Carl E. Walter, Fraser J.T. Howie, *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise*, Revised and Updated: John Willey & Sons Singapore Pte. Ltd., 2012, 260 pp.
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Deng Xiaoping famous 1980s say, 'capitalism with Chinese characteristics' still makes a good impression today among people, while keeping an air of mystery on what Deng understood by that. One possible translation would be that it definitely understood the failure of socialism and the need for open up the Chinese economy. China is today one of the largest economies in the world with GDP of US$10.3 trillion, with a huge chunk of US$3.5 trillion as foreign exchange reserves, and holding a US debt of $1.3 trillion. China is big in terms of numbers, which is a fact. But do these numbers hide anything? This might be the underlying question of Carl E. Walter and Fraser J.T. Howie's *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise*. The main idea of this book is that China's current economic and financial status is a creation of the Communist Party which rules the country and it's not based on a solid growth. The great leap forward of Mao was 'revived' and got a new face, focused on stocks, bonds and gigantic government funded projects, mainly in infrastructure and real estate. Since the 1990s, a progressive increase in capital (understood in the book as money), organized by a complex dual system with government and local governments at the core and few state owned banks,

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systematically flooded the Chinese market, generating an apparent welfare, as often economic history shows when markets are hampered and distorted by governments.

The first chapter of the book - *Looking back at the policy of reform and opening* – is a short story about what did China's leaders change in order to achieve its disputed position today. First, a drastic change in the nature of the banks for which "various laws were passed that created the basis for an independent central bank and set the biggest state banks – Bank of China (BOC), China Construction Bank (CCB), Industrial and Commercial Bank of China (ICBC), and Agricultural Bank of China (ABC) – on a path to become fully commercialized or, at least, more independent in their risk judgments" (Walter & Howie, 2012, p. 5). The Asian financial crisis, caused by loose monetary policies (Shostak, 1999), hit hard many economies, and China was one of them. Chinese bankrupt banks entered at that time, in 1997, in a transformation process, being recapitalized using the *good bank, bad bank* technique, which basically means creating an asset management company (AMC) referred to as "bad bank" which will take the non-performing assets from the bankrupt bank alias the "good bank", the latter being thus able to remain in business. The future capitalization of an AMC is made by the state, thus dispersing the costs on a social scale. "In 2000 and again in 2003, the government stripped out a total of over US$400 billion in bad loans from bank balance sheets and transferred them to the bad banks. It then recapitalized each bank, and attracted premier global financial institutions as strategic partners." (Walter & Howie, 2012, p. 5). But, one should not get too excited, because these strategic partners were called in only for simulating an *openness.*

The private sector in China is mainly concentrated in two special economic zones (SEZs) (Shanghai and Shenzhen) which "attract over 60 percent of total foreign direct investment and contribute over 70 percent of China's exports" and, worth's to be mentioned, where "there is virtually no state sector remaining".

(Walter & Howie, 2012, p. 8) This is also "the machinery" which brought China those huge foreign reserves. Besides these special economic zones is the public sector with the state owned enterprises (SOEs), "which many confuse with China". (Walter & Howie, 2012, p. 23) These were also part of the transformation program of the 1990s, and even entered the capital market, being listed at stock exchanges like Hong Kong and Shanghai where "the market capitalization belongs to companies controlled outright by China's Communist Party". (Walter & Howie, 2012, p. 14)

Chapter two, *China's Fortress Banking System*, and chapter three, *The Fragile Fortress*, explain in detail the main features of China's Banking system in the last thirty years of reforms with a critical approach on them. Banks in China survived mainly because of the support of the Party, and less because of market and consumer constraints. (Walter & Howie, 2012, p. 27) An impressive amount of money is controlled through the banks by the state. "In 2010 state-controlled commercial banks held US$15 trillion in financial assets, of which the Big 4 banks alone accounted for almost 60 percent. These four banks controlled 45 percent of China's total financial assets." (Walter & Howie, 2012, p. 29)

During the 1980s, the banking system was managed by the local governments (not by the central Beijing government), fact which according to the two authors created the path for an inflationist and corrupted system, on the verge of a civil war in 1989. (Walter & Howie, 2012, p. 33) Inflation reached nearly 20 percent at the end of 1980s and was followed by a doubling of the housing prices. Money – which followed the roots of party-driven lending – entered into real estate projects, which eventually remained unfinished. Authors offer the example of Hainan province (a SEZ), where the waste of resources reached 600 unfinished buildings and RMB 30 billion (US$ 4 billion) in bad debt". In an ironically note, it is concluded that "this is what creative local financing in China means." (Walter & Howie, 2012, p. 38) Part of the transformation in the Chinese banking system in

the 1990s was in adopting western capitalist practices in the form of "international methods of corporate governance and risk management". (Walter & Howie, 2012, p. 34)

A key in understanding money supply expansion and heavily reliance on the state banking system is to know that in China there is an "officially" accepted rate of economic growth, in the amount of 8 percent annually. To maintain this rate of growth, banks continuously lend money. As Yang Kaisheng (CEO of Industrial and Commercial Bank of China, ICBC) put it "In our country's current level of economic development, we must maintain a level of macroeconomic growth of around 8 percent per annum and this will inevitably require a corresponding level of capital investment. Our country's financial system is primarily characterized by indirect financing (via banks); the scale of direct financing (via capital markets) is limited." (Walter & Howie, 2012, p. 47)

Authors point how the Asian economic crisis revealed the fragileness of the Chinese banking system, which not surprisingly was caught in insolvency in 1998. Urgency claimed recapitalization of the big four banks ("the core of the Party's political power"), ordered by Zhu Rongji, then prime minister, and which was made according to the standards of Basel Agreement, which some economists consider, quite on the contrary, the main cause of instability. (Friedman, 2009) China's leaders view on private property rights can be observed in the course of this event, when Ministry of Finance (MOF) "nationalized savings deposits largely belonging to Chinese people". (Walter & Howie, 2012, p. 57) Chapter three also offers a detailed explanation of the capitalization process using the technique *good bank, bad bank* and deconstructs the myth of China's foreign exchange reserves, pointing that this speaks nothing about its welfare. Spending this huge amounts of money would mean "larger monetary pressures" for the domestic economy.

Chapter four, *China's Captive Bond Market* and five, *The Struggle over China's Bond Markets* give the reader a complex view of how China's bonds market works. The strategy with creating a

bond market was to get money from other kinds of investors than banks, and to put pressure on the Chinese banks to reduce the price of loans. Still, China's bond markets are the same apanage of the Party, "the symbols of the free market are there, but the market itself is not". (Walter & Howie, 2012, p. 96) And the explanation that the two authors give is that risk, as a fundamental component of a capital market, is not present in China's bond markets because bonds are traded within an autarchic market with investors controlled mainly by the state. Thus, the price formation is hindered. And state strategy of diversifying the financing sources started at the beginning of 1980s, when more than 70 percent of bond purchasers were private individuals, returned in the course of thirty years to the same old pals, state banks. "This fact has profound implications for China's financial system. If the markets today simply function as clearinghouses that move money from one pocket of the state to another, then they have developed away from their more diverse origins in the 1980s into something resembling a pyramid scheme." (Walter & Howie, 2012, p. 116)

Local governments have made "aggressive use" of bonds after Beijing allowed them to issue bonds, reaching in 2007 RMB 650 billion (US$ 95 billion). In 2009, hit by the new crisis which began with the collapse of Lehman Brothers, Beijing arranged a stimulus package to be delivered to local governments for various public projects, which had to come up with two thirds of project spending. Local governments "leveraged their utilities, roads, construction brigades and asset management bureaus by incorporating them into limited liability companies." (Walter & Howie, 2012, p. 135) This allowed local governments to issue debt on the bond market, benefiting by the "free for all lending boom". (Walter & Howie, 2012, p. 135)

China's current state of development (mostly represented by the private sector of the SEZs) would not have been real without the involvement of western finance companies in creating and listing Chinese state companies on capital markets. Chapter eight,

Western Finance, SOE Reform and China's Stock Markets describes this involvement and its consequences in today's China. However, the authors find important to re-emphasize that China's stock markets have a very fragile foundation. The listed companies, although their capacity to raise funds is impressive, are in no way subject to a real valuation process, "because the Party controls the ownership of these listed companies" (Walter & Howie, 2012, p. 166) So the question of rational allocation of resources is raised, as the true function of a market. But since in China, only the premises of a market being present, the allocation function "belong to the Party which, to achieve its own ends, actively manipulates both the stock and debt markets". (Walter & Howie, 2012, p. 166)

In the seventh chapter, *The National Team and China's Government*, Walter and Howie recommence the idea which might be considered the book's red line. China's economic and financial fortress is a creation of the Party, and every decision with regard to resource allocation must always be checked by it. This has generated an oligarchic "communist-style capitalism" system, with sons, daughters and families in the key positions of state owned assets not very much subject to market constraints. Moreover, "the sons, daughters, and families now have institutional backing outside of the Party itself and this gives rise to questions over whether these business interests have, over the past decade, replaced the government apparatus or eroded the government from within." (Walter & Howie, 2012, p. 194) How was this possible? As the authors put it, the absence of a diversified ownership of the companies. State still owns a large part of companies' shares. As a comparison shows, "the largest shareholder of Switzerland's biggest banking group, UBS, is the Government Investment Company of Singapore, with less than a 7 percent holding. Contrast that with Bank of China: even after its IPO, the bank's largest shareholder, Huijin, still controlled 67.5 percent of the bank's stock." (Walter & Howie, 2012, p. 210) However, it could be argued further that diversification of

ownership can be a false route if there is no indication of its type, public or private. Public ownership on the means of production (socialist system) makes economic calculation impossible, and along with this, any chance in having a rational allocation of resources. (Mises, 2012, p. 17) Therefore, selling government assets to other government entities other than national, is not a true diversification of ownership.

In the last chapter, *The Forbidden City*, China's economic system is compared with the architecture of the Chinese imperial palace (of Ming and Qing dynasties). The analogy serves to emphasize the command system in economic affairs of today's China. "At the center lies Beijing, a complex labyrinth of separate power centers, each with just a single reporting line that extends up to the party secretary general (although nominally through the State Council, the premier, and the National People's Congress). Coordination or integrated action across multiple bureaucracies is difficult and time-consuming unless it is ordered by the party secretary general. Without a strong leader, each bureaucracy proceeds within its own scope of authority and jealously guards the entrance to its courtyard." (Walter & Howie, 2012, p. 216) Also, an interesting forecast is delivered in this chapter, regarding how long China can continue its debt policies. The authors assume that China is not in danger of default, while the use of debt can continue "for a long time". (Walter & Howie, 2012, p. 239) However this begs the question of how much citizens and private investors are willing to accept the erosion of their capital, by the loose monetary policies.

Red Capitalism can definitely be a *must read* for any student or researcher in international economics and the economics of China. Although it is mainly a history of events (privatizations, capitalizations, recapitalizations etc.) that took place in the last thirty years of "market" reforms in China, Walter and Howie's attempt to put it in a free market theoretical framework is obvious. This elegantly guides the reader through (sometimes)

very sophisticated financial arrangements, and prevents forgetting a crucial aspect: the real owners of assets in China.

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