ANIMAL SPIRITS WITH CHINESE CHARACTERISTICS

Investment Booms and Busts in the World's Emerging Economic Giant

MARK A. DEWEAVER

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For my parents

Yi fang jiu luan, yi luan jiu shou, yi shou jiu jiao, yi jiao jiu fang, yi fang jiu luan.

[When policy is relaxed there is chaos; when there is chaos policy is tightened; when it is tightened people complain; when they complain policy is relaxed; when it is relaxed there is chaos.]

—*Chinese saying*

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Preface

A Chinese investment boom was in full swing in 1988. As a new student at Sun Yatsen University in Guangzhou, a few hours up the Pearl River from Hong Kong, the signs were all around me. Food prices were soaring at the local farmers' markets just outside the walls of our bauhinia-shaded campus. So were the black market foreign exchange rates available at the small dry-goods stores opposite the main gate or from the touts that hung around in front of all the big hotels.

Several years later I realized that these symptoms of excess demand had been the result of overinvestment. But this realization gave rise to another question: How could the economy of China—a socialist country—experience such wild gyrations? Following the start of the "reform and opening" policy in 1978, the state had relaxed its grip somewhat. But it was obviously still calling the shots.

I had not imagined that dramatic fluctuations in investment could occur under socialism. The state's firm hand, guided by the wisdom of its central planners, was supposed to keep economic activity on an even keel. Investment booms and busts were for capitalist countries.

Back then it seemed unlikely that anyone in the twenty-first century would still be analyzing trends in socialist economies. Socialism was on its way out. The successes of the Solidarity Movement in Poland and the progress of glasnost in the Soviet Union suggested that Leninist dictatorships would soon be a thing of the past. Enterprise reform and democratization were the wave of the future.

This impression was only confirmed by the student protests that began in Beijing in the spring of 1989 and quickly spread to Guangzhou and various other big cities. The Chinese Communist Party seemed destined to join its Polish counterpart in the dustbin of history.

As it turned out, of course, no transition took place. The students were crushed by the People's Liberation Army, which did not "love the people" as much as had been hoped. The Party remained very much in control.

Since then "socialism with Chinese characteristics" has kept analysts as busy as ever. Far from fading into irrelevance, the topic is becoming increasingly important as China's role in the world economy continues to expand.

I began to pay more attention to the cyclical character of Chinese investment during the early 1990s. At that point I was writing research for Peregrine Brokerage, a rising star in the Hong Kong financial firmament during the go-go years before the 1997 Asian financial crisis. As Hong Kong–listed companies began making big bets across the border, China's investment swings became a topic of considerable interest to Peregrine's foreign institutional clients.

There was plenty to write about. Following Deng Xiaoping's famous "Tour of the South" in January 1992, investment took off—as did China's nascent stock and property markets—only to come crashing back to earth in the middle of the following year. As had been the case in 1989, rapidly rising inflation left the government with no choice but to impose draconian austerity measures.

Ten years later, I watched yet another cycle unfold—this time as a fund manager. Once again the asset markets soared as an investment mania took shape. In this case, the inflationary effects were less severe and the currency was strengthening. Yet for all the dramatic changes that had taken place in China since my student days, the 2003 boom actually had more in common with the 1958 Great Leap Forward than with those of 1988 and 1992. Local government-sponsored investment in heavy industry was now the driving factor, just as it had been in Chairman Mao's time. The policy of "reform and opening" that had seemed so exciting in the 1980s had somehow taken the country back to square one.

One of my favorite books during my time at Sun Yatsen University was a 1980s Chinese bestseller titled *Sun Tzu's Art of War and Enterprise Management*. Like many modern-day applications of Sun Tzu's 2,000-year-old classic to nonmilitary fields, it began with the famous admonition to "know the other, know yourself" (often inaccurately translated as "know the enemy and know yourself"). Enterprise managers seeking the path to success in China's post-command-economy era of market competition were advised to begin by making a thorough analysis of business rivals, customers, and their own organizations.

Today, China itself is often the "other" that competitors in the global marketplace need to understand. To those with such a purely practical motive, the importance of the Chinese investment cycle will be obvious. But the average reader can find the subject equally rewarding.

China's socialist system reminds us of the foundations of prosperity in free market economies—private ownership of the means of production, free contracting, and an impartial legal system. The dynamics of Chinese booms and busts, which result from an absence of these features, make it easy to appreciate why a strong private sector, accompanied by the checks and balances of democratic political institutions, is desirable.

Knowing the other may be worthwhile for the sake of winning wars and making money. But it also contributes to knowing yourself. I hope that this book will help non-Chinese readers gain a better understanding not only of China but of their own countries as well.

CHAPTER 1

INTRODUCTION AND OVERVIEW

Seek truth from facts.

—The Book of Han

THE CHINESE ECONOMY is a large and still-expanding part of an increasingly global system. What happens in the "Middle Kingdom" now affects us all. A booming China creates opportunities and jobs all over the world. A bust would be felt from Silicon Valley to sub-Saharan Africa.

In China, as elsewhere, investment fluctuations are the primary driver of the business cycle. When investment is growing rapidly, it not only contributes directly to GDP growth but also boosts consumption via the multiplier effect. During investment slowdowns, the reverse is the case. Projects are put on hold or canceled, workers lose their jobs, and demand for both industrial products and consumer goods slows down.

This book looks closely at investment cycles in China and what we might call the "animal spirits" that drive them. It addresses two basic questions. First, what causes these cycles and how do they differ from those observed in other countries? Second, what tools does Beijing have in its economic management "toolbox" and how well do they work? The answers reveal significant differences between the Chinese economy and economies based on private enterprise. They also remind us of the limitations to any government's power to bring about economically optimal outcomes.

The analysis combines economic theory, economic history, and empirical evidence from a variety of sectors. Conventional macroeconomic models, which are built on a Western template, are inappropriate for China because of the dominant role of the state in the Chinese economy. I draw instead on the contributions of socialist theoreticians, who described how socialism is supposed to work; Austrian economists, who explained why it generally fails to live up to its promises; and on the Hungarian economist Janos Kornai's account of investment cycles in real-world command economy systems. Economic history lessons are drawn both from China's own experience and from that of the former Soviet Union. Boom–bust dynamics are examined in the specific contexts of heavy industry, infrastructure, property development, and banking.

The basic premise is that contemporary Chinese investment cycles are part of the continuum of booms and busts that occurred under the old command economy (from 1949 to 1977). While new types of investment projects and financing methods have been introduced, soft budget constraints and perverse incentives at the local government level continue to be the underlying drivers. Neither extinct nor even endangered, the animal spirits of the Maoist era are still thriving more than thirty years after the introduction of China's "reform and opening" policy in 1978.

Beijing's approach to macroeconomic policy is also a holdover from the command economy. Standard monetary and fiscal policy measures are relatively ineffective. These methods of influencing private sector investment decisions do not work well in China, where most investment is undertaken by entities that are at least partially state owned, particularly by local governments. China's leaders must rely instead primarily on ad hoc administrative interventions, much as their predecessors did during the early decades of the People's Republic.

The book draws two main conclusions. First, the Chinese economic system is still far from being free-market driven. The persistence of command economy investment cycles indicates that the state, not the private sector, plays the leading role in investment decision making. There is thus considerably more continuity between the "reform and opening" period and the Maoist era than is commonly imagined. Second, Beijing's ability to control the economy is relatively weak, much as it has always been. Booms are mainly the result of local government initiatives, which often directly violate central government policy. Busts result from the reimposition of the central government's authority. This requires strict austerity measures and harsh crackdowns on violations. The central government has relatively little scope for macroeconomic "fine tuning."

1. Chinese Investment Cycles and the World Economy

Chinese investment cycles are an important source of economic volatility, not only for China but for the rest of the world as well. In addition to their direct effects on demand for industrial raw materials, capital equipment, and trade- and investment-related services, they also move world prices for a wide range of consumer staples. China's booms and busts have become an international phenomenon.

China is similar to most other industrialized economies in that investment is both highly cyclical and more volatile than overall GDP. The most extreme swings occurred during the command economy period, when booms in 1958, 1964, and 1969–1970 were followed by severe contractions. Since the early 1970s, the fluctuations have been more muted, with the peaks in 1978, 1984, 1993, and 2003 followed by slowdowns rather than periods of negative growth. (See Figure 1.1.)

At the same time, the investment share of GDP has been trending steadily upward for most of the past fifty years. After falling to only 15 percent in 1962 (in the aftermath of the Great Leap Forward), this metric reached 46 percent in 2010. This upward trend occurred mainly at the expense of household consumption, which fell from 71 percent to only 34 percent of GDP during the same period. (See Figure 1.2.)

Until fairly recently, Chinese investment cycles were of little more than academic interest to outsiders. Today their effects are felt on every

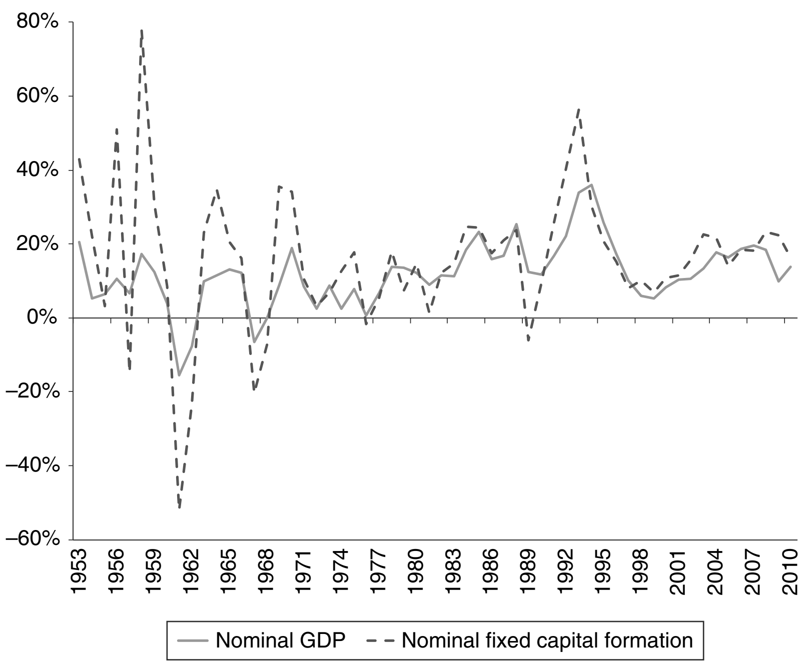

Figure 1.1 Chinese nominal GDP and investment (year-on-year changes)

Source: Bloomberg, author's calculations.

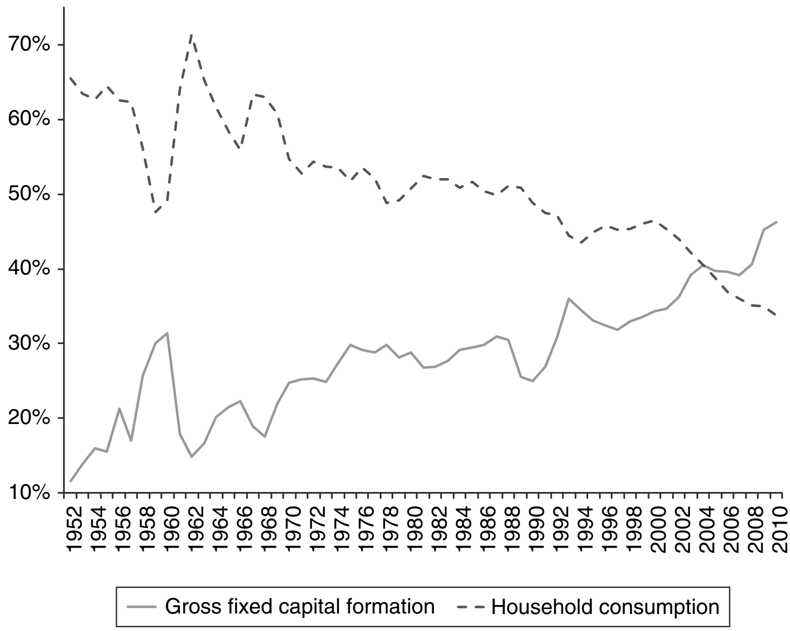

Figure 1.2 Investment and consumption as percentages of nominal GDP
Source: Bloomberg, author's calculations.

inhabited continent. Investment booms attract imports of raw materials such as coal, iron ore, and copper from as far away as Australia, Brazil, and Canada. They are good news for equipment suppliers in Japan, the European Union, the United States, and South Korea. Other beneficiaries include freight forwarders, shipping companies, port operators, engineering firms, and investment banks.

Chinese investment also has important effects on global agricultural prices. Investment draws farm labor into industry and construction and results in the large-scale conversion of farmland to industrial and residential uses. Under the old command economy, such reallocations of the factors of production led to food shortages. In the 1980s they generated trade deficits and pushed up domestic inflation. Since the 1990s, their inflationary impact has been felt throughout the world, resulting in higher prices for everything from Thai rice to Brazilian soybeans.

Chinese investment booms are no longer limited by domestic resource constraints. They draw upon the resources of the entire planet. China has become both a "locomotive" for the world economy and a source of global instability.

The fall 2010 issue of the quarterly magazine *The International Economy* contained a survey of economists and business leaders that asked, "Who globally would be the most affected if the Chinese bubble bursts?" The answers ranged from North Korea, which depends on China for over half of its external trade, to African commodity exporters such as Zambia, where copper mining is a key sector, to neighboring countries such as South Korea and Japan, which are highly dependent on exports to China for their own economic growth.

A separate article in the same issue pointed out that Germany would be hit particularly hard in the bursting bubble scenario. It is the most export-dependent of the world's major economies (exports account for about half of GDP) and now relies heavily on China because of the effect of the Eurozone sovereign debt crisis on its traditional trading partners. The author points out that Chinese markets for capital goods such as "manufacturing equipment, power generating turbines, tunnel drilling machines, chemical plants, construction equipment, green energy technology, and magnetic levitation trains" have become indispensible to German GDP growth.[1] The next downturn in China's investment cycle might well push Europe's largest economy into recession.

2. Models of China

Despite the increasing global importance of Chinese investment cycles, little has been written on them outside of China. Foreign observers tend to focus on the sources and sustainability of China's high GDP growth, while largely ignoring the reasons for its variability. They are primarily interested in "big picture" questions: What accounts for China's remarkable transformation into an economic superpower? Will China soon "rule the world"? Is the country on the verge of a "coming collapse"?

While ups and downs in investment growth also attract considerable attention, they are rarely seen as part of a cycle. Instead, analysts typically fit them into long-term bullish or bearish narratives. These often have as much to do with the analysts' own preconceptions as with Chinese realities.

The bulls tend to think of China as a highly organized society run according to rational principles. This idea has a long history. It can be traced back to early modern authors such as the Jesuit polymath Athanasius Kircher, whose 1677 book *China Illustrata* described the country as a realization of Plato's republic. In the modern version of this tradition, China is said to "do capitalism" better than Western countries. It is supposed to have a unique "model" that tempers the "anarchy" of the market with the rationality of the state.

Investment booms should not really be possible under such a system. Overbuilding is therefore seen as a sign of the leadership's long planning horizon rather than of inefficiency or irrationality. High vacancy rates for residential and office property, for example, are not evidence of a property bubble, as they would be elsewhere. China's long-term trend toward urbanization is instead taken to imply that excess supply in the real estate sector can always be justified on the basis of the "fundamentals."

At the same time, the bulls also typically believe Beijing's claim that China is in the midst of a transition to a more sustainable "mode of growth." Even if boom–bust investment cycles may have existed in the past, they are unlikely to occur in the future. Once Beijing has "rebalanced" the economy, consumption will be the primary source of aggregate demand. Fluctuations in investment will no longer be an issue.

For the bears, on the other hand, the Communist Party's right to rule is based on its ability to deliver economic prosperity. If GDP growth slips below some critical level, typically believed to be 8 percent, the long-suffering masses will revolt and the country will descend into chaos. In this view, China is a bit like the bus in the movie *Speed*. It will blow up as soon as it slows down. The cyclicality of investment, like the location of the next bus stop, is moot.

Neither of these extreme views is supported by the facts. The bullish view is based on an exaggerated idea of the power of the central government and its ability to impose economic rationality. In fact, investment booms in China result in excess capacity and wasted resources just as they do in other countries. During the command economy era, these problems were even more severe than they are today, despite the state's much larger role in the economy. The alleged stabilizing role of the state is nowhere to be seen in the data.

There is also no evidence for a change in the mode of growth. The decades-long trend shown in Figure 1.2 remains unbroken. Claims that a rebalancing toward household consumption is taking place ignore the fact that its share of GDP continues to shrink. It would clearly be premature to claim that investment cycles have ceased to be relevant.

The idea that the Communist Party cannot survive economic growth rates below 8 percent is also inconsistent with the facts. Even the severe contractions of the 1960s did not weaken the Party's hold on power. More recently, full-year real GDP growth rates for 1981, 1989, and 1990 fell to 5.2 percent, 4.1 percent, and 3.8 percent, respectively. By one estimate, year-on-year quarterly real growth remained below 6 percent in every quarter from the third quarter of 1989 to the first quarter of 1991, falling as low as −0.3 percent in the fourth quarter of 1989 in the aftermath of the Tiananmen "incident."[2]