China in the Next 30 Years

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· Wang Huiyao
· Yu Keping
· Robert W. Fogel
· Yan Shaojun
· Bjørn Lomborg
· Ma Haibing
· Li Wuwei
· Gustaaf Geeraerts

· Josef Gregory Mahoney · Jia Yuling · Li Jie
· Xiao Meiling · Liu Jing · Wei Zhongsheng
· Guan Yibiao · Wu Aihong

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China in 30 Years

Michael Hudson

Michael Hudson is the President of the Institute for the Study of Long-Term Economic Trends (ISLET), a Wall Street Financial Analyst, Distinguished Research Professor of Economics at the University of Missouri, Kansas City and author of *Super-Imperialism: The Economic Strategy of American Empire* (1968 & 2003), *Trade, Development and Foreign Debt* (1992 & 2009) and *The Myth of Aid* (1971).

For the past 30 years China has invested more than any other nation to modernize its economy. Resisting the neoliberal trend to privatize basic infrastructure and turn economic and social planning over to the financial sector to manage, China's mixed public/private industrial and real estate investment has aimed at tangible capital accumulation and rising output, not short-term financial gains (although these gains have been a natural consequence).

By contrast, the United States, Britain and much of the Eurozone face years of economic shrinkage and fiscal austerity as they work off the debt overhead that has rendered their economies so high-cost as to lose their competitiveness, leaving their real estate, banks and much industry sunk in negative equity. As long as their debts are left in place, North American and European corporate profits and government spending will be diverted away from new capital investment to carry the debts that have been run up over the past thirty years—real estate debt, corporate debt, education debts and other personal bank loans, credit-card debt, state, local and national government debt, all beyond the ability of homeowners, businesses and governments to pay without sharply curtailing their spending on goods and services.

China has remained largely immune from this debt overhead, enabling it to continue to build up the world's most modern infrastructure and fastest growth in living standards. It is precisely this success that brings challenges for its philosophy of development over the next 30 years—especially in view of the adverse financial turn that the Western economies have taken.

The main challenge for all economies in history has been to keep debt levels in line with the ability to pay, and to keep prices in line with the technologically necessary costs of production rather than siphoning off the economic surplus in the form of a return to privilege and insider dealing. These objectives require appropriate tax policy and public regulation to prevent "empty" price charges without real cost-value.

From the French Physiocrats through Adam Smith, John Stuart Mill, Ferdinand Lassalle and indeed Karl Marx, classical economists used the labor theory of value as a means of isolating technologically and socially unnecessary "economic rent", unearned income siphoned off by landowners, bankers and rent-seeking monopolies. This economic rent was defined and statistically quantified as revenue with no counterpart in a necessary cost of production. The central concern of two centuries of classical political economy was to free markets from unearned income extraction in the form of land rent, monopoly rent extraction, financial interest and banking charges.

Tax and regulatory policies—and public ownership of land, infrastructure and natural monopolies—seemed well on their way to socializing this unearned income by the early decades of the 20^{th} century. China's "nationalistic" reforms and even its Revolution shared with Progressive Era social democratic reformers in Europe and North America the common theme of trying to free their economies from the landlord and financial classes.

As matters have turned out, this long Western attempt has failed to purge economies of feudalism's legacy of land ownership, banking practices and monopolies. The vested interests fought back, mounting a neoliberal counter-Enlightenment that is redefining "free markets" to mean an economy free for the extraction of rent, interest and public subsidies to a financial oligarchy, seeking to turn itself into a hereditary global aristocracy reducing nations to debt peonage.

The United States has taken the lead in forcing other countries to risk a disruptive collapse of the existing global financial system as the price of rejecting the neoliberal Dollar Standard. This intransigent policy makes today's turning point a dangerous economic moment for the world economy. The way in which these financial and diplomatic tensions are resolved is likely to shape the next thirty years for all countries.

If China is to sustain the positive trends of the past two 30-year periods of its post-Revolutionary takeoff, it must resist this Western tendency. Independence from the Washington Consensus institutions—the International Monetary Fund (IMF), World Bank and World Trade Organization (WTO)—requires the creation of alternative institutions to promote a multipolar world financial, trade and diplomatic system. Enacting capital controls against aggressive U. S. "free" credit creation and ending the dollar's unique role as central bank reserve currency, would help the world defend itself from unipolar U. S. military hegemony.

The starting point must be to recognize that the 1945-2010 era has reached its limit. The world is dividing into rival currency blocs: a dollar-centered bloc whose economies are buckling under the debt burden that has mounted up over the past 30 years, and a non-dollar bloc (as yet undefined) seeking to insulate its economies from the former bloc's financial aggression and military adventurism. This non-dollar bloc centered on China and its Asian neighbors, Russia, Brazil and Turkey is being joined by oil-producers from Iran to Venezuela.

The coming generation will be defined by the way in which the old order disintegrates. China's development for the next 30 years will be shaped not only by its own internal policies, but by events and diplomacy in the rest of the world—and specifically by the decline of the debt-burdened and privatized West, increasingly frustrated, angry and out-lashing as its politicians blame foreigners for their own domestic financial austerity and economic shrinkage.

I. How the Debt-ridden West Will Affect China's Future

Forecasts normally are made by projecting past trends. This cannot reasonably be done for the United States and Europe, because these trends have reached four economic limits for financial and economic diplomacy. These trend reversals are critical to analyze how the Western financial agenda will affect China over the next 30 years.

1. *The debt overhead has reached a practical limit.*

Each business revival since World War II has been characterized by a higher ratio of debt to income (GDP). Real estate, industry, agriculture and basic infrastructure have been "financialized" as interest, dividends and other financial overhead have absorbed a rising proportion of profits, rents and cash flow. The result is that today's economies are so deeply "loaned up" that a third of U. S. real estate is reported to be in negative equity. Instead of becoming the source of personal wealth for most balance sheets, home ownership has now saddled families with heavy mortgage debt in excess of market value. This situation has created a shortfall in the value of collateral backing bank mortgage loans (about 80% of total bank loans in the United States and Britain), pushing the most highly leveraged banks into negative equity.

Their unwillingness to lend more under these conditions has obliged homeowners to start repaying their loans. This debt repayment is counted as saving in the national income and product accounts (NIPA), increasing the U. S. saving rate from 0% in 2008 to 3% today. Instead of the economy borrowing to sustain living standards and market demand, revenue must be spent on paying back the banks. The result is debt deflation, causing a downward economic spiral by diverting resources away from direct investment and consumption. Taxable income is shrinking, causing budget deficits at the local and national levels.

If this trend continues, debts will continue growing much more than the means to pay—causing yet deeper negative equity and a new wave of foreclosures, forced sales and economic austerity, until the system collapses under its financial weight and is replaced by a new structure.

2. *The finance, insurance and real estate (FIRE) sector has overpowered the "real" production-and-consumption economy and is shrinking it.*

China and the West both face the task of subordinating financial dynamics to serve society. In this struggle the West is suffering from its own internal "clash of civilizations" regarding which road to take: the classical Progressive agenda, or the *rentier*-sponsored Counter-Enlightenment that has gained momentum since the 1980s. The clash is being won by the large financial interests that have loaded down the Western economies with debt, overpowering industrial capital and labor, and even gaining the upper hand over public power to regulate and tax banks and their major customers in the finance, insurance and real estate (FIRE) sector.

China has been able to avoid this kind of financial takeover. But instead of emulating its mixed-economy model, Western elites are seeking to isolate China and indeed, much of Asia as an alien civilization, for no better reason than the fact that these economies refuse to let their surplus be extracted by predatory foreign financial maneuvering, arbitrage and currency speculation.

Even if the U. S. re-inflationary drive should prompt banks to start lending buyers enough to start bidding up housing and commercial real estate prices once again, this would mean living costs so high as to make its American industrial labor uncompetitive in world markets. Housing and debt service typically absorb 40% and 15% of wage income respectively. Wage withholding for Social Security and Medicare taxes absorb 11%, and income and sales taxes another 15% to 20%. So even before taking consumer spending on goods and services into account, American labor is priced out of the market by the FIRE-sector charges that employees must pay. Small wonder that the economy faces a chronic trade deficit!

3. *In the sphere of international finance, U. S. officials have abused the dollar's role as a global central bank reserve currency. Increasing the volume of U. S. Treasury obligations held by foreign central banks far beyond the foreseeable ability to pay has turned the Dollar Standard into a form of tribute to finance U. S. financial and military expansion abroad.*

Under the unipolar U. S.-centered scenario the Treasury's dollar debt would continue to provide the global monetary base. Vested interests in the United States and Europe will try to appropriate rent-extracting sectors by financial means (keyboard dollar credit), and even by the Oil War military seizures in Iraq and Afghanistan or assassination programs as in Chile and Operation Condor throughout Latin America in the 1970s. Foreign central banks would finance U. S. post-Cold War military spending, and takeovers of foreign economies with electronic "keyboard credit" created by U. S. banks and fueled by the Federal Reserve.

This is not a stable situation that can long continue, unless other countries are willing to become satellite economies to U. S. financial insolvency, as the Federal Reserve's "quantitative easing" tries to re-inflate U. S. real estate markets, stock and bond markets. The U. S. balance-of-payments deficit cannot long continue pumping liquidity into the world's central bank as a "free lunch" for U. S. military and political diplomacy. As a result,

4. *The era of open and unregulated financial markets is closing down in response to U. S. monetary and financial instability that is becoming outright aggressive.*

While U. S. diplomats seek to preserve a unipolar world along increasingly debt-leveraged lines, financial and property interests are waging a class war against labor and industry throughout North America and Europe. Economies are polarizing between creditors and debtors as the social pyramid becomes steeper, capped by the bailouts of 2008-2009 that created a new financial power elite for the coming century.

Making the usual "business as usual" scenario based on past trends therefore does not make much sense today. The global financial crisis—above all, the debt overhead—shows that existing arrangements do not have long to run. Any attempt to project the major trends that have shaped the world economy since World War II ended in 1945 shows that they cannot continue much further along their present path.

II. The Financial War against the Economy at Large

A basic policy reversal occurred after Margaret Thatcher was elected as British Prime Minister in 1979 and Ronald Reagan was elected U. S. President in 1980. Their reversal of progressive taxation and public regulation of finance and monopolies has promoted an extreme concentration of wealth in the hands of the richest 1% of the population. The U. S. Congressional Research Service has calculated that in 1979, the top 1% received 38 percent of the returns to wealth: interest, dividends, rent and capital gains. By 2004 this proportion had risen to 57 percent, and has reached an estimated two-thirds of total *rentier* returns to wealth today (2010).[①] Wage levels in the United States since 1979 have drifted downward instead of rising as they did during 1945-1980, while interest rates have fallen from over 20% in the United States to less than 1%, and cannot fall further.

The pro-*rentier* business plan is to capitalize as much of the economic surplus as possible into debt service to pay creditors. At the point where debt obligations expand to absorb the entire surplus, no revenue is left for new capital investment or higher living standards. The accrual of back-interest expands the debt overhead at an exponential rate at which no economy can keep pace. Until these debts can be written off, the West

① Interview, April 2003. Congressional Budget Office, *Historical Effective Federal Tax Rates: 1979 to 2003*, December 2005. See Isaac Shapiro and Joel Friedman, "New, Unnoticed CBO Data Show Capital Income Has Become Much More Concentrated at the Top", January 29, 2006, Center for Budget and Policy Priorities, center@cbpp. org.

will be plagued with financial and fiscal austerity as debts can be carried (to say nothing of being paid off) only by cutting living standards and business spending below break-even levels.

Within the global economy this financial business plan seeks to achieve what military conquest did in times past: gain control of the land, basic infrastructure (to impose "tollbooth" access charges) and the money-creating power so as to extract interest and fees for credit and even to use money as means of payment, *e. g.* as credit cards or bank credit.

Throughout history the aim of financial oligarchies, warlord conquerors, kleptocrats and crime families has been to make their fortunes hereditary, to abolish the estate tax and taxation of their property and income, and to dismantle public power to regulate them and to write down debt claims. The result promises to become a hereditary aristocracy by turning its economic power into political power and privilege while imposing austerity on employees and the professional middle class. And yet as European and American living standards are rolled back, China is blamed. Its best defense is to explain where the Western economies have gone wrong—and even to help them solve their problems. It should base its foreign policy on the following premises:

1. *The West is succumbing to debt deflation and economic polarization between creditors and debtors, creating a financial oligarchy reaching out to siphon off Asia's economic surplus.*

The West is failing economically as a result of its inability to subordinate its financial system, tax philosophy and property relations to the needs of tangible capital investment, economic growth and rising living standards. To see where its economies are going, it may help to review how the reformist momentum of Western civilization from the 13th through the mid-20th century was derailed—ironically, to be carried on most successfully by China.

The "Western problem" goes back a thousand years, to the time when Viking invaders established themselves as an absentee landowning aristocracy. Warlords made themselves kings, and their followers became lords of the land. And in time, inasmuch as money is the sinews of war, rulers borrowed from Italians and other bankers who adopted the financial practices pioneered by the Templars and Hospitallers within the Church itself. This created a symbiosis between government and finance. Rulers paid their debts partly by levying new taxes (mainly excise taxes) and by creating trading monopolies to sell off. From the 13^{th} century onward, Western Europe—and later the colonies it carved out in the New World—thus suffered from the absentee landlordism and privatized infrastructure ownership that were the economic legacy of the medieval epoch's military conquests.

By the 20^{th} century, finance had established a symbiotic relationship with real estate as well as government. The result was the FIRE sector, an institutional layer of hereditary (but increasingly salable) privileges wrapped around the "real" production-and-consumption economy.

One would not gather from today's neoliberal narrative of the history of economic thought that from the 1750s through about the 1950s, the thrust of classical political economy was to free European and North American markets from the land rent and banking charges that were the legacy of these feudal conquests—the unearned *rentier* revenue transfers that feudal arrangements had carved out to support a hereditary ruling class. The Progressive reform program did not aim at abolishing "the market", but at freeing it from special privilege, regardless of how such privileges had come to be sold to new buyers and outsiders on credit.

To the classical economists, a fair market price was one that reflected actual, socially necessary costs of production, without special privileges that did not entail any such cost. The objective of public spending on infrastructure and other social needs, as well as taxation, was to minimize the cost of living and doing business. Basic infrastructure services were to be priced at cost (in the case of telephone and communication systems), subsidized or provided freely as in the case of roads and water. Governments would tax away "free lunch" economic rent by individuals extracting income and charging prices in excess of necessary production costs.

The common denominator between classical economics and Chinese reformers such as SunYat-sen was to achieve what John Maynard Keynes delicately called "euthanasia of the *rentier*". Land rent paid to absentee owners (initially the conquerors of the land), and "tollbooth" type economic rent returns to basic infrastructure that had been appropriated from the public domain, were to be re-incorporated into the public sector where they originated deep in antiquity, at a time when temples and palaces were the main recipients of rent and interest. Steeply progressive tax systems were legislated to socialize hereditary fortunes—and to provide equality of opportunity. Economic gains were to go to the most productive and efficient, not simply to the luckiest to be borne into wealthy families in times past. Public education was democratized, and populations were to be provided with health care and old-age support.

Money creation authority was to pass to national treasuries. Government spending was to supply the economy with credit, not private bankers selling the basic bank commodity—interest-bearing debt. It was recognized that unproductive credit tended to load down economies and leave them debt-strapped and prone to foreclosure by an emerging financial oligarchy. The idea was for government spending and credit creation to promote industry and raise living standards.

World War I derailed these efforts. Europe's economies buckled under the legacy of arms debts and reparations, bringing on the Great Depression of the 1930s. And instead of Communism emerging in industrial Germany, Britain or France as mixed social democracies, it took an unanticipated centralized and authoritarian form in Soviet Russia. An anti-Bolshevik National Socialism emerged in Germany and fascism in Italy, leading World War II to be fought over what kind of socialism the world would have: nationalist or internationalist.

As matters turned out by the turn of the 21st century, a globalized financialization has emerged. Debt dynamics have overpowered those of tangible capital accumulation as banking systems have broken free of the constraints that centuries of Progressive Reform sought to put in place. Throughout the West, the vested interests fought back to reverse what the 19th and 20th century reformers believed themselves to have made irreversible. Democratic reform was replaced by a financial stranglehold on governments and subsequent deregulation and un-taxing of wealth, with the United States leading and subsidizing a "neoliberal" (that is, pro-*rentier*) dismantling of public authority from the Third World to the post-Soviet economies and Europe.

The upshot is that the financial sector is waging a global war against the rest of the economy. At issue is how to handle the debt overhead: whether to keep it in place even at the cost of sacrificing new investment, employment and economic growth. The financial sector—supported by the wealthiest 10% of the population—demands government bailouts to shift the bad-debt loss and negative equity onto domestic industry, labor and government.

The resulting financial austerity and debt deflation has been driving Western economies into this blind alley since the neoliberal "Thatcher-Reagan" revolution. Instead of financing investment and consumption, much credit over the past thirty years has been what the classical economists classified as unproductive—and has simply added the accrual of interest onto the debt principal. This borrowing to keep current on existing debts increased the debt overhead exponentially. Banks have loosened their lending terms, and easy credit at low interest rates has increased the "capitalization rate" of real estate rental income and corporate profit. This has inflated asset prices, enabling debt leveraging to increase. More and more credit has been extended on a smaller and smaller equity base, making economies more fragile.

The decade of the 2010s will be shaped largely by how governments handle their unpayably high debt overhead—unpayable without economic shrinkage and a transfer of property from defaulting debtors (and companies going bankrupt) to foreclosing creditors. Local and national governments are scaling back pension payouts, while companies are replacing defined-benefit pension plans with "defined-contribution" plans (in which all employees know is how much must be paid into the plan each month, not what will be paid out upon retirement).

When banks stopped such profligate lending in 2008, debtors had to start paying down these debts. This has caused debt deflation as income paid out as interest and amortization is unavailable to spend on goods and services (or to pay taxes, for that matter). Infrastructure spending to modernize or even maintain transportation, communications and other sectors is neglected as governments cut taxes on property and the higher income brackets while shrinking markets reduce the tax base. Governments respond by selling off public enterprise, permitting the new buyers to raise "tollbooth" access fees, further increasing the cost of living and doing business in neoliberalized economies.

The U. S. plan is to keep the debts in place by flooding the banking system with liquidity so as to lower interest rates. The working assumption