

1. At the beginning of your book you raise the issue of the relationship between authoritarian rule and economic growth. In the case of China, the country has remained under one-party rule since 1949, but its economic performance varied dramatically between the Mao period and the post-Mao period. Even in the post-Mao period, we can see significant differences between the current Xi period and the period of his predecessors. What do these differences tell us about China's one-party system and the quality of economic policy-making?

It is striking that the one-party system, even under Mao, generally had remarkable success in exploiting growth opportunities. During the Mao era, we should add that China began from a chronically weak and poor position, so that any organized structure was going to make some headway.

However, it is when we look at the methods of achieving the quantity and quality of growth that a light starts to shine on the significance of the changes in China's system of governance and the role played by institutions. This is what economists call "total factor productivity" (TFP)—a measure of technical progress and the efficiency with which capital and labor inputs are put to work by the institutional arrangements.

China's TFP surged in the 1980s following the agricultural and ownership reforms, in the 1990s following the state enterprise reforms and the creation of a modern housing market, and in the 2000s as China prepared for and was then able to exploit WTO membership.

The key takeaway is that China's one-party system deservedly has won plaudits when it has been most ambitious with regard to economic reforms and experimentation with market mechanisms. But this is not the case, for example, before the 1980s and again since 2012, when reforms were suppressed or stifled and inputs were boosted, but without any improvements.

2. A follow-up question: how would you evaluate the quality of economic policy-making under Xi, who enjoys unrivaled and centralized decision-making power, compared with that under his immediate predecessor Hu Jintao, who had to share power and is often described as presiding over a decade of "stagnation"?

Hu Jintao's economic record was not bad. On his watch, helped by the global boom and China's WTO accession, growth rose from about 9 percent to over 14 percent in 2007, and then returned to 9 percent. Hu steered China away from the financial crisis and presided over wide-ranging social reforms. Yet, as Premier Wen Jiabao acknowledged while still in office, China's economy became unbalanced, uncoordinated, unsustainable, and unstable.

Xi Jinping inherited a fast-growing economy that was far too dependent on credit and investment, but the party, as he claimed, had lost its Leninist purity and direction. The Third Plenum reform proposals of the Eighteenth Central Committee in 2013 suggested a program that would once again make the model sustainable, but this was not to be. Even with good economic advisers, Xi's commitment to fundamental economic reforms was, and remains, questionable. Since 2017, economic policy has become incoherent. For example, the government wants to deleverage or de-risk the financial system but also to sustain high growth; to force banks to be prudent, but to lend more to risky borrowers; to make local governments observe hard-budget constraints, but to encourage them to borrow more; and to ostensibly encourage entrepreneurship, while strongly favoring the state sector.

3. Although it is true that leveraging and financial sector risks have risen significantly since 2008, in recent years China has begun to mitigate these risks and de-leverage. How much

progress do you think Beijing has made? Is China facing a more serious situation today than, say, in 2015, before the stock market crash and the botched RMB devaluation?

The regulatory reforms in 2016–17 and the clampdown on egregious forms of risk-taking and financial behavior have been partially successful. Recorded credit growth has slipped back to just under 10 percent, growth of non-financial company debt has stabilized, and the risky funding structure of bank assets—i.e., the very short-term nature of borrowing—has lessened.

Yet household debt has been in a protracted state of agitation. Household debt to income, now almost 120 percent, is higher than that in the United States. Local governments have a green light to borrow more to fund infrastructure. The government's resolve to de-risk the system is faltering somewhat in the face of lower growth. The slower pace of credit growth simply means that the inflated \$60 trillion of assets in the financial system will double in eight years rather than in five years.

The 2015–16 policy errors have not been repeated, and capital controls are now more protective. But big doubts persist. The government's deleveraging resolve is already softening in the face of weaker growth, and its conflict of interests in the finance system, as owner, participant, and regulator, is cast in stone.

4. In the chapter on the debt trap you argue that China is more likely to experience a “banking crisis” rather than a “debt crisis.” Can you explain the subtle difference between the two and why this is the case? Some may counter that neither crisis is likely in a country that has a high savings rate, a state-owned banking system, and borrows mainly in its own currency. Is this line of thinking too complacent? Can you envision a scenario of a runaway banking crisis in China despite these three factors?

The debt to GDP ratio, per se, is not a useful indicator to foretell a crisis, but rapid and persistent increases, as those in China, are. However, timing is uncertain. Because China's debt is predominantly RMB-denominated, China's template is less like that in the Asian crisis, or more recently the crises in Turkey and Argentina, and it is more like the crises in Japan in the 1980s or in the United States in the 2000s.

A banking crisis usually consists of five features, all of which are present in China today: high leverage, significantly mismatched maturities of loans and borrowing, elevated credit risks, rising bank loans to deposit ratios, and a lack of transparency. Although the state will not permit (state-owned) banks to fail, the People's Bank already must very closely manage liquidity, credit risks, capital adequacy, and leverage. China's banking crisis will not necessarily be about bank failures, but rather about the growth-sapping consequences of deleveraging.

Indeed, it is often argued that China's high savings rate is a shield against high domestic debt, but inappropriately so. High savings predated high debt in China, so it cannot be the counterpart after the event. Further, high savings does not mitigate or offset high debt, and the principal agents are not the same. Moreover, empirically high-saving economies have succumbed to the zero or low-growth aftermath of having to address high debt. I think this will be the case in China as well.

5. Based on your analysis of the renminbi trap, it seems that, at least for now, China has given up its ambition to make its currency into an international reserve currency. What are the costs of delaying China's exchange rate and capital account reforms? Can Beijing maintain currency stability despite a host of adverse developments, such as the trade war with the United States, its debt trap, and the structural economic slowdown?

Despite changes to the exchange rate system, liberalization of the currency regime and the capital account that have been on the agenda for almost two decades may be as far away as ever, especially in light of the susceptibility to capital flight as revealed 2015–16. The main cost is that

China's potential to have the RMB used more widely for funding and financing will remain impaired. In any event, this should not be, and is not, a big priority for China.

The trade war with the United States is not great for the RMB, especially as, for now at least, China's balance of payments has slipped into a small deficit. Much more significantly, though, are the structural economic slowdown and the low coverage rate of foreign currency reserves as the growing weight of the financial system is highly likely to eventually overwhelm the peg—perhaps within five years—with profound implications for the Chinese economy and the global system.

6. If you were writing the chapter on the trade war today, what aspects or consequences would you want to add or emphasize?

I think I would further emphasize the underlying rift between the United States (or the West) and China regarding technology, industrial policy, and ultimately national security. Trade and tariffs are really the tip of the iceberg, and whatever the outcome of the current U.S.-China trade negotiations with respect to trade, I cannot see China agreeing to change its technology and industrial policies to sufficiently suit US concerns about "indigenous innovation," intellectual property infringements and protections, and technology transfer. The new fast-tracked foreign investment law may appear to be a response, but there are too many loopholes, caveats, and compliance issues.

The Huawei news is testament to this rift, with the United States and several allies charging that Chinese tech policies and companies are compromising security. The row over the use of technology and the role of private companies acting as agents for the state is spilling over into a critical gray area, namely the line between direct and indirect commercial and funding activities of entities pursuing foreign influence, which all states do, and state interference, which is often illegal.

7. There appears to be a glaring contradiction between Xi Jinping's ambitious agenda of expanding Chinese influence abroad and the severe economic headwinds he faces on all fronts. Is China making the mistake of overreach? Which components of Xi's foreign policy agenda will have to be paired back significantly due to the lack of resources in the coming years?

President Xi is certainly facing some pushback at home over the government's approach to the United States and the trade war as well as to its economic policies. Yet Xi's ambitious and signature foreign policy is not plain sailing. Several countries, including Malaysia, Sri Lanka, some countries in East Africa, and even Pakistan—the heart of the BRI—have come out against China's financing terms, opacity, and governance in the BRI, causing China to tone down its rhetoric and to reflect on how to pursue its goals. Also, the United States, Japan, India, and Australia are belatedly trying to counter China in parts of Asia and Africa.

The difficulties that have descended on Huawei also reflect a possible further pushback against the Communist Party's pursuit of commercial, security, and foreign policy goals, as I just now outlined.

In hindsight, the financial crisis and Trump certainly opened the door to Xi's ambitions, but Xi is probably trying to do too much too soon in a more hostile environment. Chinese foreign financing, which so far has accounted for the bulk of the BRI strategy, may be pared back in the coming years, especially if debt problems in the BRI countries mount, and as Chinese banks slow down both foreign asset expansion (perhaps as China tilts more to foreign direct investment, the AIIB, and other joint funded projects), and as domestic debt-management issues also crimp local currency lending.

8. Overall, your book seems to paint a very rigid system that is under enormous stress but has little room for meaningful change. This description of the Chinese system is at odds with the many

Western executives' view of China as a flexible, responsive, and resourceful one-party state. Who is right? If you are right, what does it take for the system to be less rigid to overcome the numerous "traps" that you have analyzed in your book?

I agree that in the past the party earned its reputation for pragmatism and for managing change well, and Western executives have been wowed by the opportunities afforded to them. Many Western executives continue to be wowed.

Yet, there is no mistaking there has been a marked change in attitudes and perceptions since 2012. The Western pro-China lobby is much weaker. Although some firms with good contacts and in non-threatening, non-priority sectors may still be able to make good deals, businesses have tired of China's commercial and industrial policies. Evidence is increasing about firms moving some supply chain operations into other parts of north Asia, and there is resistance to the new official narrative in which China's historical success and future prospects are seen to be tied to the party, state enterprises, and the centralized industrial policy rather than to the factors that transformed China, namely the selective encouragement of market mechanisms and entrepreneurship, and learning from the rest of the world.

With all this in mind, I argue that China's traps are not unique or insuperable, but they have emerged quickly on a considerable scale, more or less at the same time, and they face a governance system that I do not think is compatible with the economic and political strategies required to successfully spring or bypass them.

I am not saying the Chinese people will not become better off over time, or that China cannot or will not make significant scientific and engineering progress. But I do think Xi 's China has reached, what I call in the book, "the end of extrapolation" and that we need not to cower before those who nonetheless claim that Chinese dominance is assured.

I think the debt trap and Xi's reform shortcomings will lead to significantly lower growth, perhaps no more than 3 percent. In a few years, the RMB peg will break, leaving China's US dollar not too different in relation to the US dollar now. Chinese aging will become more problematic for an economy with more older people than in many other countries. And although China may prove to be the first populous, non-oil authoritarian country to avoid the middle-income trap, I feel that its governance and institutional settings are not propitious.



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George was the Chief Economist, and then Senior Economic Adviser at UBS Investment Bank from 1995-2012. He had a front row seat and key managerial position for multiple episodes of boom and bust in both advanced economies and emerging markets, including notable the Great Financial Crisis

of 2008. George famously anticipated it in 2006-2007 with a series of research papers in which he warned of an impending Minsky Moment. Whilst at UBS, he served for four years as the Chair of the Investment Committee of the pension and life assurance fund. For four years until 2016, he served finally as an external senior adviser with clients of the investment bank.

He had previously worked as the Chief Economist at SG Warburg (1987-1995), and before that in a senior capacity before 'Big Bang' at Laurie Milbank/Chase Securities, and before that, Bank of America in London and San Francisco.

George's current book, **Red Flags: why Xi's China is in Jeopardy** was published in September 2018 by Yale University Press. It examines China's contemporary economic and commercial challenges and aspirations to modernity in the light of a governance system that is a throwback to much earlier times in the People's Republic. His earlier books are **The Age of Aging** (2008), **which** investigated the effects of the unique experience of demographic change on the global economy; and **Uprising: will emerging markets shape or shake the world economy?** (2011) which examined the rise of China and other major emerging markets, and questioned controversially the widely accepted narrative that China was destined to rule the world.