

# Popping China's Bubble: An explanation of the conflict between economic health and the Chinese Dream

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## Abstract

*This purpose of this paper is to outline the institutional, financial, and cultural drivers that have led to extensive volatility in the Chinese financial system. China's adoption of Keynesian stimulus during the 2008 financial crisis confirmed the Chinese Communist Party's commitment to preserving economic growth at all costs. Liquidity crises in 2016 and 2018 illuminated public discontent with the government's deleveraging efforts and push for a negative savings environment. National distaste for deleveraging has limited the political urgency of deleveraging, and the bureaucratic institutional culture is unlikely to yield public officials willing or able to forcefully act. This paper analyzes the economy created in the aftermath of unprecedented growth, investigating the cultural orientation toward stability, execution of fiscal policy and prevalence of systemic risk.*

## Introduction

In the past thirty years, the Chinese economy has expanded at one of the quickest rates of human history. The emergence of the "China Dream," an often-used slogan by President Xi Jinping meant to denote the Chinese people's dream of a better life and a similarity to the American Dream, is evidence of the new expectations and growth upon which the current population thrives. Yet the ease of presiding over prosperity has corrupted the internal culture of China's political and regulatory institutions. A meritocratic bureaucracy on paper, which has become a corrupt one in practice, pursues its sole mission to uphold the status quo without repercussions for institutional ignorance or irresponsibility. By consistently returning to stimulus in order to prolong the growth of the economy, Chinese policymakers have begun astroturfing their real economy with growth driven by investment rather than

consumption. The Chinese economy has hit the wall of global demand. Despite grand schemes to stimulate that demand, no stimulus will generate real demand in time to rescue the economy from its savings.

The One Child Policy has artificially created a savings-oriented generation, with a culture of fear surrounding the threat of future inflation. Well-documented cases of public outrage regarding the financial sector have made the Party wary of an economic environment detrimental to savings. Twenty years of rapid growth led the entire economy, particularly the financial sector, to become encumbered with debt. As opposed to usual household-firm debt, this debt is intergenerational, bleeding into the culture of New China, preventing the Party from addressing the problem. The threat of public dissent bars any political tolerance of inflation, limiting the potential for reductions of the real debt. In the absence of deleveraging, the political status quo continues to perpetuate systemic risk through the relationships between state-owned enterprises and the private sector. The current economic system in China is unsustainable in the short run because of the cultural orientation toward political stability, fiscal policy and systemic risk.

### **Stability Oriented Culture**

The clash between traditional Chinese familial expectations and its contemporary economy has generated a structural glitch in Chinese life. The traditional promotion of stability is now at odds with the contemporary culture of chaos. The implicit pursuit of social stability has corrupted a legally meritocratic bureaucracy where regulators, administrators and politicians are incentivized to maintain the status quo in the face of mounting issues.<sup>1</sup> At the same time, historic economic growth has left the people accustomed to economic growth and expectant of personal prosperity. New expectations have given way to an evolving culture of social obligations. The One Child Policy has led families to expedite and centralize intergenerational wealth transfers to support their sole descendants, dramatically increasing household savings. This centralization of assets has led to a new fear: inflation, as savers become more conscious of their culturally and financially important holdings. The public's fear of inflation has prevented the government from performing holistic policy despite the potential benefits to firms.

### **Bureaucratic Incentives**

The most glaring institutional feature of the Chinese Communist Party's (CCP) focus on GDP growth is the incentive structure within party and state institutions creating moral hazard. The Chinese government's system of internal evaluation is built on simple reinforcement tactics. Wages are awarded based on seniority, age, level of education, and

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<sup>1</sup> Derived from the characters of steady and decide, stability is an enduring cultural virtue. President Xi recently identified six key areas of stability for China to target in 2018. See Xinhua, 2018.

administrative rank.<sup>2</sup> Three of the four -- seniority, age, and administrative rank -- incentivize self-preservative behaviors and policies rather than policies that promote long-term economic health. Simply put, the performance of local officials has been mainly evaluated based on GDP growth.<sup>3</sup> Additionally, as promotion of administrative rank involves voting among fellow cadres and senior Party officials, progression of administrative rank depends on one's statistical performance and internal alliances. In order to gather and maintain internal alliances, officials operate at the behest of other officials in the hierarchy. The system lacks mechanisms of gathering information on malfunctions or malpractices and gives higher officials the power to punish or reward lower ones.<sup>4</sup> These two factors make internal factions incredibly important to the individual success of a cadre, so it is unsurprising that provincial officials rarely disrupt existing practices without pressure from the hierarchy above.

Furthermore, cadres are bombarded with thought control, dissuading them from creatively engaging long-term issues impacting local economies. Though the practice is successful in asserting the dominance of central leaders, ideological manipulation limits administrators to addressing the problems assigned to them by Beijing, or whichever will help them obtain the next promotion. While a growth emphasis incentivizes these governance improvements, a stability emphasis not only does not do so, but actually disincentivizes improvements as counties focused on stability avoid bold institutional reforms in fear of local unrest. Regarding the likelihood of future local reforms, one official in Anhui noted, "our leaders have no courage."<sup>5</sup> The sustained rate of growth distorted the logic of evaluating performance based on growth. Promotions have become less objective, resulting in an enhanced role of patronage in local personnel decisions, which is a leading cause of corruption.<sup>6</sup> Advancement became a sign of a cadre's loyalty to their chain of command, so pursuit of advancement lost what little connection it had to administrative efficacy.

Thirdly, maintenance of one's own position requires systematic advancement in administrative ranking and seniority. Each successive administrative rank places formal and informal age restrictions upon cadres, tying political mobility closely to age. The mean age of

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2 Administrative rank refers to the legal standing of a province or institution, arguably the most important aspect in determining the power and influence of a cadre. See Ringen, 69-80, 141.

3 Guangzhong Cao, Changchun Feng, and Ran Tao, "Local "Land Finance" in China's Urban Expansion: Challenges and Solutions," *China & World Economy*, 16, no. 2 (2008): 19-30.

4 Stein Ringen, *The Perfect Dictatorship: China in the Twenty-First Century* (Hong Kong: Hong Kong University Press, 2016), 69-80.

5 David J. Bulman, *Governing for Growth and the Resilience of the Chinese Communist Party* (Cambridge: Ash Center for Democratic Governance and Innovation Harvard Kennedy School, 2016), 4-5.

6 Ibid.

Provincial Leaders' remains at 55.4, and the mean age of City Leaders is around 50, which have both remained stable throughout the 1990s and 2000s.<sup>7</sup> Meanwhile, CCP Politburo Members' median age was 63 in 2007. This indicates some degree of formalization within the Party bureaucracy regarding the age of its cadres, such that a cadre must progress up the party ladder with age.<sup>8</sup> Age restrictions prevent the entrenchment of cadres within a single institution, limiting the potential for factional capture but also the stability of human capital. Short-term stationing of cadres around the bureaucracy not only reinforces the power of entrenched hierarchies but also disincentivizes a cadre from addressing long-term problems, as they will inevitably retire or be moved away from those problems. It is not a civil service but a party service; public servants do not answer downwards to the people they serve but upwards to those they serve for.<sup>9</sup>

### **Economic and Cultural Fear of Inflation**

A high savings rate throughout the country translates to widespread sensitivity toward savings, meaning the maintenance of a savings-friendly economy is important to the CCP. A danger to the financial stability of future generations is a danger to the present political power of the CCP, and in brief moments of volatility, public outcry has not gone unnoticed. Noteworthy public demonstrations have emerged in the aftermath of a string of short-run bubbles, particularly throughout the 2018 credit-crunch that led to the bankruptcy of dozens of corporations in the third and fourth quarters of that year.<sup>10</sup> Many middle-class Chinese families who reported losing money in risky ventures refused to quietly absorb their losses, and many even notified local police, despite the person-to-person (P2P) lending business being informally banned in 2016.<sup>11</sup> During the credit-crunch, private lenders lost an estimated RMB 51,790 million in bankrupt Local Government Financing Vehicles (LFGVs) by October 2018.<sup>12</sup> Revealingly, the CCP later acknowledged public concerns by purging the word “deleveraging” from all future official press releases, instead referring

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7 Qiao Liang, *Political Mobility of Chinese Regional Leaders: Performance, Preference, Promotion* (New York City: Routledge, 2018), 23.

8 Ibid.

9 Ringen, *The Perfect Dictatorship*, 141.

10 Xiaohua Gu and Ya Luo, “Victims of P2P Lending Crash Hold Simultaneous Protests Across China,” *The Epoch Times*, October 4, 2018. [https://www.theepochtimes.com/victims-of-chinas-p2p-lending-scams-hold-protests-police-arrest-protectors\\_2678751.html](https://www.theepochtimes.com/victims-of-chinas-p2p-lending-scams-hold-protests-police-arrest-protectors_2678751.html); Orange Wang, “China’s P2P lending market could be decimated this year amid Beijing crackdown,” *South China Morning Post*, (2019). <https://www.scmp.com/economy/china-economy/article/3006170/chinas-p2p-lending-market-could-be-decimated-year-amid>.

11 Wang, “China’s P2P Lending Market.”

12 Gloria Lu et al., *China’s Hidden Subnational Debts Suggest More LGFV Defaults Are Likely* (Hong Kong: S&P Global Ratings, 2018), 8-10. <https://www.spratings.com/documents/20184/0/ChinasHiddenSubnationalDebtsSuggestMoreLGFVDefaultsAreLikely.pdf/00c1bdd1-70c0-9240-12df-850df192c602>.

to “structural deleveraging” in order to ease fears of future defaults.<sup>13</sup> Chinese savers are undoubtedly concerned about the possibility of default, but before 2018, there had been very few defaults among borrowers, and even fewer among state-owned enterprises (SOEs). What savers are more afraid of, however, is future inflation.

Though inflation has increased in the short term, the increase has been quite manageable, holding steady in the medium term. Between 2015 and 2019, the rate of inflation increased from 1.5% to 3.8%.<sup>14</sup> Though inflation hit an eight-year high in November 2019, this was driven by a localized surge in the price of pork imports, which doubled year-on-year in October, accounting for over 60% of the increase in the consumer price index (CPI).<sup>15</sup> The core inflation rate, which discounts volatile goods such as food and energy, remained steady at 1.5% in October, and in the medium-term, the core inflation rate has been quite low, averaging 1.39% from 2008-2019.<sup>16</sup> Despite the low rate of inflation, the M2 money supply has quadrupled in the past ten years.<sup>17</sup> One of the most telling signs of inflation-fearing savers is the prevalence of capital flight. Capital in China has been flowing out of the country in earnest since 2004, and its first net-capital inflow in nearly a decade was generated in 2013.<sup>18</sup> Net capital flows continued to increase before sharply decreasing in Q2 of 2019 in preparation for the introduction of new monetary tools.<sup>19</sup> All across the income distribution, savers are running to high-returns and new markets to escape future inflation. Savers are so concerned with asset maintenance because of the cultural weight assets carry. Ultimately, a majority of this new wealth is channeled into the purchasing and maintenance of property assets, as the new generation of bachelors need property and safety to meet their standards.

For serious dating and marriage prospects, property is considered a requirement in addition to savings and a stable occupation. The average age of Chinese homebuyers in 2018 was

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13 Mike Bird, “Chinese Deleveraging is Dead, Long Live Chinese Deleveraging!” Wall Street Journal, February 26, 2019. <https://www.wsj.com/articles/chinese-deleveraging-is-dead-long-live-chinese-deleveraging-11551171159>.

14 “China Core Inflation Rate.” Trading Economics, National Bureau of Statistics of China. December 1, 2019. <https://tradingeconomics.com/china/core-inflation-rate>.

15 Chen Yawen and Wu Huizhong, “China factory prices falter, while inflation soars to near eight-year high”, Reuters, November 9, 2019. <https://www.reuters.com/article/us-china-economy-inflation/china-factory-prices-falter-while-inflation-soars-to-near-eight-year-high-idUSKB-N1XJ023>.

16 “China Core Inflation Rate”.

17 “China M2 Money Supply.” Trading Economics, People’s Bank of China. November 28, 2019. <https://tradingeconomics.com/china/money-supply-m2>

18 “China Capital Flows.” Trading Economics, State Administration of Foreign Exchange, China. December 3, 2019. <https://tradingeconomics.com/china/capital-flows>.

19 Ibid.

29.<sup>20</sup> According to the 2010 Survey Report on Chinese Marriage and Love Status, 70% of women surveyed believe that men need a house, a stable income, and a certain amount of savings to get married. Furthermore, 65% of women hope that a man's income is more than double their own, while more than 63% of men do not have high requirements for a woman's income.<sup>21</sup> Unfortunately for young Chinese men, homebuyers pay an average of 10 times their income stream for a home.<sup>22</sup> Lacking a robust national system of individual credit, young people rely on their families to help afford property. Monthly payments made by first-time buyers in 2018 accounted for an average of 42.9% of their income, while for most people, monthly repayments accounted for more than 50% of their salaries.<sup>23</sup>

Much of the pressure comes from parents who feel taunted by the wealth around them in the aftermath of the One Child Policy.<sup>24</sup> The sociological side-effects of the pressure associated with these intergenerational wealth transfers are so well-known they have earned a name: Six-Wallet Syndrome, a term used to describe the spending habits of young Chinese adults upon being given their family's combined fortune.<sup>25</sup> One popular saying, "A good wife and health are a man's best wealth,"<sup>26</sup> illustrates how marriage is important for maintaining good familial relationships because it helps the family gain *guanxi*<sup>27</sup> or maintain *mianzi*.<sup>28</sup> Attending to *guanxi* is important for both personal and professional relationships in China. Business is conducted almost exclusively through *guanxi*, so a person's value in

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20 People's Daily Online, "Average age of Chinese homebuyer is 29.5", The Telegraph, February 5, 2019. <https://www.telegraph.co.uk/peoples-daily-online/society/chinese-homebuyers/>.

21 Chongqing Evening News & News Center, "Survey says Chinese candidates love stable male civil servants and female teachers," China.com, December 16, 2010. [http://www.china.com.cn/news/txt/2010-12/16/content\\_21552148.htm](http://www.china.com.cn/news/txt/2010-12/16/content_21552148.htm).

22 E. Glaeser et al, "A real estate boom with Chinese characteristics", *Journal of Economic Perspectives*, (2016), 3.

23 Maria de Guzman, "China's house price boom over in the 1st tier cities", *GlobalPropertyGuide*, August 19, 2019. <https://www.globalpropertyguide.com/Asia/China/Price-History>.

24 Andrew Jacobs, "For Many Chinese Men, No Deed Means No Dates," *New York Times*, April 5, 2011. <https://www.nytimes.com/2011/04/15/world/asia/15bachelors.html>.

25 Associated Press, "Young, Rich and Chinese: It's life in the fast lane for the emerging class of fuerdai", *South China Morning Post*, August 19, 2016. <https://www.scmp.com/news/china/society/article/2005658/young-rich-and-chinese-its-life-fast-lane-emerging-class-fuerdai>.

26 “妻贤与身体好是男人最大的财富”

27 *Guanxi* loosely translates as personal connections, relationships or social networks. It implies trust and mutual obligations between parties, and it operates on personal, familial, social, business and political levels. Having good, bad or no *guanxi* impacts one's influence and ability to get things done. See Wenderoth.

28 Penn State University and Peking University, *Chinese Culture, Tradition, and Customs*, (2018).



an occupation often counts their *guanxi* above their qualifications.<sup>29</sup> A person's wealth is an essential determinant of their quality of life, social life and employment, which is why wealth is important to contemporary Chinese culture.

### **Unsustainable Practices**

The country's meteoric rise has become a comfortably easy point of legitimacy and support for the CCP, while the economy seems to grow without fail as it expands in a young market. By consistently returning to stimulus in order to prolong the growth of the economy, Chinese policymakers have begun astroturfing their real economy, or crowding out private enterprise with growth driven by investment, rather than consumption.<sup>30</sup> Provincial governments rely on debt to fund central initiatives and regular public expenditures. Two signature investment initiatives, China 2025 and One Belt One Road, commit titanic amounts of investment toward economic evolution and international demand. The development of skills and strategic infrastructure require prolonged, high-risk investments, and returns will not arrive in the short-term. The Chinese economy has hit the wall of global demand, and despite its grand schemes to stimulate that demand, no stimulus will generate real demand in time to satisfy the national savings glut.

### **Borrowing Habits**

State-owned enterprise borrowing has exploded after 2005, and the insolvency of SOE debt is generating concerns in both public and private circles.<sup>31</sup> Among Chinese borrowers, most are SOEs, which have a political and economic obligation to remain in operation. SOEs and local government financing vehicles (LGFV) borrow absurd amounts of money to remain solvent, and in an environment where inflation is suppressed, borrowers are responsible for repaying a larger portion of their real debt. According to the latest data released by the State Council, in 2017, non-financial SOE debt reached CNY 118.5 trillion, exceeding 100 trillion in November of that year. Non-financial SOE debt increased nearly four-fold between 2007 and 2017, and during the same time, SOE assets grew 337%, revenues 159% and profits 60%. SOEs have crowded out a large share of private credit; LGFVs take the place of Public-Private Partnerships (PPPs) in China, interacting with private lending through quasi-state trust companies and secondary balance sheets to make lending safer. SOEs have been the major business group behind the soaring corporate debt, accounting for roughly 88% of it by 2017. While SOE debt was already high at 80% of

29 Yutang Lin, *My Country and My People* (New York: Reynal & Hitchcock, 1935).

30 The crowding out effect is an economic theory arguing that rising public sector spending drives down or even eliminates private sector spending; Will, Kenton, "Crowding Out Effect," Investopedia, April 30, 2019. <https://www.investopedia.com/terms/c/crowdingouteffect.asp>.

31 Margit Molnar and Jianguan Lu, "State-Owned Firms Behind China's Corporate Debt," OECD Working Paper, February 7, 2019: 12. [http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=ECO/WKP\(2019\)5&docLanguage=En](http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=ECO/WKP(2019)5&docLanguage=En).

GDP in 2005, the large stimulus in 2009 (roughly CNY 4 trillion) to counter the effects of the global financial crisis increased the debt further to around 100%.<sup>32</sup>

Many SOEs are still growing through debt, relying on it to remain in operation and contributing to major insolvency across the sector. Experts estimate 40% of SOEs lose money every year and borrow yearly to pay off annual interest payments to private lenders.<sup>33</sup> The Party does not tolerate high rates of nonperforming loans (NPLs) so SOE debts continue to be offloaded onto the real economy to be sold through wealth management products (WMPs).<sup>34</sup> Effectively, these SOEs are engines of interest payments and an increasingly small percentage of urban employment, about 10% in 2018.<sup>35</sup> Without real assets or revenue to create real value, SOEs are extremely illiquid instruments of stimulus and inefficient employment.

### Future Stimulus

China 2025 is a good example of the risk associated with crowding out. The “flagship” economic program promotes strategic industrial development through targeted investment. Although the ideological thrust behind the plan is sound, accelerating the process of adding value to an economy is challenging in the short-term. Funding cannot solve the higher education and high-skilled labor peak in service-oriented economies; the process of generating the necessary supply of high skilled labor will take decades.<sup>36</sup> As of the middle of last year, 1,940 “government guidance funds” have been established to finance investment in strategic technologies, which on paper, are modelled after private venture capital funds that financed the early development of Silicon Valley’s tech giants. In reality, these guidance funds are government-run bodies set up to direct capital to chosen sectors in accordance with government policy.<sup>37</sup> By having state-owned investment enterprises spearhead China 2025, central planners have tasked structurally inefficient bodies with creating a highly efficient sector.

In spite of China 2025’s stated plan to focus on services, manufacturing continues to be China’s preferred method of infusing stimulus. Services purchasing managers index (PMI) and non-manufacturing PMI both have continued to show steady growth, yet manufacturing PMI has been increasing since the beginning of 2019, a moment of concern for

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32 Ibid, 16.

33 Nicholas Lardy, *The State Strikes Back: The End of Economic Reform in China?* (Washington, D.C.: Peterson Institute for International Economics, 2018), 8-31.

34 Douglas Elliot, Arthur Kroeber, and Yu Qiao, *Shadow banking in China: A primer* (Washington, D.C.: Brookings, 2015), 22.

35 Lardy, *The State Strikes Back*, 93-97.

36 Ibid, 8-28.

37 Tom Holland, “Beijing’s ‘Made in China 2025’ plan isn’t dead, it’s out of control,” *South China Morning Post*, April 8, 2019. <https://www.scmp.com/week-asia/opinion/article/3004900/beijings-made-china-2025-plan-isnt-dead-its-out-control>.



Chinese policymakers.<sup>38</sup> Manufacturing PMI hit an all-time high in 2013, corresponding with well-documented stimulus taking place during that time, most notoriously in the cement sector.<sup>39</sup> It also increased in 2016, amid concerns of another recession in the financial sector. In 2019, manufacturing PMI again hit a three-year high.<sup>40</sup> At the same time, services PMI has been erratic, but generally countercyclical to manufacturing PMI, indicating that in times of recession, or administrative concern, the service sector grows more slowly, even almost shrinking in 2014 before a dramatic increase.<sup>41</sup> Non-manufacturing PMI continued to grow in the last decade, but its growth rate has steadily declined after rebounding throughout 2009, and since 2016, it has held steady around 54.<sup>42</sup> The countercyclicity of service and manufacturing sectors occurs because of the institutional reaction of the Chinese government to quickly rescue the manufacturing sector. This countercyclicity may not occur at the long-term expense of the service sector, yet it underlines the sector's lack of firm state support. Manufacturing, with its ties to the central government through widespread state-ownership and historical state monopolization, is the simplest option for stimulus, while the service sector is more exposed to a slowing real economy. Not only is China 2025 incomplete because of its impossible timeline, but also because of the lack of support for the service sector during these brief moments of distress. Potential returns on China 2025 investments will not materialize in the short-term, or even the medium-term, eliminating the initiative as a potential location for successful stimulus.

The Belt and Road Initiative (BRI) is an even more speculative investment and will not generate immediate returns. One Belt, One Road is another example of a theoretically strong idea requiring a long period of sustained investment before turning any substantial profit. Unfortunately, the short-term prospects for BRI continue to worsen, as smaller countries curtail their previous commitments to large infrastructure projects. In January 2019, the Malaysian Cabinet announced plans to abandon a \$20 billion high-speed rail across the Malay peninsula, and \$3 billion gas pipeline projects.<sup>43</sup> The Malaysian cabinet released

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38 "China Services PMI." Trading Economics, Markit Economics. December 1, 2019. <https://tradingeconomics.com/china/services-pmi>.

39 Ana Swanson, "How China used more cement in 3 years than the U.S. did in the entire 20th Century", Washington Post, March 24, 2015. <https://www.washingtonpost.com/news/wonk/wp/2015/03/24/how-china-used-more-cement-in-3-years-than-the-u-s-did-in-the-entire-20th-century/>.

40 "China Caixin Manufacturing PMI." Trading Economics, Markit Economics. December 1, 2019. <https://tradingeconomics.com/china/manufacturing-pmi>.

41 "China Services PMI."

42 "China Non Manufacturing PMI." Trading Economics, National Bureau of Statistics of China. December 1, 2019. <https://tradingeconomics.com/china/non-manufacturing-pmi>.

43 "China's Belt and Road Initiative: Why the Price Is Too High." Knowledge@Wharton. April 30, 2019. <https://knowledge.wharton.upenn.edu/article/chinas-belt-and-road-initiative-why-the-price-is-too-high/>.

a statement explaining that their reevaluation of the budget led them to determine they could not afford investments on the scale China had proposed.

In a second notable example, Myanmar's Minister of Investment and Foreign Economic Relations said the country would scale-down a \$7.5 billion plan for a deep-sea port built by CITIC Group in the town of Kyaukpyu.<sup>44</sup> He said, "We do not have any concerns about the debt trap...we are not going to borrow to the extent where we can't repay."<sup>45</sup> Ignoring the widespread concerns of debt-trap diplomacy,<sup>46</sup> the short-term future of BRI is bleak, and its short-term profitability even more so. Without global demand for Chinese products expanding with One Belt, One Road, there are no new sources of revenue that the Chinese can use to expand. Traditional benefits from stimulus are the result of a short-term boost to the real economy, so any potential increase in economic growth must by definition occur from the addition or integration of existing demand or assets. BRI is not a plan to incorporate existing assets or demand, but rather a plan to create them elsewhere. As an exporter, China cannot discover new sources of supply to create new revenue streams, as opposed to commodities exporters. In the long-term, an export economy must rise and fall with global demand, so when global demand contracts, exporters shrink.

### **Systemic Risk**

The Chinese economy has experienced the longest period of rapid economic growth in human history, but never before has an economy been able to outrun the reality of long run economic growth. A cycle of good money chasing bad money has continued for 25 years, creating an economy that is systemically overleveraged and built on cycles of worsening credit. Whenever the economy has shown signs of slowing, the response has been consistently political: the infusion of more stimulus to propel the economy to greater heights. There has been no opportunity to clear balance sheets, and the asset growth has been outpaced by the growth of credit. Provincial governments have resorted to selling rural land to compensate for a disproportionate amount of public expenditures since Beijing has refused to allow provincial governments to issue bonds or carry debt, leaving local officials with few options to raise revenue to keep pace with internal performance evaluations. Collective desperation to continue growth has led to bad growth and bad credit, a cycle of systemic risk.

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44 CITIC Group Corporation Ltd. is a Chinese state-owned investment company established in 1979, headquartered in Beijing. The group's subsidiaries include CITIC Bank, CITIC Securities, Frontier Services Group, CITIC Construction and nearly 50 other firms.

45 David Tweed, Iain Marlow, and Dandan Li, "Souring Deals Put China's Belt and Road Dreams Under Pressure," Bloomberg, January 30, 2019. <https://www.bloomberg.com/news/articles/2019-01-29/souring-deals-put-china-s-belt-and-road-dreams-under-pressure>.

46 The intentional extension of excessive credit to another debtor country with the intention of extracting economic or political concessions from the debtor country when it becomes unable to honor its debt obligations. See Chellaney.

## Artificial Growth

The simplest way to increase GDP numbers is to sponsor small-scale infrastructure maintenance projects. These projects can include necessary, routine maintenance, but oftentimes their sole purpose is to give somebody something to do. The repaving of roads, maintenance of escalators, and reconstruction of public goods are among the most common methods provincial governments use to increase GDP without adding any real value to the economy.<sup>47</sup> More well-documented is the administrative repurposing and sale of land. Many smaller cities, particularly new first-tier cities, rely on land sales for most of their annual revenue. Some cities, notably Hangzhou, Foshan, and Xiamen, generate more revenue from land sales than taxes.<sup>48</sup> Land sales do add value to the real provincial economy, but a majority of the short-term benefit from land sales returns to the government rather than to the real economy. Selling land easily accounts for local deficits, but the practice is more of a band-aid than a long-term solution. Between 1990 and 2010, the average number of land sale cases per year increased from 266 to 563 as provincial economies grew to need more land sales every year for swelling urban populations.<sup>49</sup>

The practice of selling land to account for deficit spending became widespread among Chinese city governments in the aftermath of the 1994 tax system reforms, which alleviated the national budget deficit that had sprung up in the 1980s.<sup>50</sup> As a result of these reforms, a substantial part of the money from growth flows to the central government rather than to provincial governments. Although local governments are responsible for 80% of public expenditures, they only receive about 40% of annual tax revenues while the other 60% remains in Beijing. Though the central government will often subsidize local expenditures, the threat of provincial shortfalls remains on the provincial balance sheets. Provincial governments accounted for nearly 90% of all expenditures in 2012, while only receiving 50% of revenues during that time.<sup>51</sup> The disproportionate expenditures of the Chinese state continue in 2019 as China's central government took 48% of the country's fiscal revenues in the first eight months of 2019, leaving the vast local government apparatus – which includes 31 provincial governments, 330 municipal governments as well as around 2,800 county governments – to share the remaining 52%.<sup>52</sup> The prevalence of land sales high

47 Sun Yu and Tom Mitchell, “Chinese local government funds run out of projects to back,” *Financial Times*, October 16, 2019. <https://www.ft.com/content/6aaa5bfe-efce-11e9-ad1e-4367d8281195>.

48 Li Zhang, “Political Reform and Governance,” November 11, 2019.

49 Ibid.

50 Barry Naughton, *The Chinese Economy: Transitions and Growth* (Cambridge: The MIT Press, 2007), 427-428.

51 Zhang, “Political Reform and Governance.”

52 Frank Tang, “China to give local governments bigger share of tax revenues to continue crucial infrastructure investments”, *South China Morning Post*, October 11, 2019. <https://www.scmp.com/economy/china-economy/article/3032597/china-give-local-governments-bigger-share-tax-revenues>.

lights provincial governments' desperation for revenue and the lack of regard for the sustainability of their revenue sources.

Artificial growth has even led to crowding out in finance and manufacturing. Government spending has been disproportionately awarded to SOEs through LGFVs, leading private companies to pursue riskier sources of lending. Private manufacturing has been shrinking without access to traditional sources of funding despite its higher share of exports and higher returns to capital. In 2016, non-state companies received just 11% of new loans issued by the official banking sector, while more than 80% flowed to SOEs despite the fact that non-state firms account for more than half of all spending on R&D, urban employment, and exports.<sup>53</sup>

This riskier source of capital was the shadow banking sector, which exploded with lending in 2016. As an anonymous lending executive told *South China Morning Post*, "Shadow bankers were just as discerning as loan officers at the big banks. Lending to private businesses, often without a government's implicit backing or tangible assets like property, is considered a risky undertaking."<sup>54</sup> Shadow banking loans grew rapidly as an alternative to state-owned commercial bank loans for their profitability and accessibility for small, private enterprises. Corporate debt reached 160% of GDP by 2016 and has remained a large part of national debt.<sup>55</sup> The most common tools of stimulus led to the least amount of real economic growth. Small projects and land sales both add little to no real value in the short-term, and the lack of a method of financing artificial growth has crowded out the natural engines of real growth in the financial sector.

## Lending

In their fear of future inflation, savers without the ability or knowledge to move their money out of China pursue risky, speculative investments, often with dire consequences they are unprepared for. Since 2015, experts estimate an RMB 5 trillion annual deficit in deposits as savings leave the traditional banking sector to pursue higher interest rates.<sup>56</sup> Yet these higher rates of return lead to higher rates of risk throughout the economy, leading to systemic volatility. In the wake of the Great Recession-era stimulus, Chinese finance has experienced a string of bubbles in new lending markets: shadow banking and P2P. The most recent bubble has appeared within new financial instruments known as structured deposits. A

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53 Lardy, *The State Strikes Back*, 119-127.

54 Molnar and Lu, "State-Owned Firms Behind China's Corporate Debt," 8.

55 Lu, "China's Hidden Subnational Debts Suggest More LGFV Defaults Are Likely," 8-10.

56 Lardy, *The State Strikes Back*, 8-31.

structured deposit is a deposit with embedded derivatives,<sup>57</sup> designed for investors who are prepared to sacrifice the fixed interest yield from a traditional cash deposit in return for a potentially higher return by taking a certain amount of risk, while also maintaining the capital security offered by deposits.<sup>58</sup> However, structured deposits are being marketed as infallible WMPs that provide the security of a deposit and the return of a private loan, despite the fact that structured deposits are primarily deposits and not WMPs.<sup>59</sup> These structured deposits became popular in the summer and fall of 2019 in the aftermath of the liquidity crisis in the P2P lending markets. In October 2019, an official at the China Banking and Insurance Regulatory Commission (CBIRC) said that problems including irregular product management and misleading product sales have emerged in the creation and marketing of structured deposits.<sup>60</sup> These problems seem to plague the Chinese lending sector, occurring in P2P, WMPs, shadow banking and now structured deposits. Before structured deposits emerged, P2P lending became popular as both a formal and informal sector, and before P2P, shadow banking was a key source of liquidity. The volatility of this industry originates from its repeated targeting by regulators. However, these small, high-risk lending operations continuously reappear a short time after every new round of regulations.

Though these rounds of regulations have been successful in the short-term, regulators have yet to address the problematic culture of the financial sector. There is widespread disregard for basic laws of finance, meant to protect the solvency of institutions and the system of lending. The most blatant example of this permissive culture is the commonplace use of secondary balance sheets. From small, private lenders to state owned commercial banks, secondary balance sheets are now an essential aspect of Chinese finance.<sup>61</sup> Although these balance sheets are challenging to definitively track, new regulations illuminate their popularity, or at least the concern they pose to regulators. Many Chinese commercial banks maintain a reserve of twice the required reserve ratio (RRR).<sup>62</sup> With this in mind, regula

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57 The embedded derivative requires that some portion of the contract's cash flows be modified in relation to changes in a variable, such as an interest rate, commodity price, credit rating, or foreign exchange rate. If a derivative is contractually transferable separately from the contract, then it is not an embedded derivative. See Bragg 2018.

58 Xueqing, Jiang. "Chinese regulator tightens regulation of structured deposits," *China Daily*, October 18, 2019. <https://www.chinadaily.com.cn/a/201910/18/WS5da9c35da310cf3e-355715ab.html>.

59 Lei Xuan, "Structured deposits in China tumble into a 'regulatory grey area'", S&P Global Market Intelligence, June 3, 2018. [https://www.spglobal.com/marketintelligence/en/news-insights/trending/\\_bqgdq36zx2mtc3bpgku7w2](https://www.spglobal.com/marketintelligence/en/news-insights/trending/_bqgdq36zx2mtc3bpgku7w2).

60 Ibid.

61 Elaine Chan, "China's private firms in traditional low-tech sectors struggling without government support," *South China Morning Post*, April 21, 2019. <https://www.scmp.com/economy/china-economy/article/3006995/chinas-private-firms-traditional-low-tech-sectors-struggling>.

62 In China, banks are assigned different RRRs according to their size and location. Traditionally, an RRR applies to all banks operating in a particular market/country.

tors have begun considering the idea of a ceiling in addition to a floor on RRRs.<sup>63</sup> In lieu of a ceiling on RRRs, in 2018, the PBOC began lowering its array of RRRs to support the real economy and boost social financing.<sup>64</sup> Though the targeted RRR cut should release RMB 100 billion and the broad cut releasing RMB 800 billion, the monetary tool has not kept the private enterprise from continuing to shrink. Ultimately, the potential regulation could pressure commercial banks to acknowledge their other balance sheets, or simply generate even higher rates of insolvency. The use of secondary balance sheets breeds distrust through accounting errors across the financial sector. Regulatory signaling is impossible without an accurate picture of corporate debt, and each factor compounds upon the next to increase systemic risk.

In the final analysis, the key indicator of continued systemic risk in SOEs is the internal culture of risk distortion. Off-balance LGFVs and private debt has been repackaged as safe, government-backed debt, and these highly rated loans have entered the real economy through mostly informal channels. The American Economic Association estimates 80% of private Chinese firms have received funds from these informal channels.<sup>65</sup> LGFV managers transfer money through informal channels using secondary SOE balance sheets, and off-balance sheet LGFV-related debt is loosely valued between RMB 30 trillion – RMB 40 trillion.<sup>66</sup> Local governments have been largely quiet about this mountain of hidden debt, and in many cases, instead of providing guarantees or other support in clear violation of regulations or laws, they used PPPs and investment funds to finance infrastructure projects. The central government frowns on the use of budgetary funds to directly bail out local government SOEs and would hold officials personally responsible for such actions. As such, there is little chance of another round of debt swaps as seen in 2015-2018 to convert the hidden debt into government bonds.<sup>67</sup>

In the absence of central deleveraging, enterprise managers have no incentive to address the problem themselves, and local administrators continue to use SOEs and LGFVs to expand their economic and political clout. The recent initiative to support small business, where the medium-term lending facility was established in order to incentivize safer, one-year loans, resulted in the substitution of private loans for SOE debt and LGFV bonds. While private lenders have begun to shield some liquidity from direct loans to small cor

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63 Lardy, *The State Strikes Back*, 99-117.

64 Xinhua, “PBOC cuts bank’s reserve ratio to bolster economy,” *China Daily*, September 6, 2019. <https://www.chinadailyhk.com/articles/244/76/161/1567765759896.html>.

65 Amanda Lee, “Is China about to bring shadow banking back out of the darkness to kick start its slowing economy?” *South China Morning Post*, March 13, 2019. <https://www.scmp.com/economy/china-economy/article/3001507/china-about-bring-shadow-banking-back-out-darkness-kick-start>.

66 Lu et al., *China’s Hidden Subnational Debts*, 8-10.

67 *Ibid.*



porates, this new shielding has come at the cost of replacing the liquidity of private loans with decidedly illiquid government funds. Since 2006, state assets in small firms grew every year, accounting for nearly 20% of GDP by 2015.<sup>68</sup> In short, SOE's leverage and debt service increased in tandem with their ballooning debt. However, through synthesizing debt, secondary balance sheets, and loan shielding techniques, the debt is publicly viewed as safe and manageable.<sup>69</sup>

### **Conclusion**

In digging beneath the broad statistics of GDP growth, the picture of the Chinese economy is not as rosy as we had once thought. Three aspects of the Chinese economy-- its new financially-oriented culture, impatient fiscal policy, and government-backed artificial growth -- all foundational to the contemporary Chinese economy, contribute to its volatility in the short and medium term. The challenges within the culture of the bureaucracy lie in how the features of the institutions and the habits of public officials generate substantial corporate debt, while the challenges created by Chinese savings create a political environment that prevents regulators from using traditional tools to address this debt.

The internal incentive structure of the cadre system rewards short-term solutions to long-term problems, as administrators are incentivized to focus on promotion through maintenance of the status quo rather than long-term solutions. The widespread practice of leasing reclassified urban land to account for local government budget shortfalls and the tremendous amount of assets held by LGFVs and other SOEs is evidence of the challenges faced by local administrators under the new Tax-Sharing system. Although regulators seem keen to address this problem, the importance of savings in Chinese contemporary culture has prevented them from doing so effectively. Not only are savings an important source of wealth for an increasingly unequal society, but savings connote one's social status and ability to marry in the aftermath of the One Child Policy. Thus, savers are increasingly in fear of inflation, moving money out of the country and seeking higher interest rates through newer and riskier methods, compounding the problem of corporate debt. Despite the debt being held by Chinese corporations and operated largely by local governments, deleveraging has led to widespread popular dissent, forcing the government to ignore the problem as it continues to grow.

Though traditional methods of deleveraging may yield success, Beijing's appetite for public upheaval has been and will continue to be low. While there may eventually be some kind of mean reversion, the process will be painful for Chinese savers. In the face of systemic speculation, lenders can only hope for the rapid generation of real assets throughout the econo

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68 Molnar and Lu, "State-Owned Firms Behind China's Corporate Debt," 7.

69 Ibid.

my, a prospect growing less feasible as the Chinese economy slows. Ambitious initiatives like China 2025 and One Belt, One Road will undoubtedly increase long-run demand for Chinese goods and services, but their short-term success is equally unlikely. When the potential for new spending runs dry, so does the potential for new saving. Continuously slowing Chinese growth limits the potential for growth through investment, which has accounted for 40% of Chinese yearly GDP growth over the last 20 years. As can be seen throughout the developed world, when widespread fear of future inflation becomes political, the consequences have meant the populist disruption and even destruction of institutions.

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