Review Essay

Economies Revisited

Paper Dragons: China and the Next Crash, by Walden Bello. London, UK: Zed Books, 2019. Pp. 320. ISBN 1786995964, 978-1786995964.

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Introduction

The book, *Paper Dragons: China and the Next Crash*, by Walden Bello is very ambitious. Horizontally, it tries to cover major financial crises in the last three decades. Vertically, it tries to embed the finance and monetary sectors within the economic base of countries or regions. It explains the financial crises as stemming from the search for more and more profits from speculative and unproductive activities. It discusses the clashes among economic ideologies: Keynesian, neoliberal, and Marxian economics.

The book analyzes the following major financial crises in the last three to four decades: (1) Japan's financial crises and subsequent stagnation; (2) the Asian Financial Crisis (AFC); (3) the Great Financial (Subprime) Crises (GFC) of the US; (4) the spread of GFC to Europe and the specificity of Europe's core-periphery, one-currency status; and (5) China's dangerous vulnerability to a possibly devastating financial crisis.

The book links all these crises to the real economy, the need to keep on increasing real profits, and the income distribution (class) struggle within societies. It further discusses the theoretical and ideological tensions between the more stimulus-oriented Keynesians against the conservative monetarist and rational expectations ideologues who insist on the sanctity of instantaneous markets and non-intervention of governments. The latter, of course, are the more technical names for the neoliberals who are to blame for financial liberalization, capital account liberalization, lack of regulations, and non-punishment of erring financial institutions and who also manage the allowance of monster securities like mortgage-backed securities (MBS), credit debt obligation (CDO), and credit default swaps (CDS).

Because of the enormity of the book's ambition, it opens itself to many possible suggestions for improvements and inclusions (unfortunately, making it even more ambitious and lengthy).

Long and Detailed Analyses of the US Subprime Crisis as Not Very Relevant to China's Financial Problems

First of all, in dealing with the major financial crises in the last three to four decades, the book spends much more time in discussing and analyzing the subprime crisis in the US, perhaps because this is the crisis Walden Bello knows best and is in all the financial and economic literature. However, the book's title is on the vulnerability of China to a financial crisis. Nowhere are the financial sectors, the financial policies, and the economic systems so different as in China and in the US. Except for China and Japan, the other financial problems or crises described and analyzed in the book are mainly due to too much financial liberalization and lack of financial regulations. China and Japan are systems where financial systems are well within the control of governments, thus problems or crises arise not because of too much financial liberalization, but because of incorrect or wavering policies, appeasement of opposing lobby groups, and the like. It would have been beneficial if the sequencing of the discussion left the two countries to be discussed last, because these were economies where unwarranted financial liberalization did not occur, but where overproduction and underconsumption were serious problems.

The Lack of Blame on the US-Japan Plaza Accord in Japan's Crisis and Stagnation

In Japan's financial crisis and long stagnation, Bello misses a critical factor in Japan's trouble: the Plaza Accord of 1985. Through this agreement, President Ronald Reagan of the US was able to force

Japan to strengthen the yen very significantly. This led to a crisis in Japan's export-oriented economy, which the country effectively addressed by moving more labor-intensive productions (especially of automobile and electronic parts) to Southeast Asia, specifically Thailand, Malaysia, and Indonesia. As Bello correctly mentions, these outflows of Japanese direct and short-term investments in these three countries helped propel these economies to East Asian Miracles. However, he fails to mention that this overvaluation of the yen contributed a lot to Japan's impending financial crisis and long-term stagnation. As Japanese companies moved out of Japan, the real wages and employment rate of Japanese workers declined, contributing to more underconsumption. At the same time, the electronic and automotive parts produced in Southeast Asia were brought back to Japan to be assembled, thus, the overproduction problem continued. The Plaza Accord aggravated the overproduction-underconsumption gap in Japan discussed by Bello; I emphasize this fact to remind us of the penchant of the US to intentionally wreck economies for its own good, especially in this Trumpian period when this mentality reigns supreme in White America.

Discussion on Some of the Theoretical and Ideological Points

What is commendable about Bello's book is that the financial sector is linked to the real economy, and the theoretical and ideological behavior of the players (especially governments and economists) are spelled out very clearly.

Financial Crises Proves the Mistake of Mainstream Economics on the Rationality of Agents

Neoclassical economics (at least the version neoliberalism loves) prides itself in assuming that firms, households, and financial institutions are rational and, therefore, behave consistently on maximizing their profits (for firms and financial institutions) and their utility or satisfaction (for households and consumers). Thus, they behave in a consistent and predictable fashion, making economics akin to physics and the natural sciences. Furthermore, the "invisible hand" theory of Adam Smith is proven using sophisticated mathematics, calculus, and fixed-point theorems. This is to prove that people go to the market with selfish motive, but the result is efficiency for the common good. The rational expectations people in the 1980s and 1990s especially believe in both instantaneous market clearing and super-rational agents who, in an analogy, can play billiard so well as if they were physicists who can calculate the angles, velocity, and direction of the best billiard moves.

Financial crises certainly demolished early neoclassical assumptions but still-strong thinking of economists in the neoclassical tradition. Herd mentality—wherein everybody plays “follow the leader” by either rushing to the property market when it is going up (thus contributing to the rise of the property bubble) or panicking and rushing out when it collapses due to defaults (thus contributing to the harshness of the bubble bursting)—is hardly a rational behavior. Herd mentality became fashionable after the Asian Financial Crisis, as more critical economists criticized the behavior of unbridled capital account liberalization and using its funds for property lending. The lending to subprime borrowers in GFC, based only on the belief that property prices will forever be going up, is another behavior that defies rationality.

Demolishing the Absurd Belief in Instantaneous Market Clearing

Similarly, the absurd belief of instantaneous market clearing by the neoliberals and the rational expectations school was quickly demolished from the 1990s onward when Nobel prizes went to studies of market failures: asymmetric information, moral hazards, adverse selection, bounded rationality, coordination failures, multiple equilibrium, increasing returns to scale, and the need for regulations. A strong lesson from financial crises is the need for prudential regulation and supervision from central banks because of market failures, which stands in direct contrast to the earlier school of unbridled financial liberalization with the assumption of efficient market clearing. Furthermore, the rise of Amartya Sen’s philosophical defense of interventions to provide basic economic rights and freedom from poverty, as well as the rise of sustainable development and environmental protection, further emphasized the need to shackle unbridled markets.

Monetarism Re-explained

Bello described the monetarist backlash against the Keynesians as an initiative to improve capitalist profits by stopping Keynesian spending and radically shifting income distribution from workers to capitalists through austerity measures. I took my doctorate in economics at the height of this monetarist and rational expectations frenzy from the late 1970s to the mid-1980s. Although what Bello described is correct from a Marxist or liberal perspective, what was taught in the universities to a generation of conservative economists had a very different perspective. The argument was that the late 1970s and early 1980s was stagflation time, with emphasis on inflation. The monetarists were able to convince mainstream economists that inflation is perpetuated and aggravated by Keynesians who keep on increasing money supply, which people use to spend in driving up prices. Thus, the only way to fight this is monetary austerity, a fixed money supply rule: "just let the central banks announce the target money supply and allow the markets to work unbridled"; and "don't intervene in the monetary and real economy." A corollary to this is the rational expectations assumption: "People are so smart so you don't have to intervene." This strange and simpleton logic was able to indoctrinate thousands of graduate students, so that by the late 1980s and early 1990s they actually believed that macroeconomics is dead (there is no need to have fiscal and monetary and macro policies, or better said, these macro policies have to be austere during bad times) and microeconomics is the only thing to learn in economics (the unbridled market workings)—these were *the* economists in the 1980s and early 1990s. This is important to understand Reaganism and Thatcherism and the International Monetary Fund's (IMF) handling of financial crises in developing countries, including the Philippines in 1984-85 and East Asian countries during the Asian Financial Crisis. Financial crises have to be accompanied by fiscal and monetary austerity. This thinking still survives to a certain extent. Instead of a fixed money supply rule, the current practice is for the central bank to fix the policy interest rate. If inflation occurs, the policy rate will have to be increased upward to tame inflationary expectations, or, better understood, to tame people's demand. This is exactly the policy in 2006 where interest rates were adjusted upward due to an unexpectedly high inflation within the year. This helped hasten the Great Financial Crisis in the US. Most borrowers had fixed interest rates for their loans in the first few years, but this shifted to variable interest rates. So many of the subprime and other borrowers were hit with higher interest rates in 2006 and 2007 when the interest rates were adjusted upward. The defaults were clearly becoming stronger throughout 2007 until the problem became a full-fledged crisis.

Leaving out Latin American Debt Crisis and Financial Crises in Developing Countries: "Haircuts," Debt Workouts and Sovereign Debt Restructuring, and Sovereign Bankruptcy Laws

More importantly, a major exclusion of a set of crises in the book are the financial crises that involved developing nations. In particular, the decadelong Latin American debt crisis (1981-92) is a direct offshoot of Bello's discussion of the monetarist's policies of high interest rates and cutback in global liquidity by Ronald Reagan, Margaret Thatcher, and Helmut Schmidt. Because of the US authoritarian client states' dependence on huge petrodollar borrowings for profligate spending (Philippines' Ferdinand Marcos, Chile's Augusto Pinochet, Argentinian junta, Brazilian junta, Shah of Iran, etc.) throughout the 1970s and early 1980s, the rapid and huge global interest rate increases and cut in global credit in 1980-81 directly hit these dictatorships, leading directly to debt defaults and moratoriums, particularly dictatorships in Latin America and the Philippines. The decadelong financial and debt crises provide precious lessons to developing countries.

Other countries suffered severe contagion during the various financial crises periods: the Philippines during the Latin American Debt crisis (simultaneous with a political crisis), and Russia and Ukraine during the AFC (1997-99). One big financial and debt crisis that became an omen of the AFC was the Tequila crisis in Mexico and Latin America in 1994-95. There were major sovereign debt crises in Argentina in 1999 and various years in the 2000s.

This is of course not a recommendation that all these crises should be covered by the book. But at least the mention of some of the crises, especially the Latin American Debt Crisis and the Argentinian Debt Crises would emphasize and open up the important solutions to financial crises, especially for developing countries: debt workouts, sovereign debt restructuring, and sovereign debt bankruptcy. This becomes very relevant in last section of this essay on whether I agree with Bello or not on the high probability of China falling into a deep financial crisis.

Debt workouts are negotiations between creditors and debtors initiated usually by the national government, together with multilateral agencies or a foreign country, especially when foreign creditors are significant. The Latin American countries and the Philippines were able to reduce their debt burden in 1992 when the US Brady Plan (named after the US Treasury head then) allowed the reduction of the value of the debts of the hard-hit countries by pricing their debts to the very low discounted prices in secondary markets. This was after a decade of stringent conditionalities of fiscal and monetary austerity with massive devaluations. The Latin American and Philippine debt crises ended in 1992 when creditors agreed to the Brady Plan, with US guaranteeing the payment of the still active part of the loan—this reduction on the required principal and interest payments is called a "haircut."

Similarly, South Korea was the first country to recover from the AFC because of a debt workout engineered by the South Korean and US governments. The IMF played no role here, as it insisted that the hard-hit Asian countries (i.e., South Korea, Thailand, and Indonesia) be punished by austere and contractionary policies. However, they changed their minds in late 1998. In South Korea, creditors (both foreign and domestic) got together with indebted Korean *chaebols* and other companies to negotiate the restructuring of loans that included rescheduled payments and "haircuts." South Korea was given special preference because of its strategic military importance to the US. Greece was also able to get a "haircut" from the European Union (EU) and Germany, as Bello explains, but in exchange for very painful conditionalities of fiscal and monetary austerity and flexible labor markets. The other sovereign debt crises, like those of Argentina, ended like Greece (i.e., with "haircuts" but not without very painful conditionalities). Without the austerity measures and conditionalities imposed, debt workouts (like in South Korea) could have been practical solutions beneficial to many developing and emerging economies facing liquidity and solvency problems.

Similar to debt workouts is sovereign debt restructuring. If the debtor is a government (who has taken over all the private debts), sovereign debt restructuring becomes a workout between the various creditors of the government and the defaulting government itself.

Another possibility is the establishment of sovereign debt bankruptcy laws recommended by many developing nations and international institutions, including the IMF. Here, just like any corporation or individual in a country who can no longer pay their debt, the law protects the corporation or individual by allowing the entity to stop the payments because of real incapacity to pay (i.e., the right to declare bankruptcy). A neutral court will decide on how to settle the case between the lender(s) and the borrower. In the case of sovereign debt bankruptcy proceedings, the establishment of an international court solely to tackle these cases was recommended. Unfortunately, the US and foreign investors, including multinational banks, made a united stand against this proposal. Now, during this COVID pandemic-Great Depression period, many developing and emerging economies are facing and will face depleting international reserves, a shortage of funds to respond to the pandemic, economic collapse, and the inability to fund the required foreign debt payments. The IMF and World Bank have persuaded the G20 countries to suspend repayment of official bilateral debts starting May 1, 2020 to the world's poorest countries: International Development Assistance (IDA) countries of the World Bank (plus Angola) and the least developed countries as calculated by the World Bank.

Many progressive economists have gone much further and suggested that during this grave pandemic lockdown and economic shutdown, a temporary external debt payment moratorium be given to all but AAA-rated sovereign debts (Reinhart and Rogoff 2020). This includes debts owed to multilateral lenders (i.e., IMF, World Bank), sovereign creditors (e.g., EU, China, US, Japan), and private investors.

All the above are moves to allow countries fiscal and foreign exchange space to provide social protection and economic stimulus to the gravest recession, or most likely, depression to face this generation in this lifetime.

Since the G20 countries are only allowing nonpayment of debts and interest to the poorest nations, it is very likely that many low-income and middle-income, and perhaps even high-income economies, will face default, debt repayment, and shortage of foreign exchange problems.

Joseph Stiglitz (2020) had recommended a stay on foreign debt payments during the COVID pandemic. He also recommends that mechanisms for sovereign debt restructuring or sovereign debt bankruptcy be available for defaulting economies. According to Stiglitz, just as most governments now are asking private creditors in their countries for forbearance (a lax and more understanding agreement with the debtors on debt and interest payments) due to COVID-induced recessions, so too must forbearance and leniency be given to sovereigns which need critical funds to rescue a whole population from a pandemic and also save an entire economy from collapse. Stiglitz also recommends that the IMF issue free special drawing rights for countries in need. This is like giving free money to governments that are desperate to save their people and their economy.

Will China Be the Next Country to Suffer a Deep Financial Crisis?

Finally, I am ready to discuss whether China will suffer a deep financial crisis. The question has become even more important after China's first quarter gross domestic product (GDP) has plummeted by 6.8 percent because of the pandemic and the subsequent Wuhan lockdown.

Before the COVID pandemic, I believed that there was just a small chance that a financial crisis would hit China. The logic goes as follows:

> The government in China and the People's Bank of China (PBC) are well known for their strong-arm policies and interventions. Their policies may not be always consistent but are usually counter-cyclical, that is, lax financial and monetary policies during bad times and slowdown; and stricter controls and supervision of monetary and financial sectors during good times and high growth, as well as during times when the financial problems seem to be getting out of control. This strong state nature of China's governance gives an advantage to China

> because most creditors are under the government's control: state banks, private banks, and financial institutions including shadow banking. A large portion of borrowers are also under the government's control: state-owned enterprises (SOEs), local government units (LGUs), exporters, and large financial investors. What are not in government's control are the small private investors and households, who, unfortunately, are the riskiest among the borrowers. Nonetheless, government policies can implement policies to affect their behavior.

Since most of the players can be controlled, monitored, and supervised, the financial problems are more manageable than in other countries. What makes it more convenient for Chinese authorities is that a big portion of the creditors and borrowers are government entities themselves (i.e., state banks, the largest sector of the banking system on the creditor side, and SOEs and LGUs on the debtor side). The financial problems among these entities can partly be solved by government policies that mimic taking money out of one pocket and putting it on the other. (Of course, in reality it is not as easy as this.) The nonperforming loans (NPLs) in state banks have always been blown out of proportion by Western analysts in the 1990s and beyond, but China was able to solve the problem through stricter monetary or financial policies, debt workouts between government creditors and government debtors, and government injection of funds or bailouts of troubled debtors or creditors.

The situation is in stark contrast with other countries that went through deep financial crises. In these countries, creditors and debtors were very different entities with opposing vested interests (e.g., foreign creditors versus debtor countries' government or firms). Debt workouts and restructuring of debts are conflict-ridden, leading to nonpayment of debts and the collapse of financial institutions. In the GFC, the securitization of loans made it very difficult to effect a debt workout among the many players in the financial mess. In Japan, opposing interests and lobbies led the government to keep the NPLs in the bank's books for a long time.

The Western and Chinese analysts' adrenalin increased rapidly with the rise of shadow banking. Being off-balance sheet items and the borrowers now becoming riskier than before, many analysts in the period prior the pandemic predicted that a big financial crisis will ensue in China. This heightened as China's growth rate slowed down toward the 6 percent level, and especially in the period when China was hit by strong speculative attacks in the stock and currency markets between June 2015 and February 2016.

But in the last two years, China was able to reduce shadow banking and its volume of transactions. The policies implemented included stricter rules on wealth management fund and trust products (e.g., prohibiting speculative uses of the funds), stricter peer-to-peer lending (e.g., prohibiting illegal fundraising), and restrictions on commercial banks' asset management business practices. Thus, shadow banking outlets (entrusted loans, trust loans, and bankers' acceptance flows) declined in 2018 and 2019.

Just when the problem of shadow banking problem seemed to be under control, the COVID pandemic broke out, and the massive lockdowns in China caused a 6.8 percent decline in GDP in the first quarter of 2020. Bad debts throughout the financial system of China increased tremendously with debts in the shadow banking sector estimated to have doubled. Bloomberg (2020) claims that loan loss provision for bad loans for the formal banking sector will most likely choke off the financial system. But China's interventionist approach continued. Anxin, a failing formally listed trust company, was rescued by monetary authorities as the trust company was being sued by big institutional lenders for nonpayments. Shadow banking and the entire financial system, especially trust companies where much of shadow banking funds are formally transacted, are hard-hit by the sharp recession, so it remains to be seen whether a financial crisis will occur. But we must note that it is true for all economies in the world now. PBC, the Bangko Sentral ng Pilipinas, and monetary authorities across the globe have pleaded for forbearance from creditors, asking for a temporary standstill in debt payments of struggling companies and debtors until the pandemic is well under control. The financial systems of the entire planet are in very vulnerable positions, not just in China.

Bello explains that the rise of shadow banking is caused by the preferential treatment toward exporters and SOEs which capture most of the credits of the formal system. It is a mechanism of channeling credits to the less privileged sectors, as well as an additional fund channel for property investments.

In the current pandemic moment, Chinese monetary authorities are practicing a stop-go policy on shadow banking. It has reduced the strict policies against shadow banking to allow more credits to go to the low-income and middle-income sectors. The risk is slightly lessened since property and real estate are obviously no longer attractive investments now with the strong recessionary tendencies and uncertainties on when a COVID vaccine will be available. Thus, authorities have allowed laxer treatments of shadow banking. This of course is loaded with danger as it may lead to overwhelming bad debts because of economic recession. Thus, one can understand the stop-go policy of Chinese authorities.

One advantage of China over many countries is that they seem to have beaten the spread of the COVID infection ahead of other states. The shutdown in global travel and sharp reduction in global trade will reduce the lobby power of exporters. This, in turn, will allow China to solve its underconsumption problem and effect rebalancing toward a stronger domestic demand sector. This should now include the strong participation of the previously excluded poorer Western provinces.

China is in a better position than most countries to recover from the recession through fiscal and monetary stimuli and bailout of failing firms and financial institutions. I still put my bet that China will not go through a financial crisis unless it goes first into a deep economic recession or depression. This most likely will happen only if a second and third wave of COVID infections emerge, or a massive mutually destructive economic war with the US escalates beyond control.

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