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RESEARCH ARTICLE

China's Financial Crisis in the Making –Soft Budget Constraint, Overdraft and the Missing Credible Commitment

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Abstract Multiple risks have been building up in the Chinese economy during the past decade, exposing it to a possible financial crisis of increasing likelihood. Based upon the inductive reasoning from the conventional key indicators discussed by economists, this paper also adds a deductive reasoning by examining the incentive structure for key players in the Chinese political economy to gauge the risk of a financial crisis in China. It highlights the political and structural factors that are responsible for soft budget constraint, moral hazard from major players, and the lack of institutional foundation for sovereign credibility. It argues that recent policies have not only failed to address these issues but instead have further damaged the credible commitment of the state to the market economy and ratcheted up the course of a great meltdown. This paper calls for a fundamental institutional change in China's political economy in order to prevent perversion in the state-market interaction from spawning both political and economic crises.

Keywords Financial Crisis · China's Economy · Xi Jinping · Political Legitimacy · Institutional Design

Introduction

For the past two decades, both the 1997 Asian Financial Crisis (AFC) and the 2008 Great Financial Crisis (GFC) offered historical opportunities for China to reclaim its status as a superpower. Among some politicians and researchers, a popular belief has

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emerged: China's exemption from these two crises demonstrates its economic strength and superior capacity to deal with financial crisis. Lin Yifu [53: 257], a former chief economist at the World Bank, claimed late in 2012 that China would have the potential to grow its economy at 8% until 2030 (therefore the moniker "Ever Increasing Lin") [63: 341]. The late Nobel Laureate economist Robert Fogel [25] also optimistically forecasted China's "economic hegemony": "In 2040, the Chinese economy will reach $123 trillion, or nearly three times the economic output of the entire globe in 2000. China's per capita income will hit $85,000… China's share of global GDP—40%—will dwarf that of the United States (14%) and the European Union (5%) 30 years from now." Such a solid economic performance (also see: [33–35: 17]), in the past and also in the foreseeable future, vindicates the highly centralized Chinese authoritarian system as an institutional advantage to promote and develop the economy; in return, rapid economic growth offers performance-based legitimacy to it [18, 59, 80, 108, 71]. The China model has been promoted almost as a "perpetual motion machine" that has been "insulated" or "decoupled" from financial crisis [48: 5, 107].

But, almost a decade after the GFC, is China still vulnerable to financial crisis? Has China really successfully immunized itself from financial crisis? Based upon the expanding literature on financial crisis and China's economy, I would like to identify some major culprits nudging China closer and closer to a financial crisis. In addition to identifying multiple structural, institutional, and policy causes, I will debunk a major argument that the Chinese state seems to be able to defuse any financial crisis single-handedly as *deux ex machina*. To highlight an interactive causal relationship of political factor and financial crisis, I will conclude that the structural design of the current regime in China as well as some recent political policies have worked to both insulate China from an exogenous financial crisis and to generate an endogenous one. To sharpen my argument, I will highlight the central issue of the state as the last guarantor of the systemic stability and the credibility of its commitment. If all other major actors and players in the political and economic system have been "passing the buck" due to intrinsic and chronic opportunism and moral hazard nurtured and rewarded by the unique Chinese system, if the accumulation of risks has been built upon the sovereign system, even a most omnipotent and omnipresent state such as China can face a crisis of overdraft due to its hard budget constraint because the national balance sheet is not endowed with infinite assets and credits. The shortfall of Chinese state's assets in dealing with daunting liabilities might weaken people's confidence in the state and evolve into a major causal factor in the increasing probability of a coming financial crisis in China.

Bruce Bueno de Mesquita is a leading scholar in making bold analysis in predicting and engineering the future in international political economy. BBM (as his students refer him) claims about his "predictioneering": "[I]t is possible for us to anticipate actions, to predict the future, and by looking for ways to change incentives, to engineer the future across a stunning range of considerations that involve human decision making" [6: xiv]. To be able to do so with accuracy, he advises "predictioneers" to pay attention to three major tasks: to get the logic right, to take basic information, and to be able to take exogenous shock into consideration [6: xix, 124]. If we take China's economic development as a cooperative game, we can realize that the adjustments of incentive structure under Deng Xiaoping's "Reform and Opening-up" contributed to "China's miracle". However, after China's entry into the twenty-first century, especially

under the 5 years of Xi Jinping's reign, the Chinese state as the leading player in a cooperative game of China's development has become more predatory, causing the distortion of the incentive structure for other major players (mainly include the Chinese consumers, SOEs, private entrepreneurs, foreign capital, and local governments). I will demonstrate later that in maintaining its power the Chinese state had been benefiting from a synergy between economic development and political stability. However, for the past 5 years, it has given way to a new political economy that has been increasingly locked into a "prisoners' dilemma" and hence awaiting a breakdown in cooperation.

China and Financial Crisis: a Literature Review

In addition to the insulation (or "decoupling") argument, there has been another line of reasoning regarding the relationship between China and the GFC, which outlines the Chinese economy's dependence upon and sensitivity to the global environment. The image of China as an "interdependent stakeholder" and "interactive participant" denotes that the increasing interdependence of its economy, especially during the last two decades of globalization, has made China both an equal contributor to and taker of global financial crisis, for better or for worse [107]. For example, the former U.S. Federal Reserve chairman Bernanke [4: 101] believed that the artificially low Chinese currency relative to U.S. dollar and the "global savings glut" created easy access to credit and a housing bubble in the West. China was part of the cause for the financial crisis through distorting global price with an artificially low wage and exchange rate, flooding the world with cheap credit, and creating a huge speculation of hot money due to the high interest rate in China.

As the second largest economy with many protective devices (such as capital control, huge foreign currency reserve and dominant SOEs), China has its own internal logic and evolved with a different economic cycle [105]. Early in 2007, mainly due to internal development, plus a few external factors, the Chinese economy encountered difficulties [46]. After the full-blown financial crisis broke out, it hit China hard, especially on exporting industries in comparison to the financial industry, and caused an economic crisis there [14, 77]. As factories closed down, unemployment soared, migrant workers returned to the countryside, and social and political crises occurred with increasing frequency. The Chinese government pursued a unique set of stimulus policies, in which an astronomical infusion of stimulus money further distorted the economy. Instead of deflecting the crisis, the Chinese government missed a valuable opportunity to adjust its macro-economic disequilibria and increased the potential of a banking and financial crisis in China [14, 50: 3, 55, 86, 110]. While many Western countries (in particular the U.S.) had come out of the crisis, China witnessed the increasing probability of exposure to a banking crisis. Most likely to be triggered by the debt crisis, this banking crisis can evolve into a systemic financial crisis and then an economic crisis in the short term [46, 50, 55, 107].

Scholars have raised one important question: Considering chronic systemic risks in the Chinese banking sector, why hasn't a typical banking crisis or financial crisis struck China for the past three decades or so? [57: 135]. To answer this question warrants a clear definition on financial crisis. According to Kindleberger and Aliber [41: 110]: "A crash is a collapse of the prices of assets, or perhaps the failure of an important firm or

bank. A panic, 'a sudden fright without cause'… may occur in assets markets or involve a rush from less liquid securities to money or government securities—in the belief that governments do not go bankrupt because they can always print more money. A financial crisis may involve one or both and in either order." A financial crisis can be of one specific type of crisis, such as an asset bubble, inflation crisis, debt crisis, foreign exchange crisis, or a banking crisis; they can occur as a twin crisis (for example, debt crisis and banking crisis tend to come together), or "fall in clusters" that can cause an economic crisis [57: 372, 70: 4]. Seen in this way, China can be said to have a long record of financial crises in history [57, 70]. Financial crises played an important role in toppling both the Qing dynasty and the Republic of China on the mainland [49, 111: vol. 1 and 2]. Since the Reform and Opening-up, hyperinflation (1988–1989) and deflation (1998), shortage and later the excessive accumulation of foreign exchange, debt crisis (the "triangular debts" in the early 1990s), bank runs (1988), banking insolvency (such as GITIC collapse in 1998), money shortage (2013), and the stock market crash (2008 and 2015) all have troubled the Chinese economy [79, 55: 216 57, 60, 85, 86, 81]. From 1997 to 2005, China's banking sector experienced systemic risks; as a result, many banks and financial institutions were shut down, and the central government spent trillions of dollars in several efforts to remove toxic assets from state-owned banks, which to some extent inspired Gordon Chang [9]'s "coming collapse of China" thesis. From a Western, market economy point of view, China has already weathered multiple financial crises. But we have to acknowledge, the Chinese government has thus far stemmed a festering crisis from exploding into a full blowout. The question is: Judging by 2017, has China successfully "warded off" a potential crisis [81] or just "decided to push the matter off into the future and onto some other politician's agenda"? [86: 57].

A variety of bold predictions have been made. For example, Chang [9] wrote on "China's run to ruin" by declaring: "China's banks are doomed." Gorrie [28: 269] made a more recent prediction, "[T]he time of China's collapse is now on the event horizon, and not below it." Thus, an absence of an anticipated and maybe overdue crisis has been a conspicuous conundrum. Will it be possible for such a comprehensive super-crisis happen to China? Since we are speculating on a non-event or an "unforeseen event" [6: 125], judged by empirical research, we have already encountered a fundamental question: How can we understand the "known unknown"? Bueno de Mesquita [6: 125] is not shy of saying, "Of course, the whole point of prediction is to forecast the unforeseen." (42, 24) are enlightening here with their statement: "[E]conomists maintain that there are patterns in the data and particular events are likely to induce similar response."

We can argue that the lessons from global financial crises are applicable and enlightening for our understanding and for predicting a possible financial crisis in China. First, in the long history of financial crises (or "eight centuries of financial folly" in Reinhart and Rogoff's words), non-market economies, communist countries and authoritarian capitalist countries have not been immune from the plague of financial crisis. As a matter of historical fact, the undoing of Communism started in Poland partially due to the 1982 Debt Crisis, and the dissolution of USSR could also be attributed to its financial failure [103]. Secondly, for a few decades, the developmental states in East Asia became so formidable in their rising status that they were dubbed as "miracles." However, the burst of the Japanese bubble economy in 1990 and the 1997

AFC proved that the so-called Asian miracles were mirages that could be crippled by financial troubles [43]. While Western scholars such as Hyman Minsky [58] and Susan Strange [82, 83] have argued that the unstable nature of capitalism is more defined by financial system so that financial crisis is almost inevitable [93], the current capitalism is haunted by "the curse of crash" [75], and many Chinese economists and financiers have "cried wolf" [14, 46, 50, 55, 100, 109: 165]. The Chinese economist Liu and his associates [57: 373, 2] in a research team on financial risks in China have also observed such "a curse of financial crisis" and unequivocally argued in 2012: "Will financial crisis break out in China? The answer is positive. On its road of rapid rise, China has to face financial crisis as an inevitable event of high probability."

Thanks to the explosion of literature on financial crises in the aftermath of the 2008 GFC, numerous models have been offered to monitor micro- and macro-indices in banks, corporate governance, economic trends, and socio-political developments to identify convergence to the patterns of known financial crises, such as IMF's Early Warning Systems (EWSs). This huge body of literature [92] offers a theoretical, historical and comparative foundation for us to examine the ongoing drama of the Chinese political economy. Economists have suggested taking a closer look at the eight most valid indicators for predicting financial crisis: M2 ratio, domestic credit/GDP ratio, stock value, GDP growth, export price, external debt/external assets ratio, M2/GDP, and the growth rate of domestic credit [57: 405]. Former IMF advisor, Peter Isard [37: 151], identified seven "sources of vulnerability": pegged exchange rate, weak banking/ financial sector, high level of short-term foreign currency debt, large fiscal deficits, high short-term government debt, large current account deficit, and poor general governance. In a comprehensive examination of the GFS, *The Financial Crisis Inquiry Report* [23] highlights that against the setting featured with shadow banking, securitization, proliferation of derivatives, lack of regulation or deregulation and subprime lending, a country (the American experiences can be enlightening for China) witnessed credit expansion, excessive financialization of the economy, proliferation of collateralized debts based upon land/realty, creation of asset bubbles, and explosion of financial fraud, greed and crime. All in all, they set the stage for and produced financial crisis.

In this article, I will not emulate Chang and Gorrie by determining both the validity and timing of such a crisis, in which the overdue timing has already weakened Chang's strong message. Instead, by following the basic economic logic and economic data in the past decade I will present a possible causal chain of crises in the coming years in China without specifying the trigger and timing of such a catastrophic event. As Bueno de Mesquita [6: 82] says "the beginning, not the end, is where the explanation lies."

The Multiple Predicaments of China's Development

For almost four decades, the Chinese export-led development strategy of neo-mercantilism has worked for the state's empire-building through expanding global market share without proportionally improving people's welfare at home; and therefore, it is unsustainable [73]. The transferred value through artificially low commodity price in Chinese markets distorted the labor price mechanism and caused the shrinking of local manufacturing activities and deindustrialization due to outsourcing in the West. In the meantime, the Chinese government has preferred both economic policy autonomy

and fixed exchange rate to free capital flow. Due to the constraint of the Mundell Trilemma (regarding autonomy, fixed exchange rate and free flow of capital, only two of the three goals can be achieved simultaneously), the Chinese government has aggressively accumulated a huge amount of foreign currency reserve, especially after drawing a lesson from the 1997 AFC, to safeguard its exchange rate stability and policy autonomy [87, 88]. But one unintended consequence is that the cheap credit and global savings glut encouraged consumers in the West to increase their leverage ratio to borrow and to consume [4: 92]. When the economy became sluggish in the West, a debt crisis started among Western consumers and dragged financial institutions into it. A worldwide financial crisis broke out. In 2009, affected by American financial crisis, 82 countries (accounting for 42% of the world total) succumbed to economic crises [55: 160]. China's formidable manufacturing and exporting machine was put to the test.

In the official parlance of the Chinese government, "multiple structural contradictions" have accumulated and been festering for a while in Chinese economy and the year 2007 was a turning-point. During that year, China had experienced an average growth rate of 9.75% for the past 30 years (1978–2007), with both its GDP and total volume of trade rank fourth in the world (changed from the tenth and twenty-seventh places respectively) [113: 6]. But, with the 2007 financial crisis, China, "the workshop of the world," witnessed a setback in its exports and a wave of factory bankruptcies [14]. Since joining the WTO, China had enjoyed spectacular growth in exports (the growth rates changed from 6.7% in 2001 to 22.4% in 2002, 34.7% in 2003, 35.3% in 2004, 27.6% in 2005, 23.9% in 2006, and 20.7% in 2007). This dropped to 7.2% in 2008 and −18.3% in 2009 [14, 27: Vol. 1, 1]. The Total Factor Productivity (TFP) started to decline (3.72% for 1979–2007 and 2.21% for 2008–2012) [94: VII]. The consumption rate declined to 48.8% (from 61.4% in 2001); the residents' consumption rate declined even further to 34% (from above 60% in the 1980s). In contrast, the investment rate changed from 36.5% in 2001 to 42.3% in 2007. The Chinese economic "troika," which had been pulled by investment, consumption, and export for long, was stalled, despite increasing investment. From then on, the Chinese annual GDP growth rate has been on the skid: 9.6% in 2008, 9.2% in 2009, 10.6% in 2010 (thanks to huge infusion of stimulus cash), 9.5% in 2011, 7.8% in 2012, 7.7% in 2013, 7.3% in 2014, 6.9% in 2015, 6.7% in 2016, and 6.5% in 2017 and based upon the World Bank prediction, around 6% in the coming years (World Bank data). The performances in 2011–13 were about one percentage point lower than the realistic predictions from IMF, World Bank and Asian Development Bank, indicating a more serious and long-term downturn [40: 41–42].

In his *Report on the Work of Government*, premier Li Keqiang admitted in 2016, "While dealing with the slowdown in economic growth, making difficult structural adjustments, and absorbing the effects of previous economic stimulus policies, China was also confronting with many difficult problems and choices in the running of the economy, and this called for effective responses based on the need both to combine long-term and short-term considerations and to seek benefit and avoid harm" [72: 4–5]. Premier Li emphasized the "overlapping of three junctures" ("三期叠加") which officially acknowledged the multiple predicaments confronting China. Firstly, the demographic window of opportunity for China, which existed from 1990 to 2015, has been disappearing, 5 and 25 years respectively before Brazil and India meet their closures. Even worse, in the year 2030, China's median age (43) will be higher than those of the U.K. (42) and the U.S. (39) [61: 45]. Based upon the World Bank data, the employment to

population ratio (age group 15–64) declined from 75.735% in 1992 to 69.602% in 2007 and then to 67.51% in 2016 (World Bank). Since China's multi-tier retirement ages start as early as 50 (for female worker) and 60 (for male employee), the percentage of employment over the total population is much lower in the Chinese official statistics, for example, from 42.1% in 1979 to 58.3% in 2007, 58.64% in 2008 and 58.73% in 2009 and finally to 56.43% in 2016 [19]. As the "demographic dividend" disappeared, some scholars argue that China has passed the Lewis Turning Point, which means the exhaustion of surplus labor from the countryside and also indicates the coming of more labor protests and social conflicts [32, 43: 276, 55: 210, 89, 90].

Secondly, the slowdown of export, the decline of economic growth rate, plus the Lewis Turning Point forced policymakers and scholars to ask whether China has been entering the middle-income trap. A major concern for Chinese economists is the unequal demand structure in which the government and enterprises have taken a lion's share of the national income. For example, China's government income ratio increased from 24.25% in 1995 to 30.48% in 2010. In the meantime that ratio for enterprises rose from 9.88 to 15.82%, at the cost of residents' consumption. Another concern is income polarization: income for the highest-income group (top 20%) increased by 264.3% and for the low-income group by 142.8% between 2000 and 2009. The proportion of national income earned by the low-income group dropped from 11.11 to 8.78% [40: 64]. Its Gini index, another indicator for social inequality, increased from 0.2 in the 1980s to 0.5 (possibly already above 0.6 in some calculations) in the twenty-first century [35: 98–99, 99: 38–41]. These developments made it difficult for China's economy to shift from an export-led model to a new economy driven more by domestic consumption. The Chinese Minister of Finance, Lou Jiwei, in 2015 acknowledged that China had a "more than 50% chance to have already fallen into the middle income trap." Since the ceiling for middle income trap was defined as PPP$7500 in 2011 when China had surpassed PPP$10,000 (in 2016, it reached PPP$14,000; the Chinese government figure for per capita GDP was $8000 in 2015) and became an "upper-middle-income country," some economists have argued that "a high income wall" might block China from entering the stable and sustainable growth of a developed country [40: 3–32, 84: 305–343]. Such a protracted downturn and possible crisis are not good news for ordinary people, but they are especially bad for the Chinese government and business (for example, the growth rate of government revenue changed from 31.4 to −8.3% between 2008 and 2009, while the business profits turned from 22.4 to −37.1%, much more dramatic than the change in GDP growth rate) [40: 26].

Thirdly, structural adjustments in economy have encountered crosscutting challenges. Although China had reached "the factory of the world" status in the first decade of this century, its factories tended to occupy the lower end of the value chain, often struggling for a profit rate just above the breakeven point (for example, for an Apple iPhone at retail price value of $500, only $6.50 of the $179 production cost was captured by Foxconn, a Taiwanese manufacturing company in China, and the share captured by Chinese domestic companies was even less) [20: 254–255, 35: 128, 46]. Upgrading to the higher value-adding sector in the production chain, or transforming from "Made in China" to "Created in China" has become urgently necessary for Chinese assembly line workers [107: 5]. Before the GFC, Chinese leader Xi Jinping proposed his "theory of two birds" (腾笼换鸟 "changing the cage for

new bird" and 凤凰涅磐 "the reborn phoenix from ashes") which was applied to Guangdong by its leaders Wang Yang and Hu Chunhua consecutively [95: 434]. However, as twenty-million migrant workers lost their jobs and returned to the countryside in the crisis, the global production chains had been restructured, on the one hand, to expand in countries with lower labor costs such as Vietnam, India, and Indonesia [35: 125]; and on the other hand, to move back ("near-shoring" or "reshoring") to the West in response to "re-industrialization plans" in the U.S., Japan and EU countries [20: 153]. As labor cost, land price, and raw material price soared, China stopped being the darling of FDIs. To some extent, China's urbanization is relevant here. Chinese leaders and economists have expected urbanization to offer new dynamics to China's growth. However, China's "half-way urbanization" (or "ersatz urbanization") revealed that the official urbanization rate (e.g., 53.7% in 2013) differs from the urban household registration rate (e.g., 34% in 2013) due to the strict "Hukou" system [40: 24, 90: 10]. In other words, migrant workers and their family members have been denied access to education, health, housing, and other services in the city based upon household registration status. The migrant workers are exploited at a young age in cities and then pushed back to the countryside when they are old. This makes actual composition of high percentage of rural residents different from an untapped rural population and less helpful for maintaining a high economic growth (unlike the view argued by Huang [35: 89]). Under such a dual social structure based upon the urban-rural divide, not only has China lost the opportunity to upgrade the human capital of migrant workers and their children, but also wasted human resources and the possible stimulus for a sustainable growth [32, 89].

Any single one of the above-discussed challenges can be overwhelming for any nation. Even worse, these challenges are intertwined and crosscutting so that any solution has to be a non-optimal trade-off in a choice-set of bad and worse [100]. If we consider that all these problems have to be compounded ("The whole is greater than the sum of its parts") and amplified in the context of the most populous nation, the second largest economy and the third largest territory on the earth, here, the theory of complex system (Gorrie Chap 8), the fallacy of the heap [35: 80], and the theory of the butterfly effect are helpful for us to appreciate the enormity of the problem. But the worst part comes from the top-down solution that may, unintentionally, aggravate these problems.

The Upper Hand: the Invisible or the Visible One?

As Charles Lindblom [54: 65] pointed out four decades ago, the authority systems of political economy are "strong thumbs, no fingers." During the initial jumpstart stage of industrialization for a latecomer country, the state can act like a strong thumb to transform an underdeveloped society. However, to manage well both quantity and price, market is superior to the state. As the economy matures into a sophisticated one, the "thumb" increasingly becomes clumsy and needs to defer to the more flexible fingers, namely the markets, to detect subtle signals of supply and demand as well as respond to the delicate price mechanism. Many Chinese economists have realized that China needs such a timely adjustment [10–12, 14, 94]. In a 2014 speech called "The 'invisible hand' and the 'visible hand,'" Xi Jinping himself had seemed to agree:

> We should let the market play the decisive role in allocating resources, while allowing the government to better perform its functions. This is a theoretical and practical issue of great importance. A correct and precise understanding of this issue is very important to further the reform and promote the sound and orderly development of the socialist market economy. We should make good use of the roles of both the market, the "invisible" hand, and the government, the "visible" hand. The market and the government should complement and coordinate with each other to promote sustained and sound social and economic development. [95: 128]

In the same speech, Xi [95: 130] continued to credit the Party for their achievements over the last three decades by saying: "These successes are attributable to the fact that we have firmly upheld the Party's leadership, and given full play to the roles of Party organizations at all levels and of all Party members. In China, the Party's strong leadership is the basic guarantee for the government to play its due role. While comprehensively continuing the reform, we should uphold and develop our political advantages, and use them to guide and push forward the reform." Understandably, Xi and his followers continued to rely upon the strong thumb of the Party-state with belief in its authoritarian political system to offer political and social stability for economic development [40: 21]. Following this governmentality (both a tendency and mentality to governmentalize economy in Foucault's sense), the natural reaction to the mounting challenges has been to strengthen and improve the capacity and governance of the Party-state [95: 116]. Nevertheless, such a perspective of "seeing like the state" [78] or a grandiose "Utopian social engineering" [68] may be a "doubling-down" strategy in adding to the old chronic structural distortion that led China to the present dilemma.

As a socialist economy or a "sham market economy" that China is ("socialist market economy with Chinese characteristics"), there is a damaging effect of state paternalism (or a "paternalistic capitalism") on the Chinese economy [44: 257]. Hungarian economist Janos Kornai [44: 257] explained that the total sum of financial resources available to a household or a firm is its budget constraint. Under a socialist system, if a firm has expenditures exceeding earnings and runs out of its financial resources, it can face two different situations: If the firm is left to its own resources and persistent losses will mean eventual failure, its budget constraint is *hard*. "On the other hand, some superior body may rush to its aid and bail it out financially. In that case, the budget constraint is *soft*: there is no real curb on the firm's spending. It will survive even if spending exceeds income plus initial capital over a long period." Although China's initial reform in the early 1980s emulated Hungary and Kornai's ideas attracted attention of the Chinese [13: 347–354, 44: 322–325, 97: 42–49], as a consequence of which, bankruptcy was introduced to Chinese enterprises and a provisional bankruptcy law ratified [29: 116–117]. However, privatization referring to the "selling off of state assets to non-state owners" did not happen in China [85: 13]. With absence of massive privatization and clear ownership structure, the hard budget constraint has not been rigorously applied to the central state-owned enterprises (SOEs), banks and financial trust companies. As pointed out by Kornai [44: 262], "the ill effects of soft budget constraint on productivity, competitiveness, and incentives" are still visible in the Chinese economy, especially among the SOEs and local governments.

Under a regime of financial repression, banks are mostly owned by the Chinese state, interest rate is controlled, and foreign exchange is under central control. The

SOEs have monopolized most important industries and national resources. Since the Chinese official interest rate for depositors has been artificially low (the real interest rate of saving often dropped to negative, for example, in seven out of the 18 years from 1978 to 1996 [39: 193–196, 106: 143], the SOEs have privileged access to banks' cheap loans, from which the non-state sectors edged out. Furthermore, local governments also favor the SOEs under their jurisdiction in order to boost their GDP growth and increase their chance for promotion ("the two impetuses"). They set up thousands of local government financial vehicles (LGFVs) for issuing bonds to raise funds for local development, especially in long-term infrastructure projects. In the Wuhu model (later evolved into the Chongqing model), the China Development Bank (CDB) acted on behalf of the state to work with local governments and enterprises in providing huge credit and investment [76]. Thus, in this kind of "new Great Leap Forward Economy" [86: 69], three major sources of moral hazard, risks, and liabilities were created for Chinese economy: SOEs, banks, and local governments. None of them faces the discipline of hard budget constraint. If an SOE becomes a "zombie company," for the sake of preserving employment and therefore political stability, banks come to its rescue with instruction or pressure from the local governments. LGFVs raising funds from depositors (ordinary citizens) for the local government, therefore, acquire an implicit guarantee from the government. Since China is a unitary Party-state, "owner, manager, and regulator are all the same—the Party" (81, 159), an implicit government guarantee often translates into an explicit guarantee from the central government. As SOEs, banks and local governments keep passing the buck, the central bank (PBOC) has to step in to take the burden and inject capital by writing off toxic loans from their balance sheets. In order to do so, the Ministry of Finance (MOF) and the central government have to turn the bad debts into budget expenditures. If the central government does not have enough financial resources, it increases debts through bonds or runs budget deficits and prints more currency [28, 47, 55, 81].

To illustrate this logic, we can look at the real political economy in China. The beginning of the current system can be traced back to the 1990s, under then Premier Zhu Rongji, who introduced a variety of reforms relating to SOEs, banks, and the tax system. The national tax system was restructured to strengthen the extractive capacity of the central state. *The Central Bank Law* was adopted and the PBOC (People's Bank of China) was designated as the central bank. Under the new policy of "grasping the big and letting go of the small," the state continued to control 1000 large SOEs and introduced "share system" and "corporatization" to the rest of the more than ten thousand medium and small SOEs [67: 514]. More and more Chinese enterprises were listed on the two domestic stock markets (Shanghai and Shenzhen) and some were internationalized on the Hong Kong Stock Exchange, NASDAQ, and the New York Stock Exchange. In 1998, the central government issued special bonds of RMB (¥ thereafter) 270 billion for beefing up the bank capital of commercial banks. In 1999, the central government established four financial asset management companies to take away ¥1.4 trillion of toxic assets from four commercial banks respectively and turned them into bonds with the MOF's support. In 2004, the Huijin Corporation, a sovereign bank holding company under the MOF, infused US$22.5 billion each to the Bank of China and China Construction Bank [39: 168–169, 60: 462–464].

With regard to troubled local governments, the central government also uses fiscal transfer payment to support and bail out them. For example, from 1994 to 2004, due to

budgetary crises of local governments under the new tax structure, the central government transferred a total incremental quantity of ¥1.9575 trillion to local governments. In 2004, Premier Wen Jiabao allocated an extra ¥15 billion to help alleviate the fiscal crisis of local governments at the county/township levels [3: 20–21]. In the middle of 2013, the total debts of local governments reached ¥17.9 trillion (direct debt of 10.9 trillion, plus 7 trillion by LGFVs that local governments supported with implicit guarantee). At the end of 2012, the ratio of total debts over GDP reached 30.6%, and the ratio of total debts over the local government revenue reached 112.8%. The alarming part was that after an increase of 61.92% in 2009, within two and a half years from the end of 2010 to June of 2013, the total debts of local governments increased by ¥7.2 trillion (67.3%). Facing the deteriorating debt crisis of local governments, in March and June of 2015, the MOF had to issue bonds twice with ¥1 trillion each to change the short-term debts into longer term bonds [51: 54–55, 66]. That year alone the Central Government issued local government bonds of ¥3.7 trillion to replace the outstanding debts of local governments. In 2016, the government ran a deficit of ¥2.18 trillion (the deficit to GDP ratio rose to 3%). Special bonds for local governments added another ¥400 billion for the debt-converting-to-bonds scheme [72: 6, 39]. Despite the central state's herculean paternalistic rescue, the absolute majority of provincial-level units are still wallowing in the swamp of mounting debt. In August, 2017 a group of investigative business reporters in China reviewed the balance sheets from all provincial units and provided a panoramic sketch of the budget deficits and fiscal transfer payment from the Center. They found that among 31 provincial units in total, six plus Shenzhen (a Special Economic Zone listed as a municipality directly under the central government) contributed ¥3.0373 trillion to the central government in 2016, while the other 25 ran budget deficit with a total number of ¥4.8 trillion. Comparing this income and expense gap to the one in 2014, the ratio worsened from ¥3.1 trillion to 3.2 trillion [101].

The national balance sheet in China can be analyzed in a longer perspective. In 2011, in response to the "critical barrage" (81, 226) from "worriers and alarmists" regarding Chinese economy, the Chinese Academy of Social Sciences (CASS) created a research team on the national balance sheet to assess the national debt to assets ratio covering governments, enterprises, financial institutions, residents, semi-government organizations and NGOs, and foreign entities. They found that:

> Taking a longer time period from 1996 to 2014, based upon the measurement from the research team, the ratio of total debts to the GDP changed from 113 to 235.7%, an increase of 122.7 percentage points within 18 years and an annual average of 6.8 percentage points. Among them, the residents' debts to GDP ratio changed from 3.1 to 36%, an increase of 32.9 percentage points. Non-financial enterprises saw an increase in their debt to GDP ratio from 83.7 to 123.1%, an increase of 39.4 percentage points. Financial institutions increased the ratio from 3.5 to 18.4%, an increase of 14.9 percentage points. The ratio for the government increased from 22.7 to 58%, an increase of 35.3 percentage points. [52: 12–13]

Based upon the same report, in 2014, the total debt for the entirety of China (residents, non-financial enterprises, financial institutions, and the government) reached ¥150.03 trillion, the leverage rate 235.7%. These four major categories contributed differently to the growth of the total leverage by 26.8, 32.1, 12.1 and 28.8%. In other words, non-financial enterprises (mainly SOEs and SMEs) and the government are two major

concerns [52: 12–13]. Meanwhile, a 2015 report from McKinsey Global Institute gave a more dire assessment:

> Fueled by real estate and shadow banking, China's total debt has nearly quadrupled, rising to $28 trillion by mid-2014, from $7 trillion in 2007. At 282 percent of GDP, China's debt as a share of GDP, while manageable, is larger than that of the United States or Germany. Three developments are potentially worrisome: half of all loans are linked, directly or indirectly, to China's overheated real-estate market; unregulated shadow banking accounts for nearly half of new lending; and the debt of many local governments is probably unsustainable. [21]

By the end of 2015, nonperforming loans (NPLs) in China’s commercial banks hit ¥1.27 trillion, the ratio of NPLs to gross loans reached 1.67%, an increase of 0.38 percentage point in comparison to the previous year. Also it is important to notice, in 2007 as the subprime lending crisis started in U.S., the same ratio was 1.40% [72: 148; Fred Economic Data]. The Chinese government has been aware of such “risks in broken chains of funding among industries and enterprises as well as Internet finance” [72: 148].

Two more festering crises further shroud the future of China’s fiscal and financial development with darker clouds: under-funded social security and unregulated shadow banking. Firstly, the system of social protection in China can be too huge and complicated to delve into. Its mounting crisis of insufficient funding has become urgent. From 2009 to 2012, the number of contributors for social security fund increased from 71 million to 353 million, and the number of recipients from 15 million to 130 million. Among the qualified population both in urban and rural areas, about 93% have been covered under the pension system [31: 332–333, 52: 176]. A CASS study in 2015 predicted that the surplus of pension funds for urban residents and enterprises’ retirees would be around ¥300 billion in 2012. Instead, in 2013 the surplus was merely ¥16.4 billion and in 2014 the deficit reached ¥132.1 billion [52: 173–175]. Based upon a declining pension replacement rate (the percentage of pension over the pre-retirement income), the fund would be emptied in 2028 and the cumulated shortfalls would amount to ¥849 trillion (year 2050 value), which would account for 95.49% of that year’s GDP; in case of a constant replacement rate (44.69%), the fund would be emptied in 2024 and the cumulated shortfalls would reach ¥1378 trillion (2050 value), accounting for 155% of that year’s GDP [52: 177–179]. If all the government subsidies are calculated from 2010 to 2050 based upon the converted value of 2011, the implicit debt liability could reach ¥66.2 trillion, accounting for 137% of the GDP in 2011 [52: 181].

Secondly, another nightmare for the Chinese government is the looming crisis of “shadow banking system” or “non-bank credit intermediation” due to a lack of regulation, its lack of transparency, and risk-taking practice (81, 232). According to Joe Zhang [109: vii], a Chinese banker and corporate advisor, “In China, shadow banking started with a low base but it has grown at exponential rates. Between 2008 and 2012, its size tripled to ¥30 trillion, equivalent to 20% of the country’s GDP. The trend now seems unstoppable.” Huang [35: 76] puts it at 50–60% of GDP and 20–30% of banking assets in China. According to a Brookings report, “the figures range from a low of about ¥5 trillion to ¥ 46 trillion” [22]. Among a variety of shadow banking participants, Zhang [109: 82-84] highlighted the financial guarantee companies

supported by the governments as "the banks' toxic dumping ground" and "the Wild West of Finance." This sector peaked around 2001, its number nationwide reaching 15,000 to 20,000. Since they could "guarantee credit up to 10 times their equity capital", their risk was minimized during booming time but exposed as the economy went south. From late 2011 to early 2012, one third of them were shut down leaving frauds, debts and social unrests behind. He also pointed out that China's trust companies, arranging and managing ¥6 trillion of assets in 2012 (growing from 1 trillion in 2007 to 3 trillion in 2010), could apply a leverage ratio "1/1000 or more" and exposed to high risk [109: 92].

Facing the mounting pressure of social, economic and financial crises, Xi Jinping has followed a statist, nationalist, and heavy-handed strategy to tighten his grip over the commanding heights of the economy. One conspicuous example is the "advancement of the state and the retreat of the people" (国进民退) under which the SOEs have expanded further and monopolized more at the expense of the private sector and foreign companies. For example, the number of SOEs declined from 191,000 in 2000 to 112,000 in 2007. Years later, the number increased to 136,000 in 2011, 147,000 in 2012, 155,000 in 2013, and 167,000 in 2015. From 2002 to 2015, their total assets increased from ¥18 trillion to ¥140 trillion (a factor of 7.8) [52: 90; china.com.cn/]. More important, Xi made it clear in 2016 that the Party has the ultimate say over the SOEs (with a surname of Party-owned, 国企姓党). Although SOEs account for 70% of total assets of all enterprises and contribute to 30% of economic growth and less than 20% of employment, their ROC (return on capital) as only half of those in non-state sector. Therefore, many have become "zombie enterprises" and still enjoy a privileged place (access to state fiscal subsidy, cheap loans from banks, and free use of land and other natural resources, etc.) in the national economy and have monopoly over many industries [52: 28–30]. The continued decline of ROC in the recent years could trigger a financial crisis [55: 158, 190].

President Xi's other two signature performances include his handling of the stock market and the "One Belt, One Road" (OBOR) initiative. In early 2015, China's stock market experienced a big jump from the previous year's 2000 points to 5178 (A share in Shanghai Composite Index, SCI) in June. One commentator projected eventual breakthrough to 8000 points within the year. The social media reported that Xi Jinping even indicated a possible rise to 10,000 points. The stock market, known as a "market supported by government policy," became even more bullish as more speculators rushed in [86: 185, 81, 184]). However, the inevitable loss come on July 2 with the SCI losing to go below 4000; 2 days later, it lost another 5.77% to fall below 3700; and on July 8, it lost another 5.9%, to fall below 3507. Within 4 weeks it lost 26%. On August 26, it further dropped to 2850.71. Within 2 months, China's stock markets lost 30%, a total of US$3 trillion in value [36, 74]. In response to the crisis, the Chinese government rushed to "rescue the stock market by violence" through implementing a heavy dose of different remedies: infusing ¥1.72 trillion as a rescue fund, China Securities Finance Corporation (CSF) coordinating a "national team" to shore up the stock prices, completely suspending new IPOs, introducing "circuit breaker," banning short selling, putting hundreds of companies on trade suspicion, forcing the management of major companies who sold shares during the past 6 month to increase their purchase, invalidating transactions, running propaganda calling on investors to follow the Party, targeting speculators, sending an investigation team led

by a Vice Minister from the Ministry of Security into the China Securities Regulatory Commission (CSRC) for possible criminal act, and rounding up people who "circulating negative news on stock markets". Later, the government suspected a malicious "financial coup" orchestrated by Xi's political rivals and arrested dozens of securities managers and business people, including kidnapping business tycoon Xiao Jianhua in Hong Kong and bringing him back to the mainland for investigation. On July 9, a nationwide sweep was carried out to round up almost 300 lawyers for "subverting the state". Three law firms were raided [16]. A Bloomberg analyst remarked, "China shows how to destroy a market" [74]. Tackling this single crisis, the Chinese government severely damaged both the emerging market economy and the rudimentary rule of law.

As for the "OBOR" policy, it reveals another fundamental flaw in the Chinese leaders' thinking and decision-making: insensitivity to or complete ignorance of cost-effective calculus, marginal return of utilities, and price mechanism. In 2013 Xi Jinping proposed this "national strategy" first to Central Asian countries; eventually including 65 countries, with a population of 4.4 billion and extending to Africa and Latin America [56: 70]. Later in 2014, the Chinese government invested US$40 billion in the Silk Road Fund and in 2016, US$100 billion into the Asian Infrastructure Investment Bank (AIIB) [56: 32]. Xi indicated in 2014 that China would invest US$1.25 trillion overseas in the coming decade [112: 31]. The Chinese government also intended to turn its overseas assets of US$6 trillion into investment to serve this ambitious strategy [15: 29]. From 2008 to 2015 China also signed agreements with 25 countries for currency swap (a total value of ¥2.7 trillion) to promote the internationalization of RMB [112: 145]).

However, even Chinese researchers and government officials have realized a huge number of potential and immediate risks in this strategy. For example, the two starting points of "OBOR", Xinjiang and Fujian, face political and military crises. Most developing countries that China has counted on are politically unstable and corrupt, without clear legal system, and short of well-trained workers. Some major powers, including Russia, the U.S., Japan, India, and Turkey, have various reservations, doubts as well as hostility about/towards the initiative [35: 26, 112]. The SOEs, which are counted as the trailblazers for the strategy, have their own problems; this opportunity could become a vehicle for capital flight [35: 131] and corruption. For example, the scandals surrounding Jiang Jiemin, chairman of the China National Petroleum Corporation (CNPC), and controversies over private entrepreneurs Wang Jianlin (Wanda), Jia Yueting (LeTV), Wu Xiaohui (Anbang) and Guo Guangchang (Fosun), who shed their assets in China and transferred capital overseas, are cases in point. China's experience in Venezuela, where CDB lent US$40 billion from 2008 to 2013, is a problem of "hubris" [76: 127, 142]. Mugabe's downfall in Zimbabwe (where China was the largest investor country) does not advertise well for the OBOR, either.

Pinpointing China's Central Challenge in Political Economy

The Chinese economist Liu Haiying [55: XXXVIII)] has observed in his *China's Huge Debt* that in a gathering financial storm, among all players (trust companies, banks, investors and many others), "the central government is the only one who can combat

the storm"; the Chinese government has become "the guarantor of the last resort" [*zuihou doudiren* 最后兜底人]; all participants in this "stakeholders community" of "debt chains" have been overdrawing the credibility of the Central Government, who was forced to offer insurance for the option sales.

Considering the total size of China's economy at US$11.22 trillion (2016 at official exchange rate, ¥74.4127 trillion) and the unlimited overdraft of the central government's credits from all directions (SOEs, local governments, banking sector, the social security fund, and foreign exposures), if any one of these potential crises breaks out and starts a chain reaction in the entire economic system, will the central state with its budget constraint have the capacity to maintain the upper hand over such a super-complex crisis? Liu [55: XXXVII] raised a fundamental question: "The remaining uncertainty is, if the storm befalls, whether the central government can singlehandedly come to the rescue and restrict its damage to the periphery. If we cannot say this is an impossible task, at least, it will be an extremely difficult one." Concerning the question of whether the credibility of Chinese government will or will not fall short, Liu [55: XXXIX] refuses to offer any policy suggestion by saying, "As for solutions, there certainly will be other professionals to offer wise opinions."

For some scholars and politicians, the credibility of the Chinese government can be taken for granted based upon its "stunning track record," competency of the leadership, the effectiveness of their macro-economic policies, and the "abnormal" or "unique" nature of Chinese political economy. Three analysts who have observed the Chinese economy as participants explicitly hold their trust in the fiscal and regulatory capacity and political leadership of the state to deal with potential risks [35: 76–79, 65, 81, 234]. Henry Paulson, a former Goldman Sachs CEO and U.S. treasury secretary who had underwritten many Chinese deals, has learned "never to underestimate their capacity to get difficult things done" [65: 349]. The top Chinese leaders he had known "have been able, ambitious, incredibly hardworking men and women focused not on personal gain but on solving the nation's problems and improving the lives of the people" (362). They include Xi of "an unexpected personal charisma" (352) and Wang Qishan of "a spotless reputation" (358). All in all, "China has deep financial pockets and decisive leaders who are burdened by few constraints on their ability to act quickly" [65: 375].

Based upon his major argument that the banking system is working in China, Stent (81, 264) further inferred that it reflects a "microcosm of China as a whole." "An understanding of the banking system in turn assists in understanding how the broader political economy works." His catchphrase is "the power of the state" (81, 150) and more specifically the role of the Party both of which constitute the secret to the capacity, rationality and stability of China's banking system.

Huang, by emphasizing "the financial strength of the government" [35: 182], "backed by the financial resources of the state" (Ibid, 138), went further to rationalize, normalize and naturalize a system which would be problematic in political science and the science of economics by appealing to the uniqueness, "outlier" factor, cultural characteristics, and the sound promises of the leadership (Ibid, 189–190). On the last securitization of future for the sake of political status quo, all three of them have emphasized the importance and ingenuity of the Third Plenum in 2013 that has already found a way for China.

However, if we examine China's political economy, in particular its past 5 years under the Xi-Li era, the arguments of Paulson, Stent and Huang can be put upon their

head by realizing that the broader political arrangements in China have become subversive to the reformed economic system and banking system.

A market economy does not equate to an economy with a market. Under the command economy of the slavery system or feudalism, markets existed as a compliment to the dominant economic mode. Only if the market logic has become the fundamental organizing principle of the society and the economy is organized with the logic of market, especially the factors for productions (labor, capital and land) are allocated by the market, only they can talk about a market society, to which even the state has to defer [30]. Karl Popper [69: 350] extended "Ockham's razor" to his "principle of the 'Liberal Razor'" that restricts the state to "a necessary evil: its powers are not to be multiplied beyond what is necessary." Therefore, the tension between authoritarian politics and free market, an autocratic state and footloose capital, becomes inevitable. A market society must be a democratizing agent of the state in the long run.

However, the Chinese state has never built up a credible institutional foundation for credibility that has provided the psychological linchpin for assuring the capital and stabilizing the market, which both are often plagued by irrationality, corruption, fraud and other "animal spirits" [2]. To understand the institutional arrangement for credibility from a sovereign state, Niall Ferguson's theory of the "Square of Power" is illustrative here. Based upon his comparative studies of the competition for global hegemony between Great Britain and France in the nineteenth century, and the U.S. and USSR in the twentieth century, Ferguson noticed that financial power constitutes the main foundation for a great power, and the institutional construction is the key foundation for financial power. Specifically Ferguson pointed out "an optimal combination of four institutions": professional tax bureaucracy, representative institution (parliament), a system of national debt (bond issuance agency), and an autonomous central bank [24: 14–15]. The representative institution controls the purse string based upon popular election and mandate; it gives legitimacy to the tax bureaucracy which with its professionalism guarantees impartial and efficient implementation of taxation law made by the parliament. If the current wealth based upon tax revenue falls short, the bond issuance agency on behalf of the state can borrow from the future income of either its own domestic sources or from the global financial market. For this purpose, the sovereign state has to follow a prudential fiscal policy and maintain a good record of fulfilling the debt obligation. In modern times, a rating agency can do the job to monitor the risk of national default and bankruptcy, thereby affecting the rating score and the costs of borrowing from the capital market. To guarantee that future yields would not be diluted by inflation, the sovereign state has to make another concession to investors by maintaining a professional and autonomous central bank, such as the Bank of England or the U.S. Federal Reserve, whose main function is to target inflation and maintain a stable currency.

Coming to China, the "Square of Power" is nowhere to be found. The legislatures (people's congresses) experienced a short period of resurgence and quickly wilted back after Xi came to office, therefore, they lack both their own legitimacy based upon electoral connections and the power to supervise the government [98]. A conspicuous example is that the National People's Congress (NPC) does not have full budgetary power and the government can easily hide astronomical amounts of debt in the national balance sheet as "receivables" [86: 50, 62–63]. The property tax, a possible revenue source, has been stalled by the vested interest as well as due to a deep concern about the bursting of the housing bubble. The central bank has also regressed to the "comfortable

cocoon woven by the Party" and has never gained autonomy to fight inflation in China. "The 2007 figures show that the central bank is leveraged at nearly 800 times its own capital" [86: 70]. The M2/GDP ratio reached 157.97% in 2008 (respectively 53.5% for U.S., 107% for UK and 21.1% for India) and 208.31% in 2016 (respectively 90.55% for U.S., 144.04% for UK). Among all countries with available data on M2/GDP ratio in 2016, China was second only to Lebanon (278.99%) with very adverse ratios (World Bank Data). The government has run budget deficit almost every year for the past two decades even when the Chinese economy had been doing well [57: 212–213].

The Chinese economy has been highly monetized and financialized. A 2016 McKinsey report pointed out: "More than 80% of economic profit comes from financial services—a distorted economy" [91]. Inflation has become a major way for the Chinese government to steal wealth from the household savings without either taxation or representation, which damaged the bond market (81, 211). "Stagflation" has been lurking behind, if not already happened in, Chinese economy [46: 2, 104: 25–26, 107: 27].

Like Ferguson, other economists have identified other historical parallels and the significance of wider institutional infrastructure in explaining economic prosperity [1, 5, 38]. In the sixteenth century, due to Inquisition in the Iberian Peninsula, it became dangerous for Jews to live in Spain, Portugal, and later, these countries' colonies. As a result, they decided to "leave in droves." Economic historian David Landes [45: 134] wrote, "They took with their money, commercial know-how, connections, knowledge, and—even more serious—those immeasurable qualities of curiosity and dissent that are the leaven of thought." The decline of Spain and Portugal in the coming 300 years was causally attributed to the capital flight, divestment, and the loss of human capital that resulted from this flight of Jews (and Muslims, too). This is an early indication of the major difference regarding mobility between land/animal stocks/grain and cash/capital/gold. People, in particular the sovereigns in Europe, started to realize the foot-loose nature of capital (In Chinese old saying, "Money runs on eight legs.") and the ineffectiveness of treating it in the old fashion as if capitalists were "sitting ducks" like the land-based nobility. Absolutist monarchs had to resort to a gentle way to woo and keep capital, namely, to offer a "credible commitment." However, this can be a "credible commitment problem" due to two factors: the promise made today can be broken tomorrow ("time inconsistency problem") and the high risk of reneging, as the promiser often is more powerful than the beneficiary of the promise ("mediator issue") (17, 188–192).

Douglas North and Barry Weingast [62: 803–832] looked at how the "arbitrary government" with "confiscatory power" in the seventeenth century Great Britain improved its relationship with capital markets and helped economic growth by fundamentally changing itself into a constitutional government. These institutional changes viz. the removal of executive expediency in taxation and borrowing loans, added more veto powers such as parliamentary consent and court rule. Once the propertied class felt their property rights secure and their wealth protected the growth of private capital markets and public capital markets contributed to a financial revolution and a fiscal revolution. They wrote,

> [T]he development of free markets must be accompanied by some credible restrictions on the state's ability to manipulate economic rules to the advantage

> of itself and its constituents. Successful economic performance, therefore, must be accompanied by institutions that limit economic intervention and allow private rights and markets to prevail in large segments of the economy. Put another way, because constitutional restrictions must be self-enforcing, they must serve to establish a credible commitment by the state to abide by them. [62: 808]

If Kornai's model sheds light upon the relationship between the state and its SOEs under a socialist economy, as in the case of China, then North and Weingast's neo-institutional economics can help us understand the dynamics between state and the capital (foreign and national capital that has the ability to leave the country). In terms of Kornai's theory, we can see a deepening dependency of SOEs upon the state budget and credibility, but a rapid increase of moral hazard from these SOEs. North and Weingast's theory explains the root cause of an increased flight of capital and possible long-term divestment in China.

These theoretical and historical discussions shed light upon the issue of governmental credibility and the nexus of credibility and the legitimacy of the government in China. The increasing threat of a systemic financial crisis presses for an essential and assuring role from the central government, which itself can be the cause of concern for lacking its own validation and warrant. As we have already discussed, under Xi Jinping, both the rule of law and the market economy in China have been seriously impaired. The previous developmental state has given way to a predatory kleptocracy and oligarchic state [66, 99]. The loss of benevolence and the change to a malignant autocracy has created a "perfect dictatorship" [73]. The global response has been strong. Despite 15 years of WTO membership, the U.S., EU and Japan still refused to grant China the market economy status [35: 145–146]. In April 2013, Fitch ratings, one of the three most prestigious global rating agencies, downgraded China's long-term local currency rating to A+ from AA-. In March 2016, S&P Global Ratings downgraded its outlook on China's sovereign credit rating to negative and in September 2017 further downgraded to A+ from AA-. In May, 2017, Moody's Investors Service downgraded China's long-term local currency and foreign currency issuer ratings from Aa3 to A1. This was the first time that Moody downgraded China since 1989.

The outlook of the Chinese economy was deemed "negative" rather than "positive" in the eyes of all big three rating agencies due to rising debt risk, which means higher costs for China to access the global capital market and stronger demand for discipline from an integrated global economy; in Thomas Friedman's words, "golden straitjacket" has been working [26: 87]. However, the Chinese leadership has been resisting this straitjacket, but keeping their Teflon coating jacket and building a "fortress" [86: 79]. Despite the rhetoric of "top-level design," the Chinese government under Xi Jinping during his first 5-year term (2012–17) has failed to convince the global capital market that it is qualified as a "credit worthy government" [2]. Although the 19th Party Congress in October of 2017 explicitly put stress upon "perfecting the financial regulatory system and safeguarding the bottom-line of systemic financial risk", the totalizing tendency of emphasizing Party's control over everything ("From the Party, government, army, to the masses and students; from East to West, from South to North and finally to the Center"), only makes sense to strengthen official loyalty to Xi and prolong the political survival of the regime. However, this would not keep global capital markets closer to China [96]. The aggressive political logic of reducing veto

power-players, shrinking the selectorate more to a personal patronage and strengthening the loyalty norm in Chinese system has further been worsening the perverse incentive structure. This development would alert citizens and entrepreneurs (both private and foreign) to safeguard their wealth through hiding, withdrawing from long-term investment or capital flight. Bueno de Mesquita and his associates have convincingly demonstrated that such autocratic move can be "good politics" for the sake of dictator's survival, but is "bad behavior" for public goods and overall economic welfare [7, 8]. Most prominently at the Party meeting, Zhou Xiaochuan, who has served as the PBOC governor for 15 years, warned the possible "Minsky moment" befalling upon China. But overall, we can say that Chinese decision-makers have developed two syndromes of "TTID" (This Time Is Different) and "TPID" (This Place Is Different), and believe that China exceptionalism defies commonsensical economic law and that they are entering a great "new epoch".

Conclusion

China's heavily state regulated economy and its partial integration with the globalization process explains, on the one hand, why the economy was not been brought down by foreign shocks as in 1997 and 2008; on the other hand, the GFC has aggravated multiple long-existing predicaments in the Chinese economy.

Knowing that foreign banks account for merely about 2% of the total assets from all financial institutions in China [57: 320, 81, 192], an exogenous financial crisis in China is less likely. If China is going to step into a major financial crisis, most likely it will be an endogenous one with a clear label of "Made in China." China's multiple economic and social predicaments, in particular the declining growth rate and its impact upon the confidence factor, as well as the overall political governance, set the stage for a possible breakdown of Chinese economy, most likely in the form of a systemic financial crisis.

It is easy to identify many candidates for triggering such an event, but it is difficult to ascertain the flashpoint. Therefore, on the one hand, while some economists are able to list multiple causes that could lead a crisis they have missed the systemic flaw in the fundamental arrangement of political economy: i.e. the issue of soft budget constraint, the pervasive moral hazards, the heavy-handed government, the backtracking of top leadership, the perverse incentive structure, and the loss of overall information flow and feedback under a new cult of personality. The loss of an effective feedback loop and the integrity of the information system destroys the confidence multiplier: "Change in confidence will result in changes in income and confidence in the next round, and each of these changes will in turn affect income and confidence in yet further rounds" [2: 16]. As an insider of the Chinese financial system, James Stent (81, 60), who certainly is not a naysayer of Chinese economic development and banking, has to admit that, among major obstacles and challenges the Party-state confronts, "foremost… is the absence of institutionalized trust." On the other hand, some economists have emphasized the positive track record of the Chinese decision-makers and placed their faith in the government's ability to deal with each crisis (growth slowdown, NPLs, shadow banking, local governments' debts, stock market crash, asset bubbles, etc.) in a salami-slicing style. Their presently accommodating

attitude (only critical in the future sense, e.g., Paulson, Stent, and Huang) toward the state elevates the latter to a status like the "Wizard of Oz," who can magically respond to every call for help and rescue.

Considering the Chinese Party-state has been acting as the last guarantor for many liabilities of Chinese banks, SOEs, local governments, government-supported financial vehicles, and overseas aid and investment programs, we have seen a great advantage (systemic effect) from such a sovereign guarantee to maintain the confidence in China's economy and mobilize resources for contingent shocks. However, the fact that the Chinese Party-state ("the emperor of finance") has become so encompassing forces people to ask the question: "What in China isn't a sovereign-wealth fund?" [86: 196]. The Party-state, although it has tried to portray an infallible and invincible image for itself, has squandered tremendous resources for underwriting and bailing out major political and economic actors without fundamentally solving the problems of soft budget constraint and moral hazards, because, to some degree, they are intrinsic to the system by design. More important, as the chief security officer in China, the Party-state and its top leadership led by Xi Jinping have undone many reforms intended for deepening marketization and the rule of law.

One of the major failures is that the Chinese Party-state has not been able to contain, not to mention eradicate, official corruption. As the state capacity and policy effectiveness from the central Party-state have become a public good often neglected and undermined by the free-riders within the Party-state, the political efficiency and legitimacy of the whole system has been weakened. The old "perpetual motion machine" of performance-legitimacy has been slipping into a vicious circle of declining economic growth (at the end of 2017 the Beijing University finance professor Michael Pettis pointed out the actual GDP growth rate might be 3% if debts were excluded) and loss of credibility. It is also reasonable to think about whether such an overstretched Leviathan is a Noah's Ark for final salvation or a Titanic destined to a catastrophe. Three most prestigious global rating agencies have collectively been unequivocal by casting a vote of no confidence and taking a short-sale position on China's economy.

Facing daunting challenges and risks, Premier Li spoke at the Central Economic Work Conference in December 2016 with a keynote of stability:

> Preventing and controlling financial risks should be further prioritized. We should make determination to defuse some flashpoints, control assets bubbles, increase and improve regulatory capacity, to ensure no possibility of systemic financial risks. We should insist on the basic economic system, the reform orientation of socialist market economy, and the expansion of opening-up in order to stabilize the confidence of private entrepreneurs. We should strengthen anticipatory guidance and the credibility of the government. Following the guideline of guarding the bottom line, focusing on priorities, improving institutions and guiding the public opinion, we should accomplish well the work of social guarantee, deepen people's sense of gain, and safeguard social harmony and stability. [102]

Premier Li's policy prescription above to some extent reveals a rift between the State Council filled with more pragmatic technocrats and a new super-presidency under Xi assisted by ambitious loyalists. Certainly, there exists no rational unitary state that has transcended factional competition and power struggle in Beijing [79]. The

marginalized role of the state bureaucracy and the premier as its head does not calm the market that already has been teetering. On the contrary, the multiple predicaments have been deepening, leaving shrinking discretion for the central state to maneuver, and ratcheting up a movement towards the turning point.

Since China has no representative democracy, the NPC to which the premier reports is the closest equivalent to a parliament, and it is the natural institution of representation conveniently available to mobilize and represent tax-payers (average citizens) for a fiscal sacrifice and bail-out if a major financial crisis descends due to the burst of asset bubble (land and realty causing balance-sheet crisis), bank insolvency, or hyperinflation [107: 266]. We have seen that during the 2008 crisis, Henry Paulson, then U.S. secretary of treasury, a Republican, "walked over" to Nancy Pelosi (the opposition Democratic Party leader) and dropped his knees, "genuflecting at the altar of the Speaker of the House" [64: 300]. The continued marginalization of the NPC will further expose the absence of an institutional foundation for a modern state to acquire credibility vis-à-vis the market. Will the connections between democratic politics (such as rule of law, protection of property, representative institution, independence of the central bank, information efficiency, etc.) and financial stability as well as economic prosperity convince the Chinese leaders to think about liberalization and democratization as an urgent priority to deflect a gathering storm of financial crisis?

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