JCAP

China Primary Insight

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Commentary

The Turn Against China

Was the world wrong to welcome China into global institutions?

- **Shifting views:** The tide of public and government opinion has turned sharply on China, and electorates are asking whether China's net effect on world commerce has been positive or negative. We suggest that China's financial metastasis has become ungovernable by international institutions. In that, China is not alone.
- **The limited value of old labels:** Whether economies are socialist or capitalist is almost irrelevant compared with the power of financialization of all major economies. Neither national governments nor multilateral institutions have the right toolkit to contain and tame internationalized capital.
- **China's innovativeness:** Perhaps the most impressive aspect of the Chinese economy is the speed with which it has adopted and adapted to new norms of financialization, and yet China's political system is even less equipped to cope with the power of capital than are the systems of the U.S. and Western Europe. So far, the oligarchs are calling the shots.

Anne Stevenson-Yang

There is a general narrative that U.S. policy toward China since Jimmy Carter has been driven by the dominant U.S. political vision—shared by Republicans and Democrats alike—of a liberal world order. This narrative says that free markets are inextricably linked with democratic political systems, that moves toward one lead inexorably toward the other, and that people of every nation seek and welcome those openings. Under this narrative framework, China's economic opening to the world should benefit both China and its foreign trade and investment partners by supporting development of a more stable nation with much greater buying power.

There is no denying that, since reforms gained traction in the mid 1980s, China has grown at an unanticipated if not totally unprecedented speed. But recently, the dominant emerging narrative outside China, once very positive about China's role in the global economy, has turned. For years In the wake of the Global Financial Crisis global media generally aligned with China's self-promotion as the consumer-led economy that would absorb excess global capacity and pull the world out of the depths of crisis. That did not happen. China continued to stand as the dragon head of an Asian export behemoth and rack up huge export surpluses with the world's leading mature economies. An ill-conceived globally promoted series of campaigns, illustrated best by Made in China 2025, raised alarms in North America and Western Europe for its explicit declaration of a devel-

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opment plan that was protectionist, isolationist, and oriented toward a return to a more centrally planned and domestically focused growth model. Complemented by a decade of easily visible but officially denied military expansion right up to the shores of neighboring countries in the East China Sea and South China Seas, China's growing might triggered a rising concern in the world.

In a slowly rotating perception of China and presentation in global media, we now see an unmanageably large Chinese economic threat and a "Thucydides Trap" warning of inevitable military confrontation between China and the United States. The Thucydides Trap argument holds that a waning power and a rising power cannot avoid military confrontation. It is flawed in many ways, not the least of which is that in the center ring of the global circus is not a military competition but an economic one. While close encounters In the blue waters and blue skies south of China are shiny objects for global media, the real issues are how China will handle the border around its own Mainland economy, the nature and impact of Chinese engagement with global financial systems, and control of off-Mainland financial assets by Chinese enterprises and political elites.

How it all happened

At the start of the process of Reform and Opening, China's government, in controlling every aspect of its then-small foreign-trade sector, suppressed the value of its currency and, in doing so, took jobs away from other countries that, flooded with cheap goods, had no choice but to outsource manufacturing. China effectively destroyed the economic value of manufacturing in mature economies. After a decade of growth based on cheap but efficient labor, China began aggregating financial resources from across its continent to invest with virtually no cost of capital in a frantic buildup of capital assets in the major coastal cities-- steel, petrochemical, automotive, energy. When the cheap capital was nearly exhausted, China's economy became a vast suction machine for intellectual assets and financial assets from around the world. Discarding the gray-blue world of its Mao era past, Chinese leaders successfully marketed a dream vision of Its growth potential and huge consuming population to direct investors and capital market investors from every corner of the globe.

At the same time, through government-financed tech acquisition, an ultra-tolerant hospitality for IP theft and product replication, economic espionage and direct theft, overseas acquisitions, and industrial policies designed to force foreign owners to transfer their IP, China has acquired and disseminated vast stores of knowledge in IT, medicine, manufacturing, agriculture, mining, energy—indeed, every aspect of the economy—so broadly as to maintain significant progress in import suppression through import substitution and commodify and cheapen the market value of the most rarefied and formerly valuable of technologies.

Failing to anticipate the potential for these deleterious effects of China's economic expansion on foreign economies, the business community in the United States and Europe has been the most enthusiastic supporter of China's participation in the world economy and the structures that govern it. That era is nicely summarized in the once common practice wherein delegations "to exchange ideas for mutual benefit and on terms of equality" were cheerfully paid for in both directions by the foreign party. While it is now common to accuse China of dishing out distorting subsidies across its economic landscape, we need to remember that foreign counterparties were once also writing subsidy checks.

Were China's economic partners wrong to support and enable China's growth? And is the United States with its bellicosity and broad effort to isolate China and reduce its economic strength, on the right track?

The win-win days

It is broadly true that freer markets are tied up with political liberalization. One had only to experience the nearly daily enhancements to personal freedom that accompanied the economic liberalizations of the 1980s-1990s in China. Increased productivity required labor mobility, and Chinese citizens had to be released from the modern serfdom that characterized the pre-1995 relationship for both the urban and rural workforce. Labor mobility entailed a reduction in surveillance, personal behavior portfolios, and freedom from the culture of immobility that formed the fabric of traditional and modern China's social control. Greater choice about what to manufacture, sell, and buy entailed greater freedom of speech and association. By the time of the 1989 Tiananmen uprising, the average Chinese person was not only more prosperous than in 1979 but far, far more free. Not coincidentally, public regard for liberal Western democracies was extremely high, and, consequently, China seemed like a more stable place post-reform than it had in the 1970s. Of course, as events transpired, the young people who occupied Beijing's central square had overestimated, as did much of the world, the degree of political freedom and political participation the Party leaders would tolerate.

The forceful clearing of Tiananmen marked a turn away from political liberalization, and the post Tiananmen compact offered lifestyle liberalization in exchange for political fealty, even as the economy drove more deeply into capitalism and corruption. Fearful of political fragmentation, China's political leaders centralized the structures of political control, bringing revenue collection, personnel decisions, surveillance and policing, and, critically, finance into central-government control.

Top-tier political processes remained as opaque as ever, and the business of running the country, including the deployment of massive financial assets, was no business of the common people. This prepared the machinery that would be deployed in the financialization of the economy and the creation of China's large oligarch network. While not as blunt as what evolved in Russia, it is likely just as bloated with assets and just as extensive in reach.

Creating the plutocracy

Zhu Rongji is the seminal figure in China's liberalization as well as its wholesale enrichment of the political class. As premier through the period of political re-centralization and the bank bailout of 1998-2002, Zhu almost singlehandedly dismantled the money-losing SOEs that were mostly owned by provincial governments and shored up the central-level SOEs that had monopolistic positions and therefore fat profits, especially the Party's core control players that included the big banks, energy companies, and telecom and IT companies.

As this was being accomplished, Zhu put his son in charge of China's first national investment bank, China International Capital Corporation (CICC), which invited foreign capital to finance, package, and resell Chinese assets and itself, of course, took major stakes in the companies to secure government interests. CICC was instructed by the world's biggest New York and London banks in the ways and means to extract money via overseas capital markets. Established as a near monopoly in China, CICC was a required partner in all Chinese overseas listings. Global financial players, from PEs to hedge funds, mutual funds, investment banks, and equity market regulators, could not get enough of the Chinese capital pie.

The post-1998 decade was one long Boxing Day, a festival of repackaging pokey old government institutions to look like exciting private corporations that would be reliable stewards of foreign capital. Never mind that even in the early days the use of IPO proceeds by such repackaged SOEs was frequently called out for being unreported, opaque, or downright inappropriate; the flows grew and grew unimpeded.

No one suspects Zhu of corrupt intention. The creation of CICC and the participation of Zhu Yunlai and other second-generation elites in all important Chinese IPOs was and is viewed not as a conflict but an alignment of commercial and political interests. It is only natural that the *"fu er dai"* ("wealthy second generation") has been personally rewarded for finding these win-win formulas. Remembering that what annoyed the British most about Chinese Customs, which they took over after the first Opium War in 1842, was that the lavish lifestyles of senior customs officials was supported by their direct extraction of an appropriate fraction of what they could collect in their official regulatory roles. In other words, Customs was a collection of specially licensed family businesses that only had to remit a specified fraction of their take funds to the center. In reform China, it is clear from the financial trajectories of Politburo members and their families that, in the eyes of the people, using political power to amass great wealth is not a violation of any principle; it is corrupt only if out of proportion.

China's dark assets overseas

In a classic Harvard study of Chinese business tenets done in the early days of reform, one of 10 key rules was to "keep your bags packed at all times." If nothing else, China's tumultuous history in the 20th century and the first decade of the 21st taught that fortunes on the Mainland can change quickly and unexpectedly. For anyone and everyone, there are strong incentives to move personal wealth outside the Mainland.

The financialization of the world's economy started slowly and has accelerated to a terrifying speed. Richard Nixon's break from the gold standard in 1974 is a useful starting point, in that it permitted the unrestrained expansion of fiat currencies. But it took the IT tools of the 1990s to accelerate money transfers to the speed of light. As financial assets flew around the world, the enabling institutions—principally, investment banks—found it in their interest to create new investable assets, and this was most easily done by making unlike things look alike to investors. Western investment banks, for example, devised a way for the post offices in every Chinese town, which also in the mid-1980s were the only locations from which to make phone calls, to get bundled into a corporate umbrella, described in a prospectus as a financial asset familiar to Western capital, and listed on overseas exchanges as China Telecom.

In those early years of Chinese IPOs, every company that went to market made enormous capital gains for the early investors who got access to pre-IPO shares, and China developed a class of politically connected millionaires and billionaires, the *fu er dai*. The gauntlet of permissions and approvals needed to do an overseas IPO enabled a whole string of political elites to stake out their own personal interests in the process. The dynamic was stepped up by an order of magnitude when the increased political centralization around Tiananmen and then around generously funded preparations for the 2008 Olympics expanded into the massive stimulus-propelled financial expansion of 2009 to the present. In the decade since the Global Financial Crisis, China not only permitted but encouraged an unbridled, unlicensed, and unsupervised diversification of financial services that created capital gains wealth for the top 10% of the urban population and unfathomable levels of wealth extraction by political elites.

The legerdemain that enabled the growth of financial assets and capital gains was simple. Create paper Renminbi wealth in the form of real estate and asset-light WMPs for the general public to own, protect them from market tests that would undermine their value claims, then extract Renminbi capital from these assets, convert It to USD, Euros, Yen, or GBP, and get it offshore. This was the widely trod pathway from political power to financial prosperity.

Just as liberalizing grassroots economic participation supports democracy, concentration of wealth creates and enhances oligarchic control, and oligarchy intensifies wealth concentration. The last decade in China has witnessed an unprecedented level of theft, as the government has grown addicted to creating new assets, pumping up their value, and then swapping them for more reliable possessions overseas. We needn't labor the point. Paths for capital flight are well understood, whether it is the murky private financial institutions like Wanda and Anbang that embarked on an erstwhile buying spree overseas, the serial money-raisers in overseas markets like Alibaba and Tencent, or the policy banks, which swap their Renminbi for dollars and have exported nearly $2 trn in government loans, $3 trn in official government reserves, and untold trillions in gray money. The ever-hyperbolic Miles Kwok, in a recent interview on Real Vision, called the Bank of China the world's biggest money-laundering institution, and serious people around the world find that credible.

Inside or out?

The United States, if not Europe, is now re-opening the debate that surrounded China's WTO accession in 2001: Is the West better off with China inside or outside the post-World War II political and economic structures? China very visibly impeded forward progress of the World Bank's Doha Round, which seriously eroded the credibility and power of the institution, and it has basically ignored many of its WTO commitments. Since China at least sometimes misuses the rulebooks under the UN, the WTO, the IMF, the World Bank, Interpol to achieve goals that those institutions were designed to avoid, should those institutions simply have shunned Chinese membership from the very start?

As we noted above, China's leaders have consistently resisted surrendering any political power to domestic institutions whose independent mandate would be to stabilize the making and implementation of policy designed for the public good and long-term stability. There are no powerful institutions in China that have independence from the Party and political guidance, including the big banks, the judiciary, and the military. As China's engagement with global institutions has expanded, that same mentality has resulted in a significant Chinese impact on institutions like the World Bank, WTO, and IMF. One means is to work on the inside but work for ulterior motives. That is the WTO story, and one reason China was not Invited to participate in the TPP negotiations was the WTO "sabotage" experience. The other is to create alternative institutions to weaken the rule and process consistency that existing institutions are meant to provide, AIIB, CIP (as an alternative to SWIFT), CNH abroad, and BRI are all examples worth study in this regard.

Capital and liberalism

Capitalism is too broad a term to describe the types of economies that have emerged in the early 21st century; "financialism" might be a more useful word to describe the sub category of oligarchic economies of which China is the most advanced example, with Russia and the United States being others. The "tell" is an irreversible concentration of wealth in a sizeable growing financial elite, whose families and fortunes enjoy the support of a political leader or a political party that enables them to behave free from the constraints of law and order that bind mere mortals. Very direct consequences of relentless concentration of wealth in a world of relatively free and available media exposure include widespread political instability, desperate uprisings, and mass migration by the disenfranchised.

The conundrum for the world economy is that the tools of financialization far outstrip political tools in speed, power, and sophistication. The technical tools relevant to the moving and storage of vast financial assets are not within the control of any sovereign regulator. And the roots of dissension, rebellion, and unrest are likewise outside the control of any single sovereign authority. If international institutions are weak, forces of chaos in the world grow in strength.

In a world of large, dark pools of wealth, sovereign controls for the purposes of stability, predictability, counter-terrorism, and even taxation are likewise weak and weakening. Many enterprises and even individual families have resources that exceed the resources of many of the world's nations. The weakening not only of large global financial institutions but basic protocols of global stability, like anti-laundering protocols, has also enabled the stewards of major economies to avoid accountability for actions that are grossly self-serving and even corrupt. Consider what would happen if the Chinese government declared that Alibaba would henceforth become a State-owned company and would cancel public shares. Applying legal tools like a class-action lawsuit in New York would be something like confronting a tank with karate moves. Similarly, there is very little the U.S. government can do about Apple's choice of tax havens or manufacturing locations. And one can only speculate about the size of fortunes held in the world's tax havens by the political elites of many of the world's bigger economies, fortunes beyond the reach of any sovereign authority.

China is not the only player in this global process of financialism, but it is the newest player, and it playing at a scale that absolutely invites an examination with hindsight, into the role U.S. banks and other multinational corporations have played in Its growth. More than that, China's big role in global asset control demands some level of admiration, for its swift disposal of the shackles of Mao-era anti-capitalism ideology and the great innovation and agility China has shown in mastering the rules of the new global money game.

Data Matters

The Commodities Conundrum

Steel production is up, iron ore consumption is down, and commodity prices are high? That is what the data says, but it is not physically possible. Crude steel production is up 6.1%, pig iron (made from iron ore) is up 4.5%, iron ore imports are down 2%, and domestic production of iron ore is down YTD Sept.

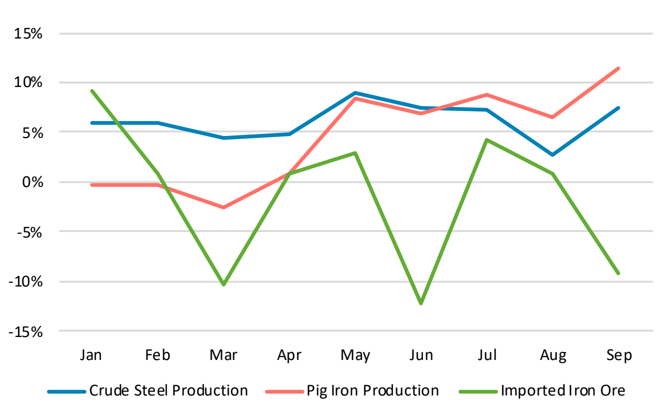
The steel industry this year has been glum about market demand. The industry says that demand from property construction is weak, and they are not seeing a lot of new infrastructure projects.

Clearly steel production statistics are overstated. We suspect this is due to statistical problems caused by the significant renationalization of the steel sector that has occurred de facto, as private capacity has been eliminated.

We estimate that steel production is likely down by around 1% this year.

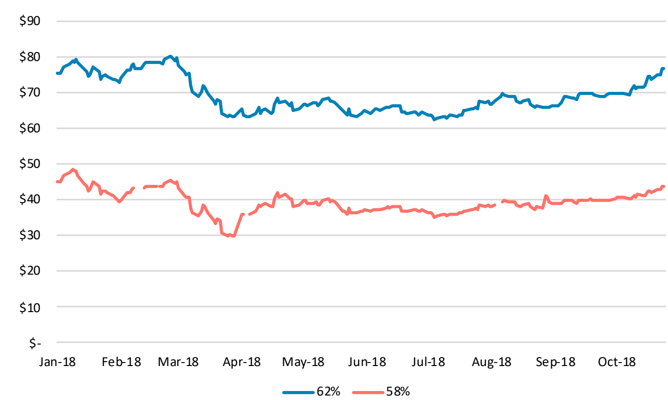
The recent rise in commodity prices is being caused by a demand surge from stimulus projects and a tightening of supply of iron ore. There is also an expectation that winter production curbs will be lighter than last year, driving some speculation in stronger iron ore demand. You can see in the chart below an upturn in steel production and downturn in supply of iron ore. We believe the direction, the upturn in production, is happening.

Chart 1. Crude Steel and Pig Iron Output vs Iron Ore Imports Monthly YoY



Source: NBS

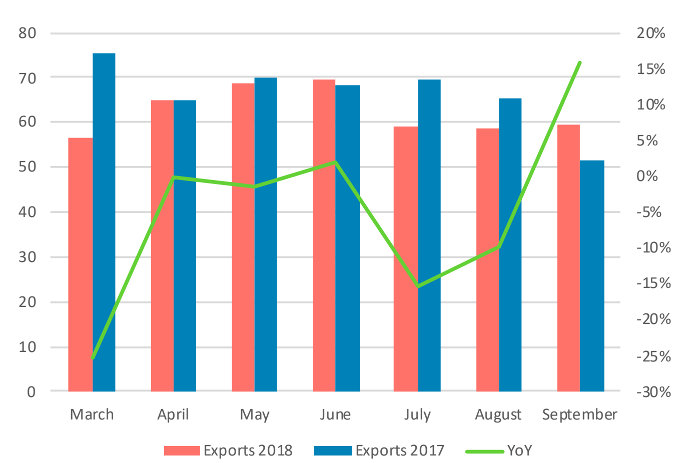
Chart 2. Iron Ore Prices (58% and 62% Fe, USD)



Source: NBS

Exports are clearly in decline, down 10% YTD after falling sharply last year. China steel exports are returning to longterm trend of around 50 MMT per year.

Chart 3. Exports (mln ton and YoY)



Source: NBS

UPCOMING J CAP EVENTS

November Trips

Banking, Insurance, & Regulation

Shanghai

We will meet with bankers, insurance executives, & policy experts to understand the current status of liquidity in the financial system and expectations for government stimulus for the beginning of 2019.

- **Led by Ada Wang, November 20-21**

December Trips

Payments in India: Paytm, Ebix, Wirecard, Western Union, Moneygram

Mumbai, Delhi, Ahmedabad, Jaipur

We will see companies working to digitize payments in India and understand the economics of the market.

- **Led by Pranav Bhavsar, December 3-6**

Steel: Is demand really up?

Shenyang, Tianjin, Guiyang, Chongqing

Steel data is not matching what we are hearing from the market. We would like to visit fiscally challenged provinces like Tianjin and Liaoning to see if infrastructure is still being used to stimulate. Then we will visit Guiyang in Guizhou, which we considered a basket case, and is now being touted as one of the fastest growing provinces due to all the infrastructure that is being built. Lastly we will visit Chongqing, China's largest city to gauge change in manufacturing and infrastructure.

We will visit LGFV, banks, trusts, steel mills and steel traders on this trip.

- **Led by Tim Murray, December 3-6**

January Trips

Electric Vehicles in China: Nio, Tesla, BMW, Mercedes, etc..

Shanghai, Ningbo, Shenzhen

We will see supply chain companies, EV manufacturers, and policy experts in order to develop a better understanding of the supply/demand characteristics in the Chinese electric vehicle marketplace.

- **Led by Anne Stevenson-Yang, January, 21-23**

Please email Brian Emanuelson (brian@jcapitalresearch.com) if you'd like to see a preliminary agenda for any of the listed trips or share with us any trip bespoke ideas you might be thinking about.

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