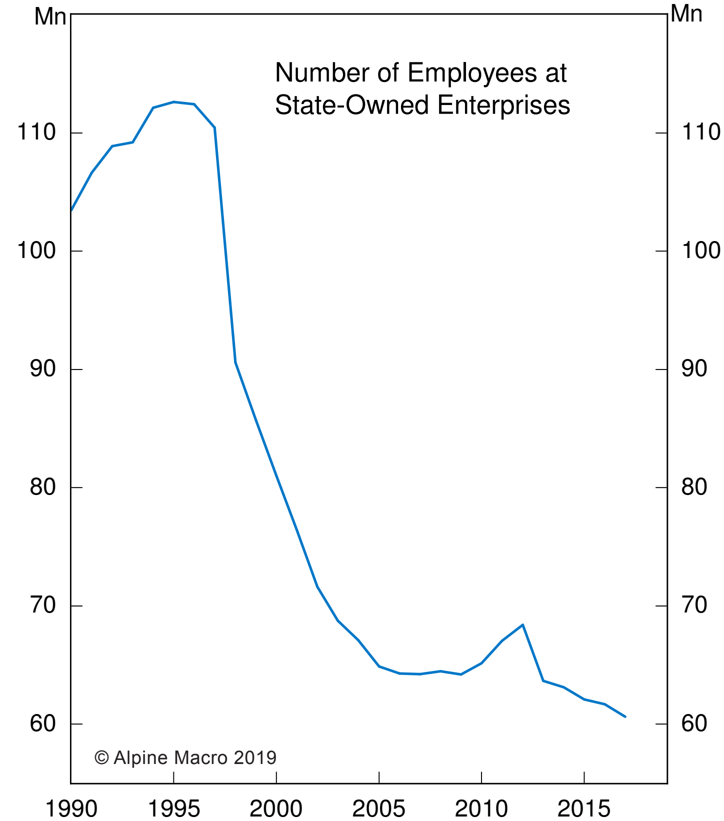
Start with Zhu Rongji. In his desperate effort to use market reforms to save the banks and the big enterprises, 45 million manufacturing workers in SOEs had to be moved to service jobs between 1994 and 2003 (**Chart 1**). Remember what happened to U.S. politics when a mere 3 million manufacturing jobs disappeared in a decade. And Zhu sought to cut the Chinese government in half. Imagine Ronald Reagan trying to cut the U.S. government in half. It would never happen. In China, it mostly did, at the top levels.

Initially people accepted the social stress, as the price of saving the country. But by 2001-2002 Chinese society was stressed out. People just weren't going to take it anymore. By 2002 Zhu was a hated figure. Today he's a retrospective hero, and that's the appropriate assessment of him, but not when his term ended.

So Zhu Rongji was succeeded by a leader, Hu Jintao, who promised a harmonious society, a phrase with deep philosophical roots but in practical terms it meant no more stressful Zhu Rongji market reforms. Hu was a weak leader, crippled by diabetes. His team of nine Politburo Standing Committee members worked by majority vote, slow like the U.S. Supreme Court, and older leaders frequently interfered. Economic and political reform largely stopped. Demonstrations increased geometrically. Powerful interest groups were asserting authority over policy.

An example of a powerful interest group is the Petroleum Faction, which controlled the flow of

**Chart 1** **Falling State Sector**




hundreds of billions of dollars worth of energy. It arbitraged the difference between the official price and the market price and pocketed the difference. The head of the Petroleum Faction was one of the nine Politburo Standing Committee members and was China's chief of security. The Petroleum Faction makes the National Rifle Association seem like a mere puppy dog. China's interest groups are the size of European countries and as difficult to manage as the EU.

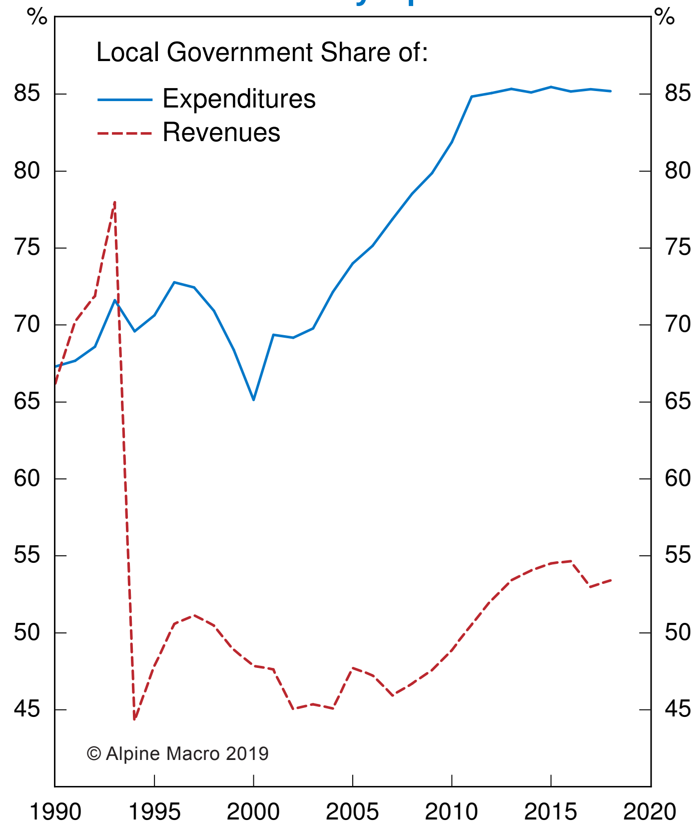
*This is China's crisis of success*. The leaders had to re-start economic reform and restore central authority.

## Reform Strategies

On economics, they worked with the World Bank, American Nobel Prize winners and many others to develop a plan based on market allocation of resources. Seldom in world history has an economic plan been so thoughtfully prepared.

Politically they saw the challenges as requiring drastic centralization. They cut the Politiburo Standing Committee from nine to seven members and eliminated the most extreme views. They created a new National Security Council and created new small leading groups to manage things like military reform and economic reform and put one new leader in charge of all of them. They gave the new leader immediate control of the military and told the older leaders to stop interfering. These were consensus decisions, separate from the decision to choose Xi Jinping as the new leader.

**Chart 2** **Local Governments Are Financially Squeezed**




## Reform Difficulties

Immediately the problems began. Market allocation of resources implied squeezes on the state enterprises and therefore on the banks. If the market was making decisions, then Party and government groups were losing power. If state enterprises were put on a market basis, they would be squeezed financially and that would hurt both them and the banks. Local governments, which have predominant responsibility for social services, were squeezed the most (**Chart 2**). Simultaneous military reforms added the military to groups pushing back. There is no more dangerous strategy for a leader than one that threatens all major power groups simultaneously.

But Xi Jinping had a hammer to employ against resistance to reform: the anti-corruption campaign. Not surprisingly, the first tiger brought down was Zhou Yongkang, head of the Petroleum Faction, followed quickly by top military leaders. But the broad application of the anti-corruption campaign meant that the interests of all major power groups in Chinese society were doubly threatened. This meant trouble.

Xi Jinping's team came to power worried about a suspected coup plot. Their threat to so many groups' power led to spectacular infighting. One top executive told me, *"Bill, the game in Beijing is, you die or I die."*

Adding injury to injury, the anti-corruption campaign, intended to be the hammer of reform, scared and immobilize the officials responsible for reform. Any reform that stepped on someone's toes, and that means all reforms, was bound to lead to accusations that the reformer was corrupt. And, along with almost everyone else, the reformer was typically vulnerable to such an accusation and this immobilized him or her.

Because of this political warfare, Xi Jinping's first term had to be devoted to subduing rivals. This he accomplished superbly. The second term, just begun, is designated for implementation of reforms. The leadership then realized the risk of reversals and reprisals and therefore opened the possibility of a third term for Xi.

## How Is Reform Doing?

In almost every important case except military reform, when the leadership has faced a fundamental choice Xi has announced that the regime will have its cake and eat it too. They will move to market allocation of resources, but they will provide massive subsidies to state enterprises. They will marketize the state enterprises but in every state and private enterprise they will strengthen the Party Committee's control of strategic decisions. They will emphasize the rule of law, but they will strengthen the Party Commission that tells the courts what to decide. This determination to have one's cake and eat it too is not like Mao Zedong or Deng Xiaoping. This indecision is like Theresa May explaining that Britain will have both Brexit and a gloriously prosperous future.

But the indecision is not completely indecisive. Whenever there is a tension between market reform and political control, this government leans mainly toward government control. Mao's era was Politics in Command. Deng's era and Jiang's were Economics in Command. Xi's is Politics mostly in Command. That is ominous for the economy.

## Xi's Role

Recognition of this strategic indecision illuminates the role of Xi Jinping. Our media, and many specialists, describe Xi as the omnipotent President for Life, as China's Putin. That image is totally misleading.

Xi is powerful. He has eliminated his adversaries. He has many titles and roles. He is enshrined in the constitution. He is promoting movies and speeches that attribute China's new greatness mainly to himself and his father, not so much to Deng Xiaoping.

But the important test of a leader is whether he can implement his policies. Xi is hardly all-powerful on that dimension. He faces universal pushback and limited success.

Xi is not China's Putin. Xi is a creature of the Communist Party, an executive given a job to do and ultimately accountable for performance. Putin's party is a creature of Putin, engineered just to enhance Putin's wealth and power. This contrast is entirely in China's favor but it belies the image of the all-powerful dictator for life.

The sober reality is that Xi has a job to do and he is not doing that job. He is not reforming the economy. The consequences take a long time to ramify. Jeff Immelt held on a long time at GE, and China is a lot more complicated than GE.

Confident, competent executives do not accumulate all possible titles and roles. The CEO of a major industrial company does not make himself director of every division. Deng Xiaoping governed China as honorary chairman of the Chinese Bridge Players Society. Deng would give a speech at the age of 80 and a billion people would live differently. That is real authority. That is incomparable power.

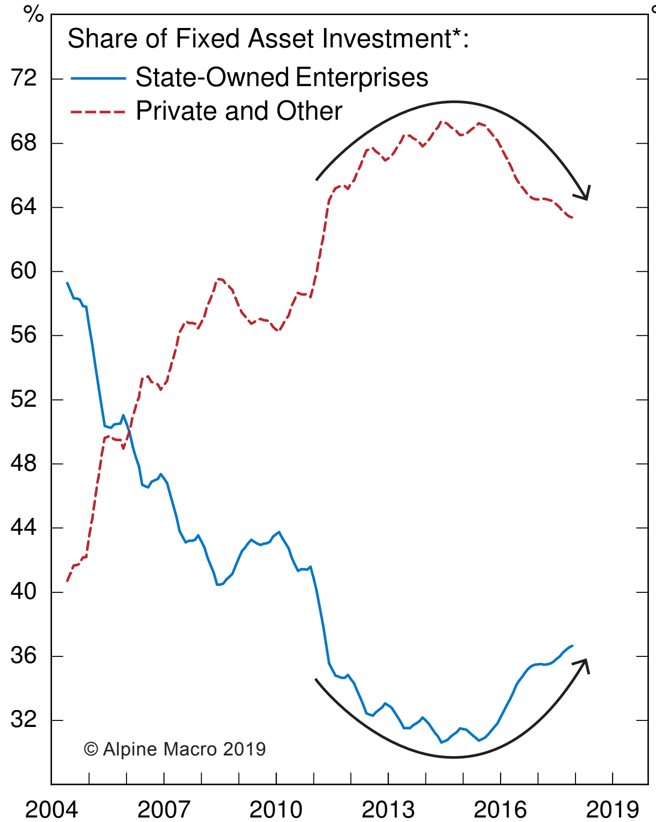
## Stability And Instability

There are two contrasting and complementary perspectives on China's prospects for stability. On one hand, pressures for a more sophisticated political strategy are inexorable. On the other hand, modern China has built a very sustainable social and administrative structure.

A key lesson of the earlier Asian miracles is that the pressures of political complexity are inexorable. The current Chinese administration has chosen the Park Chung Hee strategy of sitting on the lid of the boiling kettle. The result is a vicious circle of repression, pushback, more repression, more pushback.

The tides of political support are shifting. Five years ago China was one of the few developing countries where academics supported the government—on the view that, while there were many things they didn't like, the Party had done so much for the Chinese people that the costs of repression were quite tolerable. No more.

**Chart 3 Headed For Wrong Direction**




*Shown as 6-month moving average; source: CEIC

China's professionals — academics, journalists, lawyers, the leading edge of society — today express helpless but emphatic alienation.

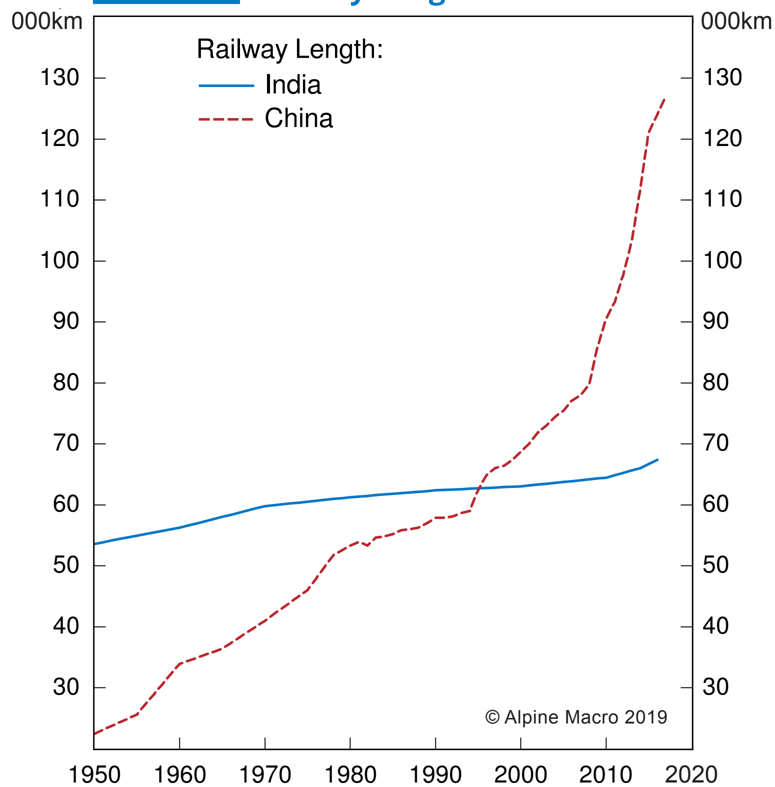
Of decisive importance is the business community. State enterprise executives have lost more than half their previous compensation. But the private sector, the source of almost all growth and almost all new jobs, is most decisive. The private sector is being squeezed financially and devoured by the state enterprises. Private sector investment growth has fallen by two thirds (**Chart 3**). Every private company is vulnerable to the local Party Secretary, who calls up and says, *"I have a new project downtown. I need your million dollar* *contribution by next Tuesday."* That causes resentment. Today the local Party Secretary finds herself squeezed by the national campaign of financial deleveraging. China's localities have a disproportionately large share of social responsibilities and a disproportionately small share of revenues. As they are squeezed, there are more and more calls for private sector contributions. The economic and political costs are going to be severe. The tides shift gradually, but they are shifting.

This shift against the administration does not mean that China is headed for a great revolution. The fundamentals of the governance system created by China's Communist Party are as strong as the ones created by their Leninist predecessors in South Korea and Taiwan. But to understand this one has to discard much of Western social science. Nothing highlights the malign influence of ideology and methodological fetishism on contemporary economics and political science as a look at the realities of China.

Start with economics. The greatest development economists of our day, Acemoglu and Robinson, have shown persuasively that sustained development requires a relatively inclusive economy. They frequently derogate China on the grounds that it is not an inclusive polity. The assumption is that an inclusive economy is the same as an inclusive polity. But that is ideology, not science.

The Asian miracle economies specialize in creating inclusive economies, and they greatly outperform democracies at this level of development. They begin by taking the greatest asset of their agricultural societies, land, and distributing it widely in a great land reform. Democracies

**Chart 4** **India Vs China: Railway Length**




are incapable of land reform. Then they provide universal basic education so that everyone has a chance. India has proved unable to do this for its people. Then they build infrastructure to attract labor-intensive industry and gradually get nearly everyone a job in the modern economy. For comparison, China builds about as many modern roads every six months as India has built since independence in 1947 (**Chart 4**).

The economy based on labor-intensive textiles, computer assembly, and the like particularly benefits women. In most traditional agricultural societies families have an overwhelming preference for boys, because family survival may depend on muscle power. In modern light industry companies strongly prefer women. A typical assembly plant may have 11 Taiwanese bosses and 8,000 Chinese women. It's still unfair that the bosses are Taiwanese men, but for most families the key is that the women are the ones who get primary exposure to the modern world. The women are the ones who can save and fund the downpayment on a home.

The women get out of the villages where previously they were under the very oppressive thumbs of their fathers and brothers. Women travel 500, 1000, 1500 miles to get these jobs and they cite getting out of the village as the greatest benefit.

Next these Asian miracle economies promote widespread homeownership. China has the world's second highest rate of home ownership—around 85 percent. You will never see that mentioned in a report by one of the U.S. Congressional commissions, or even in most academic studies of China. The number of families in China that own a home is about twice the number of families in India with access to a toilet.

Finally, each of these economies experiences a great property price inflation, making people's homes far more valuable.

That is how to create an inclusive society in a poor country.

Similarly, it was long a shibboleth of Western academic studies of China that because of the dynamics of a communist system China had the worst pollution in the world. On the contrary, the effect of air pollution on human health is eleven times worse in India than China. Like London in 1950 and the U.S. and Japan in 1970, China just had to get through a development threshold where basic needs were assured and environmental consciousness became high. Starting around 2010 China has become the biggest investor in environmental improvement, more than the U.S. and more than all of Europe. It is the leader in every form of green energy.

Similarly, contrary to much of the Western academic literature, China has developed an effective meritocracy. That is why it builds more and better roads, railroads, ports and much else, than India. For space reasons I will just refer you to my book, *China's Crisis of Success*, for an explanation of why our academic literature so often reaches false conclusions about this.

Like its predecessors in South Korea, Taiwan and Singapore, the leaders have built very solid fundamental systems. Because of this, leadership is the Communist Party's to lose. But the example of Taiwan's Guomindang shows that even a party that has done one of history's most extraordinary jobs of development can squander its dominant position. China's Communist Party is now particularly vulnerable to that risk.

## Risks

One must never lose sight of the extraordinary economic strengths of the system China has built. China's economy is far more open and competitive than Japan's. But the emergent weaknesses are quite fundamental. Under the current administration China is starving and cannibalizing its private sector, which is the source of virtually all new job, growth and productivity improvements. It is giving political control priority over economic reform, at a cost that will eventually prove staggering. Moreover, the history of socialism shows that legal ownership of big enterprises does not in fact empower the government; the big enterprises end up controlling the government. They protect themselves from competition and the productivity growth declines. Growth has been declining for years and will continue to decline. Growth is less than the official statistics show. Growth is being sustained by unproductive investment, paid for by rapidly increasing debt. Political officials are being given final authority over business strategy in all corporations. China will not have a great financial crisis. But rising debt and the rising emphasis on subsidies and protections and consolidations for big state enterprises threaten China with a slide into Japanese-style stagnation.

That is what Xi Jinping was hired to prevent, but that is the likely outcome of his policies so far.

Finally, China faces a very fundamental political problem, one that is not much remarked in Western commentary. I began this paper by remarking on the courage displayed by Deng Xiaoping, Zhu Rongji and Jiang Zemin as they jeopardized the most powerful and pervasive levers of communist power by surrendering direct control of the farms and industries in a bet that improving the life of the Chinese people would also consolidate Party power. That is what a vanguard party does, and that is why society comes to admire it as a vanguard.

The counterparts today would be Party decisions to step back from direct control of big enterprises and from direct control of the courts, accepting a diminution of political control in return for the gratitude induced by improved livelihoods and a more secure sense of justice. But today the policy is to grasp every lever of power, however small. That policy transforms the Communist Party from a vanguard to an interest group. Consciousness of that transformational change, an emerging sense that the Party's claim to be a revolutionary vanguard is hollow, will proceed quite gradually but the legitimacy of the Party is undermined.

China is moving decisively away from the Asian miracle system. So far, its response to its crisis of success is contradictory and inauspicious. We cannot predict the exact outcome, but we can predict that the ongoing transformation of China's system will coalesce with the emergence of a new generation of leaders to create deep structural change. From a Western viewpoint China will either become much better or much worse. It cannot remain the same.

It is a terrible mistake for us to overreact to this new China based on an assumption that revived statist economic policies and its new authoritarianism will yield an economy that will continue to grow very fast for the indefinite future. It is a moral imperative for us to express horror at the degree of repression that is occurring, particularly in Xinjiang, but it is a mistake for us to lock ourselves into a cold war mentality that bolsters the hardliners in Beijing and attenuates ties that, when change comes, might encourage a more positive future.

**Alpine Macro**, founded in 2017, is an independent global investment research firm based in Montreal, Canada. We focus on the analysis of major macro economic forces and specialize in forecasting the direction of global financial markets, while providing actionable recommendations on investment strategy and asset allocation.

## Our Leadership

**Chen Zhao, Founding Partner and Chief Global Strategist** From 2015 to 2016, Chen was Co-Director of Macro Research at Brandywine Global Investment Management. Prior to Brandywine Global, Chen spent 23 years at BCA Research. As a Partner, Managing Editor and Chief Global Strategist, Chen developed and wrote BCA's China and Emerging Markets publications in the 1990s. Chen became the firm's Chief Global Strategist in the 2000s and was the author of BCA's flagship publication, Global Investment Strategy from 2005 to 2015. He holds an MA in economics from the Central University of Finance and Economics, was a visiting scholar at the University of Illinois at Urbana-Champaign and pursued post graduate studies with a PhD candidacy at McGill University.

**J. Anthony Boeckh, PhD, Founding Partner, CEO & Editor-In-Chief** Tony was previously Founder, Chairman, Chief Executive and Editor-In-Chief of Montreal-based BCA Research for 34 years. He authored The Great Reflation (Wiley) in 2010 and was publisher of, among others, the Bank Credit Analyst, a monthly big-picture analysis of the U.S. and global economies and financial markets. He is a founding trustee of the Fraser Institute in Vancouver, British Columbia — an economic "think tank" dedicated to free market principles. Tony has a PhD in Finance and Economics from the Wharton School, University of Pennsylvania, and a B.Com. from the University of Toronto.

**David Abramson, Partner and Senior Strategist** David was a Macro Strategist holding a variety of senior roles at BCA Research. Most recently, he was Chief U.S. Strategist and also Director of Research for the firm. During his tenure at BCA Research, David launched and managed the European Strategy and Commodity & Energy Strategy services. In addition, he was the Managing Editor for the Foreign Exchange Strategy and the China Investment Strategy services. He has taught international finance to MBAs at McGill University for 20 years, and is on the Client Committee of the Kenneth Woods Portfolio Management Program at Concordia University.

**Yan Wang, Partner and Chief Emerging Markets and China (EMC) Strategist** Prior to Alpine Macro, Yan spent 15 years at BCA Research, as Managing Editor and Chief Strategist for BCA's China Investment Strategy service, and played a major role in formulating BCA's view on the Greater China region and emerging Asia. Prior to joining BCA, he spent six years as an equity analyst in China and Hong Kong. Yan holds an MBA in Finance from McGill University, an M.A. in Economics from Tianjin Institute of Finance and a B.A. in Finance from Nankai University. He also holds the CFA designation.

**Harvinder Kalirai, Partner and Chief Fixed Income & Currency Strategist** Before joining Alpine Macro, Harvinder spent a decade with BCA Research, where he headed the firm's Foreign Exchange Strategy service from 2008 to 2016 and Daily Insights from 2016 to 2018. Prior to BCA, Harvinder was Head of Currency Management at CIBC Global Asset Management. Previously, he held various positions at State Street Global Markets, including Senior Macro Strategist (London), Head of Currency Research, Asia-Pacific (Sydney), and Senior FX Strategist (Boston). Harvinder began his career at the Bank of Canada in 1995 with an MA (Economics) and a BCom (Finance) from McGill University. He also holds the CFA designation.