

# China's financial PARADOXES

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China's international financial showmanship at the Asian Infrastructure Investment Bank should not distract attention from its deep financial fragilities at home.

The UK recently defied its "special relationship" with the United States by applying to join the China-led Asian Infrastructure Investment Bank (AIIB).

Other leading European countries France, Germany, Italy and Switzerland quickly followed suit. And there is now talk that Australia, Korea and even Japan might be the next AIIB suitors.

China's leadership in the creation of the AIIB and also the New Development Bank (formerly the BRICS Development Bank) is a direct challenge to the US-dominated post-war international financial system centered on the IMF and World Bank.

It is thus seen by many as symbolic of the financial power of China — and the waning influence of the United States.

But China's international financial showmanship should not distract our attention from China's deep financial fragilities at home.

China's total debt has risen from US\$7 trillion in 2007 to \$28 trillion by mid-2014, according to a recent report by the McKinsey Global Institute. It accounts for more than one-third of the growth in debt globally. Representing 282 percent of GDP, China's debt is now even larger than that of the United States (269 percent) or Germany (258 percent).

China's rapid debt buildup is about double that of the United States before the global financial crisis or that of Korea before the Asian financial crisis. If the current pace of debt buildup continues, China's debt would reach 400 percent of GDP by 2018.

This debt surge is the result of the government's stimulus program in response to the 2008 "Lehman shock". This stimulus took the form of an explosion in directed bank lending, mainly to state-owned enterprises and local governments. More recently, this was followed by a boom in shadow banking finance.

China's debt is concentrated in the SOE sector. Indeed, at 125 percent of GDP, China now has one of the world's highest levels of corporate debt. While China's government debt is more modest at 55 percent of GDP, this could change quickly if the government were obliged to bailout SOEs or to recapitalize financial institutions.

China's debt binge has created many vulnerabilities. Unregulated shadow banking accounts for nearly half of new lending since 2008. Some local government infrastructure projects are not capable of generating financial returns to enable debt repayment.

And nearly half of China's total debt is directly or indirectly related to the volatile real estate sector.

Real estate prices in China skyrocketed over the past decade, increasing by some 500 percent from 2004 to 2013. Some analysts have described China as the biggest bubble the world has ever seen.

A price correction has already begun. In fact, a slump in the housing market seems to be accelerating, as housing prices have fallen in each of the past six months.

"A plausible concern is that the combination of an overextended property sector and unsustainable finances of local governments could

result in a wave of loan defaults in China, damaging the regular banking system and potentially creating a wave for investors and companies that have put money into shadow banking vehicles," the McKinsey report argues.

"Don't worry, China won't crash," was the message from Premier Li Keqiang at the end of the recent National People's Congress. But even Premier Li acknowledged that the Chinese economy faces a long period of adjustment.

At this stage, the Chinese government has the financial wherewithal to deal with its debt challenges and stave off a full-blown financial crisis. Premier Li also indicated a willingness to continue propping up the economy if necessary.

But as the case of Japan two decades earlier highlights, public finance can get quickly out of shape if the government does not promptly address financial problems.

To prevent a recurrence, the government must implement structural reforms to empower provincial governments to raise sufficient tax revenues to finance their expenditures and to enable the financial system to allocate finance more efficiently. Too much of China's financial resources are currently being wasted.

Some observers have argued that China could use its immense foreign exchange reserves (about \$4 trillion in value) to solve its sudden debt problem. But it's not as simple as that.

Such an approach would require selling foreign currency-denominated investments and converting the proceeds into renminbi. This would push up the renminbi exchange rate, harming exports at a time of economic weakness.

China must now navigate a major turning point in its development trajectory. A period of slower growth is being heralded as the new normal. But what is most important is unlocking productivity as a fresh driver of growth and industrial upgrading now that the demographic dividend of cheap labor has come to an end.

This will require urgent implementation of the commitment of the 2013 Third Plenum to allow market forces to be the decisive factor in resource allocation.

In the past, China's economic policy makers have proven themselves adept at navigating treacherous waters. But introducing more market forces into China's still state-dominated economy with all the creative destruction that entails, while at the same time finding a path out of the clutches of financial instability, will require even more skillful policy making than in the past.

In contrast to its domestic policy prowess, China has not been adept at making friends with its neighbors like Japan, the Philippines or Vietnam, or its own antipodes such as Xinjiang, Tibet, Hong Kong or Taiwan.

The AIIB could serve a very useful role in financing some much-needed infrastructure in South East and South Asia, thereby improving China's soft power.

But it will also be used to enable President Xi Jinping and his government to project their imperial image to their neighbors.

How all this plays out will be fascinating to watch. It is not irrelevant that the people of little Sri Lanka have just voted out a government which had sold its soul to Beijing.

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# WHEN JOKOWI IS MUCH MORE TRUSTED than Megawati in leading PDI-P

VIEW POINT



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Her inner-circle supporters quickly questioned the motive of pollster Lembaga Survei Poltracking Indonesia after it announced its findings last Sunday that public trust in Indonesian Democratic Party of Struggle (PDI-P) chairwoman Megawati Soekarnoputri had drastically declined. Her daughter, Puan Maharani, and son, Prananda Prabowo, seemed even worse in the eyes of the public.

Hanta Yuda, the executive of the polling company, said the PDI-P should speed up leadership regeneration, since the public wanted to see new leaders.

The PDI-P will hold its congress next month in Bali. Only a miracle could change the fact that Megawati, the country's fifth president, will be unanimously reelected for another five-year term.

Citing the survey's results, Hanta said President Joko "Jokowi" Widodo was more desirable than Megawati as future PDI-P party leader, a party based on the ideology of her father, first president Sukarno.

The survey merely confirmed public sentiment that

Megawati has lost credibility as party boss and that Jokowi is perceived as one of its most promising leaders.

There are a couple key reasons for the public's growing impatience with Megawati and her family. For starters, many PDI-P supporters, even Megawati's die-hard followers, felt angered and disappointed by her emotional defense of National Police chief candidate Comr. Gen. Budi Gunawan. She was reportedly outraged with Corruption Eradication Commission (KPK) leaders when they named her former adjutant as a graft suspect in January. The media reported that she tried to force President Jokowi to install Budi as the new police chief, despite public protests. Speculations about her motives read like screenplays for soap operas.

The Indonesian public is upset that the political elites systematically destroyed the KPK. And in relation to that it is very difficult for Megawati and her party to cover up their displeasure with Indonesia's most trusted state institution. The party is ranked number one when it comes to the number of politicians jailed for graft.

Until last week, the party was still eager to foil Jokowi's attempt to name National Police deputy chief Comr. Badrodin Haiti the new police chief after he withdrew Budi's nomination. The childish attitude of the politicians is irritating. From time to time they indicate that they will abandon Jokowi, who would be left standing alone without control over any of the country's political parties.

Indonesians also felt frustrated because the PDI-P often acted in opposition to Jokowi's plans, despite the fact that the PDI-P leads the ruling Great Indonesia Coalition. PDI-P politicians in the House of Representatives seem eager to disrupt the government's activities. The opposing Red-and-White Coalition often shows greater understanding — and perhaps even greater support — for governmental policies than the PDI-P.

Megawati apparently cannot accept that she does not control Jokowi and such stubbornness has become a great burden on his administration. Her own daughter, Puan, has made no visible contribution, despite being awarded the post of Coordinating Human Development and Culture Minister.

It was Megawati herself who nominated Jokowi as the party's presidential candidate in the July election. But I suspect her decision was not based on a sincere desire to support the best available candidate to become Indonesia's seventh president. She was simply making a compromise and attempting to accept the bitter reality that very few Indonesians wanted her to return to the State Palace.

Megawati, who ruled the country from 2001 to 2004, had ambitions to run in the

2014 presidential race, even though Susilo Bambang Yudhoyono had already defeated her twice in the 2004 and 2009 presidential elections.

The PDI-P now needs Jokowi more than the President needs Megawati. The former Jakarta governor and Surakarta mayor has, thus far, been much luckier than his predecessor. During Yudhoyono's 10-year term, he was often betrayed and cheated by his own coalition members in the Golkar Party and the Prosperous Justice Party (PKS). They gained lucrative Cabinet positions but often attacked Yudhoyono's government through the legislature.

Having accomplished next to nothing, the opposing Red-and-White Coalition is now collapsing. Two of the major opposition parties, Golkar, the second largest party after the PDI-P, and the United Development Party (PPP), are deeply divided, as is the National Mandate Party (PAN), though on a smaller scale. It is beginning to seem as though the only solid opposition parties remaining are Gerindra and PKS. The leader of the opposition, the loser of the July presidential election, Prabowo Subianto, evidently realizes that being too harsh with Jokowi will negatively affect his camp.

Megawati will remain unchallenged in the upcoming PDI-P congress. But Puan will likely face bitter rejection as the next party chief, given her inability to perform both as party executive and as a minister, which would leave her accomplishments amounting to nothing more than being Megawati's daughter.

If Megawati wants the party to maintain relevance with the times and its current supporters, she has little choice but to accommodate Jokowi in the party. It will not be easy for her to criticize the government because her motives would be all too evident. Hopefully she will be smart enough to offer Jokowi a position on the party's new executive board. It will boost the party's credibility while still allowing her to rein queen of the PDI-P.

Megawati can no longer act as the party's virtual dictator. She may be credited for the party's massive amount of support but she has done little to transform the party into a modern democratic institution. For the sake of her own interests, and the interests of her family, Megawati should share her power in the PDI-P with President Jokowi. She increasingly has less and less room for her dictatorial political maneuvers. Something has got to give.

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# Israel's victory of fear

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Benjamin Netanyahu is probably the most deficient prime minister in Israel's history. His blunders and vices have been laid bare in great abundance during his nine years in power. When he embarked on his most recent campaign for re-election, even his own supporters and constituents could not hide their disgust at his egomaniacal behavior and his wife's embarrassing public conduct.

Beyond Netanyahu's noxious personal characteristics, Israel has consolidated its position as one of the OECD's most unequal countries under his rule. Netanyahu, the most fanatic neo-liberal leader in Israel's history, asked the country's penurious middle class and poor to re-elect him on a record of high living costs, unaffordable housing and a 21 percent poverty rate. Yet re-elect him they did.

Nor could Netanyahu find any respectable security experts to vouch for his return to power. Some 180 generals and war heroes, chief among them Meir Dagan, one of the

most revered former heads of Mossad, Israel's intelligence service, came together to oppose the re-election of a man they described as a threat to Israel's security.

But one does not have to be a security icon to see how Netanyahu has burned Israel's bridges with the international community, particularly the United States, Israel's most indispensable ally and benefactor. Not only did he openly seek to sabotage President Barack Obama's negotiations with Iran by aligning himself with Obama's Republican opponents; two days before the election, he suddenly reneged on his commitment to the two-state solution, the cornerstone of the international community's vision for achieving peace in the Middle East.

Given all of this, why did Israeli voters reward Netanyahu with a third consecutive term as prime minister (indeed, with his most comfortable margin of victory since his first election in 1996)? Quite simply, the vast majority of Israelis agree with Netanyahu in a fundamental respect: A small country surrounded by enemies, in a chaotic region of failing states and vicious

non-state actors like Hamas, Hezbollah, and now the Islamic State, cannot afford to run elections on socioeconomic platforms as if it were a peaceful West European duchy.

The pathetic attempt by Netanyahu's opponents to shift the campaign to the spiraling cost of living and prohibitive housing prices was easily defeated by that compelling message. One must, after all, ensure life, before working on the cost of living.

## Achieving a two-state solution would be a formidable task even if Israel had not explicitly voted against it.

Like their prime minister, this ever-growing constituency does not trust Arabs, including those who are their fellow citizens. Liberal Israelis were shocked by Netanyahu's warning on Election Day of "Arabs voting in droves, bussed in by the left".

But to his constituents, emulating the racist politics of Europe's far right was a legitimate exhortation to turn out.

Nor were they scandalized when Netanyahu reneged on his commit-

ment to the creation of a Palestinian state. The Palestinians, having turned down the peace proposals of left-leaning governments as well as the most comprehensive US peace proposal, the so-called Clinton parameters, appear to such voters as not really interested in peace.

They also agree with Netanyahu that Israel's disengagement from Gaza, and the subsequent rise of Hamas there, proves that every piece

of land that Israel relinquishes is destined to turn into a base for launching missiles against the country.

There is, however, another reason for Netanyahu's victory. The left failed to recognize that Israeli elections are not strictly political affairs; they are an expression of an ongoing Kulturkampf in an ethnically kaleidoscopic society. Israeli elections are in some ways a tribal affair; people vote on the basis of memories, insults, religious sensibilities, and

group grievances.

The Israeli right's current political dominance is fed by a widespread yearning for Jewish roots, a deep-seated fear of Arabs, and an uncompromising mistrust of a "world," the so-called international community, with which Jews have a centuries-old dispute. The left's yearning for peace is seen as naive, if not an exercise in political lunacy (and in either case an unpardonable betrayal of Jewish identity).

Netanyahu positioned himself as a magnet for the fears and complexes of a broad array of aggrieved voters, including Russian immigrants, Orthodox Jews, most traditionalist Israelis, and religious settlers. Whether motivated by tribal animosities, an ideological rejection of the peace process, or cultural estrangement from Israel's liberal elites, anyone who feels alienated — ethnically, culturally, or socially — joined Netanyahu to defeat those on the left who had usurped Jewish history and betrayed Eretz Israel.

Achieving a two-state solution would be a formidable task even if Israel had not explicitly voted against it. Indeed, the hope that Netanyahu's

opponents could achieve a breakthrough is misplaced. The Palestinians, after all, never accepted any of the left's peace proposals over the years, and the current fragmentation of Palestinian politics — defined by a weak and ineffective PLO and a Hamas obsessed with an irrational and self-defeating war option — does not give room for much optimism.

The Israeli left certainly cannot be expected, after years in opposition, to crack the code of Israel's labyrinthine politics and lead the country toward a peace agreement with Palestine. If the Palestinians are to avoid the sad destiny of the Kurds, the world's largest stateless nation, and if Israel is to extricate itself from its suicidal march to an apartheid state, both parties need the world to save them from themselves. But does the world have the will, and the wisdom, to act?

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