

Demetri Kofinas: What's up everybody. Welcome to another episode of Hidden Forces with me, Demetri Kofinas. Today, we speak with Anne Stevenson-Yang. Anne is the co-founder of J Capital Research, which conducts ground up, primary research for institutional money managers on equities and the Chinese economy.

She is the former [00:00:30] co-founder of Blue Bamboo Ventures and also founder and operator of the CRM software company, Clarity Data Systems. And she's the creator of 66 Cities, a publishing company whose flagship magazine is "City Weekend". One of the highest circulated English magazines in China.

Anne first moved to the middle kingdom in 1985, making her family and home in China for the next 25 years. She is the author of "China Alone". China's [00:01:00] emergence and potential return to isolation. A subject that we will cover in depth today.

In this episode, we take a trip to the other side of the world, to the land of China. The territory that one in every five people, calls home. Our conversation concerns itself with the contemporary changes in Chinese society that came after the death of Chairman Mao. Beginning with the ascendancy of Deng Xiaoping. The architect of a new brand [00:01:30] of thinking that combined socialist ideology with pragmatic aspects of market economics that the Chinese have called socialism with Chinese characteristics.

What changed in the 10 years between the beginning of these economic reforms, and the events in Tiananmen Square. And how do the Chinese government reaction to the uprisings in 1989 alter the opening of Chinese society? How does the Chinese response differ from the Soviet reaction, [00:02:00] in the same year, to the fall of the Berlin Wall? And what has set China apart in its path of development since?

Some have called it a miracle, and by any measure it has been exactly this. The Chinese miracle. The size of the Chinese economy has increased more than 25 fold in the last 25 years from six percent of US GDP in 1992 to 60 Percent today. An accomplishment that defies all principles of economic gravity. Loan [00:02:30] growth in China has averaged 16 percent in the last 20 years reaching an all-time high of 35 percent of GDP in June of 2009 amidst the greatest economic contraction the world has seen in almost a century.

Total debt in China recently surpassed 300 percent of GDP making western finances seem frugal by comparison. In the first seven years since the financial crisis bank liabilities in China grew [00:03:00] by nearly 15 trillion dollars. The near equivalent of a consolidated size of all of US commercial banks. China has used more cement in three years building and over-building than the US did in all of the 20th century. Hundreds of thousands of meters of unsold residential real estate, the size of Singapore. Massive industrial over capacity. Ghost cities by the hundreds. The Chinese economy is in terrible need of a recession. A recession [00:03:30] that it cannot afford but one that it cannot avoid.

How will the citizens of China, it's trading partners, emerging markets and developed economies react when the reckoning finally arrives. And how much longer can the Chinese government continue to postpone the inevitable?

As always you can get access to reading lists put together by me ahead of every episode by visiting the show's website at HiddenForces.io. Lastly if [00:04:00] you are listening to this show on iTunes or Android, make sure to subscribe. If you like the show write us a review. And if you want a sneak-peak into how the sausage is made, or for special story lines told through pictures and questions, then like us on Facebook. And follow us on Twitter and Instagram at @hiddenforcespod. And now, let's get right to this week's conversation.

So Miss Anne Stevenson-Yang thank you so much for coming on the Hidden Forces podcast. Welcome.

Anne Stevenson-Yang: Well thank [00:04:30] you. And just Anne is good.

Demetri Kofinas: Okay, Anne. Alright. So Anne before we begin our listeners should know, and maybe you can clarify for me as well, now you have lived in China for the last 30 years. Is that about correct?

Anne Stevenson-Yang: Yep, people adding on for me, but yeah that's about right.

Demetri Kofinas: That's, about right? You've raised your children in China.

Anne Stevenson-Yang: That's right. The second one was born there.

Demetri Kofinas: Your husband is Chinese.

Anne Stevenson-Yang: Yep.

Demetri Kofinas: And you speak fluent Mandarin.

Anne Stevenson-Yang: Yep. Always trying but I would call it pretty fluent.

Demetri Kofinas: And what is your background besides that? I mean what did you start [00:05:00] off with? How did you find your way in China and what is your background?

Anne Stevenson-Yang: I'm a mutt. I started out as a journalist in New York, and I just floated over to China because I thought it was ... I was actually politically interested in what was going on at the time. I got offered this job at Chinese government foreign languages press and I thought, "why not for a year, that will be fun".

Demetri Kofinas: When did you leave?

Anne Stevenson-Yang: That was 1985.

Demetri Kofinas: 85. Wow.

Anne Stevenson-Yang: I met my husband there. Got married. [00:05:30] And then, just the growth of the Chinese economy kinda sucked me back so I would say I'm an economic migrant.

Demetri Kofinas: Great adventurous of you. Why did you choose China specifically? Because you found politically what was going on there interesting, or had you studied the country for a long time?

Anne Stevenson-Yang: This is really embarrassing but this is my age. I grew up in the 1970's. Mao Zedong was a hero. We didn't really know that much about China. I went to a parochial school. I had a copy of the "Little Red Book" in my blazer pocket. [00:06:00] I thought this is finally the version of communism where they understand the peasants right? I know it's really embarrassing, but I thought that this was a model that would work and I wanted to see it. When I was ... I was actually working a night shift at "Business Week" on the desk in New York and I had a break so I went out. I went to China Books and Periodicals, which existed then. I bought all the magazines and I wrote to them and said I want to go work for you and then I forgot about [00:06:30] it.

One of them sent me a telegram like six months later. I thought, "why not?" Yeah, telegrams existed.

Demetri Kofinas: That's exciting. Very exciting.

Anne Stevenson-Yang: Yeah, it was kinda ...

Demetri Kofinas: Wow. And how long after you moved to China did you meet your husband?

Anne Stevenson-Yang: We worked in the same building but I wasn't really aware of him until we ... Okay you really want to know this?

Demetri Kofinas: Sure.

Anne Stevenson-Yang: In 1987 the ... there was a county in [00:06:58] province that was growing fruit [00:07:00] trees for the first time and they'd gotten sort of relatively rich and they wanted propaganda about this. They invited journalists from Beijing to come and visit. I was sent with my interpreter, and the guy who worked at our magazine, who the Indian guy was sent and he had his interpreter who is now my husband. He was a Hindi interpreter because he'd be in the Chinese army and been trained in Hindi to be in the army on the border with India. We spent [00:07:30] three weeks together traveling around Jiangsu going to commune, and learning about tea growing and congratulating people on their factory accomplishments, and we just got married.

Demetri Kofinas: The rest is history.

Anne Stevenson-Yang: Yep.

Demetri Kofinas: Alright, so well then let me ask you, what's going on in China?

Anne Stevenson-Yang: What's going on ... basically in China every man, woman and child, government, private, [00:08:00] dog, cat is focused on trying to make sure that the government, that the Chinese economy rises in value. That prices rise. That assets stay high and rise and that there's enough stimulus to create growth. That's the maniacal focus of basically every human being in China right now. Not on value. Not on creating something new, but on making sure asset prices stay high.

Demetri Kofinas: So what is the timeline of events that have sort of [00:08:30] raised concern for people in China because there's something else that I've picked up on which is, usually I like to cover subjects that are controversial, aren't not necessarily consensus. I feel like the case with China is where, there isn't much controversy around the idea that there is a bubble in China. Certainly I've been hearing about a bubble in coastal real estate for like 10 years or more. This isn't something where many people are going to come out and say you're a wack job for saying this, or you're crazy for suggesting that the hard lining in China [00:09:00] is a possibility.

Anne Stevenson-Yang: That's true but it's fairly new. I would date that general apprehension from summer of 2015. Prior to that you were pretty much a heretic if you didn't believe in the ever growing value and strength and emergence into the sunlight of the Chinese consumer and the Chinese economy. But what happened in 2015, is number one the Chinese stock market crashed and in spite of the Chinese government's insistence that they [00:09:30] would hold the stock value at 4,500 it went down below 3,000. The second thing is that the RMB devalued by three percent and that shocked the world. It indicated that the Chinese government, in fact, is not in control of the whole economy. Basically, the western world believed.

Demetri Kofinas: Why did the RMB crash?

Anne Stevenson-Yang: Well it didn't crash it declined by three percent and that was just really because the PBOC ... you [00:10:00] have an offshore RMB and an onshore RMB. The offshore RMB was trading at a premium, or at a gap, with a gap. That's not legal under IMF rules. China very much wanted to become a reserve currency for the IMF. They decided, okay we're just gonna close that gap and we're gonna depreciate the onshore RMB by three percent. They didn't realize that all hell would break loose.

Demetri Kofinas: The offshore RMB is for the tradable goods sector, right? There's like one currency for the [00:10:30] service sector in China and one ... what is the breakdown there?

Anne Stevenson-Yang: No the offshore RMB is really quite small. It's just sort of China testing the waters to try to consider whether they might make the RMB convertible at some point. They've actually retracted the offshore RMB quite a bit since that time. At its height I would say there was ... I don't even remember the numbers, but let's say three trillion RMB offshore, one place or another. Which, if, you think about it is really quite small.

Demetri Kofinas: Right. There is [00:11:00] some sort of currency arbitrage discrepancy between certain class of people in China and others, right? From what I understand there's one market for the vast majority of people when it comes to exchange and then for another part. Is that incorrect?

Anne Stevenson-Yang: Well there are people who have access to RMB offshore. If you have an account in Hong Kong or if you have export earnings, or for some reason you're exposed to the international economy, then you may have access to offshore RMB. To that [00:11:30] extent you may have more window on the foreign economy than the average Chinese person. Otherwise, it's really just who has access to hard currency dollars and who doesn't

Demetri Kofinas: Okay, so let's begin at the beginning, which is reform in China. I'm fascinated by this reading your book and preparing for this interview. It put me in a place of thinking about the Chinese economy and the Chinese political system in a way that I never had before. We're used to ... certainly I am ... [00:12:00] to this China of the post-cold war. But of course, there was a pre cold war China. Reforms did not begin until after 1989, nor have they ended. What has that process been like in China and where can we pinpoint some of the more significant turning points?

Anne Stevenson-Yang: It's an interesting question. Reform is a word that we attach to essentially all government change in China since 1979 when Deng Xiaoping began the current program of opening. [00:12:30] I think that in the west we graft on to that word, the idea of increasing liberalization and openness when in reality that's not really what's behind it. I think the way we should look at China is 1979 to 89 and then 1989 on. 1979 was when Deng Xiaoping essentially walked out of prison and into Zhongnanhai, the leadership compound in Beijing, and became the government leader [00:13:00] and began liberalize China in a whole lot of unexpected ways.

Allow people to stop if they met their quotas for growing grain for example, then they could begin to grow cash crops and sell them. Allow people to have some private markets. Allow people to start taking over bust factories and run them for profit as long as they paid off the debts and paid the workers. Things like that. The country really blossomed in a lot of ways. Then you came up to 1989. [00:13:30] Essentially what happened was that this really worked very well. People got a whole lot richer. In many ways it was confusing but it was also exciting.

There was a lot of cultural opening, whereas in the past it had been impossible to listen to western music, or read western newspapers, or wear western clothes. All of a sudden, these things were coming in. There was experimental theater. There was what they used to call disco [00:14:00] dance. There was art. There was all sorts of stuff. There was Qi-Gong, which is a type of sort of quasi-spiritual, physical exercise that became very, very popular.

All of this lead to a sort of almost chaotic opening. To concurrent demand for more rights. More political rights. It culminated in 1989. As we know ... we all know what happened in 1989. 1989 [00:14:30] was followed very quickly by breakup of the Soviet Union in 1990.

Essentially what happened was that the Chinese central government grew terrified that China would go the way of the Soviet Union and would crack up. They prioritized decentralizing the apparatus.

Demetri Kofinas: When you're talking about 1989 you're talking about Tiananmen Square. We know that the government cracked down heavily on the society after that ... after the uprisings. Is [00:15:00] there much information that is available? I know in China you can't get much of anything right? Even if you google Tiananmen Square there's nothing there.

Anne Stevenson-Yang: Yeah of course. You can't get a lot of information on what precisely the crackdown consisted in. There are very wide ranging estimates on how many people were killed, how many people incarcerated. I think for my purposes, what's really interesting is what happened in the years culminating in 1995 thereafter. Where, China changed its tax system. It changed [00:15:30] it's customs. It changed the way local governments managed their budgets. It changed really personnel appointments within the party. In order to arrogate more power to Beijing. They did it in a very clever way.

For example, under the old system localities, provinces would have a negotiation with Beijing every year and decide how many taxes they would pay to Beijing. What Beijing did was they went to the provinces and said, look you're [00:16:00] paying us let's say 25 percent of your whatever, gross nation product of Shanghai every year and that's let's say 100 million dollars. Let's fix your payment at 100 million dollars and what we're going to do is we're going to impose a VAT tax and income tax and Beijing is gonna collect all of it. Then rebate to you the portion that's due to you. Initially the localities were fine with that. [00:16:30] The cost was the same over time. Over time it became very unbalanced. The lower the level of the government, the less money you had.

Demetri Kofinas: The government made a deal with the people, but was that an explicit offering that the government did that they said look, not in these exact words ... leave us in power and we will reform certain parts of the economy that many of you had wished we would in order to expand economic growth. What was the conversation that happened internally in the country around that cataclysmic [00:17:00] event?

Anne Stevenson-Yang: There's a little bit of a misunderstanding embedded there. A system like the Chinese system is not concerned with what people think. The interlocutors are not individuals. The interlocutors are entities, state owned enterprises and local government and those are the constituents for the national government and the people to have to the individuals will follow.

What the central government did, it was a process of negotiation not one of strong [00:17:30] arming. Although it was pretty clear who had more power than whom. The central government would go to the localities and negotiate over tax authority. Negotiate over appointment's authority. Gradually, gradually, gradually they pulled more budget authority and appointments authority up to the central government so that they would have control.

Demetri Kofinas: Is there any comparative framework in the United States that would help us understand the functioning of the Chinese state?

Anne Stevenson-Yang: [00:18:00] No. I think that's very important, because we tend to think that it's similar. There's a national government, there's provincial governments there are local governments but it's a unitary system it's not a federal system. For example, local governments don't have the authority to make their own budgets to collect taxes and make their own budgets. That's the chief reason why we have this huge property bubble because local governments are stuck with the tab for schools and hospitals and roads and bridges [00:18:30] and water processing and all that sort of thing. Yet, money trickles down to them from the center. Goes to the province first then to the city level. The prefecture ... there's five levels of government in China. The prefecture at the bottom is stuck with all the cost, but it doesn't have the right to keep most of the revenue. What can they do? They had to raise money through debt.

Demetri Kofinas: Wow. How would you compare it to the Soviet system pre-[00:19:00] 1991 pre-1989?

Anne Stevenson-Yang: I don't know enough about the Soviet system to be able to tell you. Let's just say the Chinese system is ... they're very, very different in a lot of different ways. The Soviet Union was and is a petroleum state. They have a lot more natural unitary organization to their government and also it has radically lower population. What 130 million or so compared with 1.3 billion [00:19:30] with a territory that's much, much larger and tributaries, rivers and a few railways that connect all the key cities. That's very different. The kind of power that you can exercise over Russia and the former Soviet Union is very different from what you can exercise over China.

Demetri Kofinas: Right. The resource point being important which is that the Soviets would be able to raise living standards by selling natural resources with greater ease or commodities than the Chinese who needed to build. For whom building [00:20:00] an industrial economy was much more important. I suppose you're suggesting.

Anne Stevenson-Yang: I think that's true. Also, the Soviets would be more capable of using repressive power to control their public. The Chinese, that's true out in the less populated areas in the far west, but in the densely populated areas along the coast that's not what's going to fly. What's going to fly is raising investment capital, because in a place where you have, let's say 30 million people living [00:20:30] in a fairly dense area, to build a road or a bridge raises economic performance very rapidly. That creates unity and support.

Demetri Kofinas: That brings us really to the crux of this conversation, which is debt. Because debt and the financial system is the mechanism through which you can exercise control over people in a non-coercive manner.

Anne Stevenson-Yang: Yeah, I think that's right. It's ... there's some brilliant person named Goodhart. I can't remember who it is exactly [00:21:00] who said that ...

Demetri Kofinas: Goodhart's Law

Anne Stevenson-Yang: Yeah. Goodhart's Law. Exactly.

Demetri Kofinas: I wrote that right here actually to begin with this conversation because I felt when a measure becomes a target it ceases to be a good measure.

Anne Stevenson-Yang: Exactly. Great minds think alike.

Demetri Kofinas: I thought to myself that sounds like a Confusion saying. I wrote that there when I was thinking about this conversation. I kept coming back to that. Which is the Chinese have an obsession with numbers. With hitting targets. I was astounded when I looked into this fact further. One of the things has to do with the measure of GDP in China.

Analyst [00:21:30] were not trusting the GDP numbers that began measuring electricity. I'm telling you things that I'm sure you know. In short order it turned out the Chinese government was encouraging contractors and builders to leave the lights on in these places in order to present false figures of electricity consumption.

Anne Stevenson-Yang: Yeah. It's not even that complicated a lot of the time. A lot of the time you simply invent the number that you need. This is important to remember about GDP and so many other numbers in China that these numbers [00:22:00] are organizational tools and targets. They're not calculated results of a data set. Whether or not you distort the calculation the point is, you use something like GDP to mobilize people and to indicate what production levels should be. If you were to drop the GDP target it's a self-fulfilling prophecy.

Demetri Kofinas: They have pretty much relied on that number as their sort of prime point of national pride. As the calling card for ... [00:22:30] the entire point of their existence as a legitimate authority in China. That seems to be so connected to their legitimacy.

Anne Stevenson-Yang: Yeah you could say that. It has a couple of purposes. One, purpose is that organizational purpose. Your principal constituent if you're constituency if you're the Chinese government or state owned enterprises. State owned enterprises make their budgets with reference to the GDP target and they receive their investment capital with reference to the GDP target. The GDP target is measured against [00:23:00] historical industry performance next to GDP and then you do a calculus and you figure out how much investment capital this company should get.

They're required to use that when they make their budgets. On one hand, it's a campaign tool. On the other hand, it's an external messaging tool for investors. Incoming capital investment and portfolio investment, whether it's FDI or portfolio is very, very important to the Chinese economy.

How are you going [00:23:30] to get capital investment if your economy is only growing three percent and Brazil's is growing five? You got to show growth that outstrips other developing countries.

Demetri Kofinas: Is there FDI, Foreign Direct Investment ... is there a lot of foreign direct investment? There are so many aspects of this Anne that I want to get into. Hearing you talk, I'm trying to figure out how to get in without getting lost in the weeds.

Anne Stevenson-Yang: Sorry.

Demetri Kofinas: No. You're not ... Don't be ... Don't apologize at all. I'm, in fact, I feel like this has been an overwhelming task for me to try to figure out how to come in here. [00:24:00] There are so many interesting aspects of this. One of which is the extent to which the Chinese boom has been led by domestic savings. It seems from my research that it is even more than it was the case in the Japanese boom. The Chinese boom has been largely fueled by domestic savings. Is that correct?

Anne Stevenson-Yang: Yeah that is correct. It tends to mislead people by leading them to think that it's all about thrifty individuals storing their money in the bank, when really, it's just a measure of the amount of capital [00:24:30] domestically as opposed to the amount of capital washing over the shores. But that's true. China pulled off quite a remarkable feat. Which was to increase its investment.

You noted that simply the increment in bank assets in China between 2009 and 2013 exceeded the total bank assets in the United States. This is an economy that's 40 percent larger and that's been building it's bank assets for 150 years. It's a remarkable [00:25:00] number. As they were doing that, generally speaking, as you increase your investment to that degree you're going to depreciate your currency. You're expanding the pool of currency, right?

China actually has the expand and control ability to build so much stuff, that it could actually increase demand for investment even as it was investing so much money. The currency was appreciating returns on investment domestically [00:25:30] were rising very high. It was attracting high capital ...

Demetri Kofinas: It's a Ponzi scheme. That sounds like a Ponzi scheme to me.

Anne Stevenson-Yang: Yeah you could put it that way.

Demetri Kofinas: Certainly does. The focus ... Then I say it, and here are a couple other numbers that I got for you. The total amount of concrete used between 2011 and 2013 in Japan far exceeded ... I've got the numbers here ... looks like 4.5 gigatons was what the United States used for 100 years between 1901 and 2000. 6.6 was used by China for just two years.

Does that sound right to you? About [00:26:00] close to 50 percent of the economy is construction. Less than half of the economy, slightly less than half is construction. Is that also right?

Anne Stevenson-Yang: I think that, that's an exaggeration. I would put construction and real estate at about 20 to maximum 25 percent of the economy. It's not really fair to count all building materials because they also go into ships and automobiles and other sorts of things. It's very significant. As for the amount of cement, yeah, I've heard [00:26:30] that as well. It is phenomenal. It's taken a very severe toll on China's natural environment. Eventually that will end, but one hopes it will end sooner rather than later.

Demetri Kofinas: On the thing ... to bring it back a little bit ... You were talking about the growth of bank assets and I think you said from 2009. That was the number that I had found as well from 2009 to recently the amount of assets generated by the banking sector. In other words a reflection of the growth and liabilities was the total [00:27:00] amount of US bank assets. It is basically a reflection of loan growth. That suggests a great amount of mal investment. It suggests it without proving it because it's very difficult to expand that type of credit. In particular in the face of an economic contraction, which is what the world was experiencing globally at that time.

Things like that about China alarm me. Again, I speak very humbly because ... unlike you, I do not live in China. I don't know the country. I don't speak Mandarin. [00:27:30] Just on the very high level it seems to me to defy every sort of principal of common economic sense.

Anne Stevenson-Yang: Well this is the thing about China. It's tremendous size and it's centrality. China can create growth phenomenon that exceeds anything the world has ever seen. I can also create disasters that are greater than the world has ever seen. It's important to remember, it's not just the bank assets. Because the central government was really panicked to create ... to pour [00:28:00] investment into the economy and to avoid the downturn that the rest of the world was seeing.

But they were also committed optically to sound banks with good bank assets. They had to create a shadow sector that became far, far larger than it had ever been before. It had been something like 5 percent of the financial system. It grew at the height to a 55 percent of the financial system. That's really because you insist on making banks that are making prudent loans. Yet [00:28:30] you need four times as many loans that prudently can be made. You create a shadow sector. The banks buy the loans back, and then everybody's happy.

Demetri Kofinas: How does that shadow sector operate? Are you talking about the SCOs?

Anne Stevenson-Yang: Companies like the trust companies. Shadow makes it sound sinister. It's not sinister. It's brokerages, private equity funds, public equity funds, trusts. All sorts of non-banking financial institutions. What essentially happened from [00:29:00] 2009 was the governments wanted more capital than the banks could lend with any

reasonable prudence. What would happen is a trust would lend the money ... you're a developer. You're very risky. We're not really sure what's gonna happen but you'll pay nine percent.

I'm the trust. I'll lend to you at nine percent, and then I'll sell that loan to the bank tonight. I'll give the bank seven percent. I keep the two percent spread. [00:29:30] It's on the banks' balance sheet. I don't have risk. I do it again tomorrow.

Demetri Kofinas: Yeah. There's something similar in the United States with the CDO market and the disintermediation of loans and ownership and everything else.

Anne Stevenson-Yang: Yeah in a sense it's like that.

Demetri Kofinas: Where are we today? What does the picture look like? You mentioned 2015. What was the drop there? About two-thirds of the Shanghai composite?

Anne Stevenson-Yang: I think it was 40 ... 40 percent maybe.

Demetri Kofinas: I have it reversed.

Anne Stevenson-Yang: Maybe 45 [00:30:00] percent.

Demetri Kofinas: I had it reversed. Okay, so about half the market collapsed in China. What have we seen since then?

Anne Stevenson-Yang: Well, essential stability for them. The central government and it's deputies spent trillions of RMB supporting the Shanghai market value to make sure that it ... they couldn't quite pull off 45 hundred for the index, but they pulled off three thousand. It's been hanging out at that level. They've been keeping all the debt rolling over. So essentially have a situation where China ... where [00:30:30] the return on capital invested just goes down every year. So in the best of circumstances you have roughly seven to one ratio for investment to GDP growth. You have to invest 40 percent of the economy to get a six percent ... six, six to seven percent GDP growth.

Demetri Kofinas: That's a reflection also of the inefficiency of the deployment of the capital.

Anne Stevenson-Yang: Exactly. You figure that ... if you put it in really simplistic terms, you figure that GDP growth [00:31:00] should be roughly on a par with lending growth. If you were to bring lending growth down to six and a half percent or so of GDP then you would see GDP growth of one seventh that. So no more than one percent. That you figure is where organic GDP growth is now.

Demetri Kofinas: In other words to say this is basically the Chinese government is committed to a certain growth rate. It has political reasons for wanted that. These are real people in position of power, who [00:31:30] want to maintain their position of power. The

way they're attempting to do that is continue to force an otherwise unsustainable situation to go on a bit longer.

Anne Stevenson-Yang: Yeah that's right because you have a situation where it's just ... it's in ... nobody wants to put their hands on that tar baby. Everybody has the intellectual realization that it's not really a good thing. That the quality of life for the average Chinese person has declined not improved. That education standards, [00:32:00] health standards, environmental standards, all of those things are not improving even as GDP growth rises.

Demetri Kofinas: That's something I actually wanted to ask you about. We see video footage from China constantly. We see people with smart phones, snapping pictures. We see lots of lights. We see all these buildings, and it's impressive. It's something I often wonder about. What has been the improvement in the quality of life in Chi over the past 30 or 50 years, if when measured in the total [00:32:30] sense of the word. Given the pollution and given the urbanization.

The fact that people have moved from the rural parts of the country ... this mass migration... which is also really remarkable. The fact that hundreds of millions of people have actually migrated, physically moved through that country. It speaks again to this ... to the power of the Chinese state. Which is pretty remarkable and I think difficult to comprehend as an American. Really what has been the real improvement in the quality of life? Where can we see improvements in quality of life. Where can we not see that or have we seen a decline in quality [00:33:00] of life.

Anne Stevenson-Yang: There's significant improvement via the better communication system. The fact that there's an internet. That there are smart phones that are universal now. The roads and the transportation networks are phenomenal. That greatly improves the quality of life. As to the other things, yes you can replicate the hardware. I'll give you an example. I've been to three replica Mannhattans in China. One [00:33:30] of them quite large and two others kinda smaller, but still replica Mannhattans. I've been to a replica Hong Kong. I've been to a replica Venus. Although they call themselves Florence.

Demetri Kofinas: Are these replicas... how do we think of them ...

Anne Stevenson-Yang: No, it's not like a toy. It's the real thing.

Demetri Kofinas: I know, but I mean. Okay this is why I ask that. It's astounding. I've seen the replica Paris. To me looks like a full blown town or city.

Anne Stevenson-Yang: Right.

Demetri Kofinas: Is that what it is?

Anne Stevenson-Yang: In the middle of Anhui province. Yeah. It's sort of ... It's kinda ...

Demetri Kofinas: What is it for? [00:34:00] And what I'm trying to understand is it the equivalent of a suburb in so far as, it's another community with a town and people who can commute from there to other work. Or is it itself supposed to be, and what ... what, what

Anne Stevenson-Yang: This is the point. You can replica the hardware, but it's not the same thing as having the original.

Demetri Kofinas: I cut you off, but I also want you ... if you can address at some point this would just ... Do they have any idea what they're doing? Does the leadership, are they just sort of ... we see this all the time. We wonder right? People [00:34:30] ask that about Bernie Madoff. I'm not drawing a direct relationship, but for me personally speaking, there is a Ponzi aspect to this. I think there's just a point in which you're in so deep, that you just hope you can keep it going before you die.

Anne Stevenson-Yang: Yeah.

Demetri Kofinas: Is that sort of what the dynamic has been, is in China?

Anne Stevenson-Yang: Yeah. I think Bernie Madoff is an apt comparison. Not to say anything about the ethical quality of Chinese leaders, but you start out by thinking well, you know. Isn't this a great thing, all this portfolio investment we can capture from overseas [00:35:00] if we just pretend that China mobile is a real company. We sort of paste together all our post offices and call them China Mobile and we'll list it and gain a billion dollars. That's a great thing. Then over time you get caught in it. So now they're in a situation, where if they don't continue to reinvest and to raise the amount of investment capital, then a whole lot of credits just go bust. Nobody is willing to accept the consequences of that, because nobody knows [00:35:30] how far systemically it will go.

Demetri Kofinas: Well how far systemically will it go? Without knowing exactly. What do you think?

Anne Stevenson-Yang: It is really tough to say. It's really tough to say.

Demetri Kofinas: Why?

Anne Stevenson-Yang: Because there are so many contingencies, independencies and so many things we don't know. But let's take one company, Ever Grand. Which is a company I love to hate. There's a real estate company that has projects in 170 cities. Probably has 250 projects or so.

Demetri Kofinas: Ongoing or it's completed.

Anne Stevenson-Yang: Not all of them are [00:36:00] ongoing. Some of them completed. But almost none of them occupied. All of them, most all of them sold. These are projects that are specifically that are pitched to the Chinese aspirational investor. There not

supposed to be places you really want to live. There supposed to be places you buy because in some, in some mythical future, there will be wealthy people who will want to leave here, and commute to their wealthy jobs and their wealthy cars. [00:36:30] And you'll sell your unit to them for a lot of money.

Demetri Kofinas: Sounds like Vegas.

Anne Stevenson-Yang: Yeah. But way bigger. Way bigger. All of Vegas would fit into one Ever Grand development. It is just totally ... Let's not even pick on Ever Grand. Let's just go to any sort of interior city. There's a city that I've been to called Shiyan which is off in the west of Hubei province, and for complicated [00:37:00] historical reasons it lost its core industry. So they were in a panic to invest. They invested in all this real estate.

There was one real estate company that actually tried to recreate Niagara Falls. Shree An is in the mountains. There's no water. This is in the mountains. They actually tried to dig Niagara Falls as a sort of ornament to the real estate development. There's a development in Yunnan where they dug 150 kilometer canal so that they could [00:37:30] have a moat around the five star hotel in the development. Totally loco things. What happens is you have finance these things. The ultimate ... you finance them maybe originally with bank loans and then with shadow bank loans.

Then generally over time those things get securitized and sold to the general public and it runs like a river. Tributaries all over the country. You [00:38:00] really don't know which grandmother and which small town owns the security that will go bust if Niagara Falls is never built. You just can't take that on. How are you going to deal with that. The guy who sold her that security might well be a government official in that town. How are you as the provincial government of the central government going to say to her, oh that ... we didn't mean that. That wasn't us. That was him. That's on you. You lose all your savings. [00:38:30] You don't have a pension. Sorry lady.

Demetri Kofinas: So a few things I'm thinking about. When you talk about the Niagara Falls, I thought about the fact I discovered recently that there is a mock Dubai in China. Are you familiar with that?

Anne Stevenson-Yang: No which one is that?

Demetri Kofinas: A mock Dubai city. I'll find the pictures and I'll show it to you. Unless this is fake news.

Anne Stevenson-Yang: Everything can happen there.

Demetri Kofinas: To me that signified that ... for me Dubai is Dubai.

Anne Stevenson-Yang: Dubai has already mocked Dubai.

Demetri Kofinas: Exactly. Exactly. You know they're building [00:39:00] fake islands. It was in fact in the center of the city was the fake island Dubai sort of palm treed.

Anne Stevenson-Yang: I know where you mean. Hainan. Okay. That's way down in the south.

Demetri Kofinas: Talk about a derivative. Talk about really going ... That to me reflects ... that's wild. I think that's fascinating. It's one thing to replicate Venice and call it Florence or whatever. It's a whole other thing to replicate a replica. How meta. The other thing, again you're talking there and this is something that I've spoken about for years, [00:39:30] it's not even just something recently. I did speak about it recently in a conversation with Mark Faber.

Although I don't think I expressed it explicitly. Which is, I find that the use of debt and the financial sector in particular in China, specifically in China, is very much meant to coerce through other means, to get these people to work way harder than they would otherwise work with the expectation that they will be able to reap the rewards that are sitting in their savings [00:40:00] account. But, those savings that they experience as being theirs, are not actually theirs. They're the state's, right? To do whatever they want to with.

Anne Stevenson-Yang: That's a particularly harsh way of putting it, but you can certainly say that the Chinese government is very focused on capturing savings and retaining them within China for these mad projects. Wouldn't it be nice if a Chinese person could instead buy a mutual fund overseas. Eventually, [00:40:30] I don't know what. Send their kids overseas for education. People do, do that, but it's a very small proportion.

Demetri Kofinas: I guess what I mean is ... and I definitely want you to correct me if I'm wrong here ... I guess what I'm thinking is there seems to be no respect by the financial sector in China for the savings of the people that are putting the money there. It seems that they feel that they can wield that for investments at their will.

Anne Stevenson-Yang: They can because there's a universal backstop, right?

Demetri Kofinas: We have that here in the US as well, but there is the pretense [00:41:00] that, that's your money. That pretense seems more specious in China.

Anne Stevenson-Yang: We sort of do. But losses are born by investors here, and they're really not born by investors in China. In small places where you don't hear about the people, a bunch of people invest in a private P2P platform in some locality. Sure those people lose. If you go to your bank and you buy a wealth management product that's actually not sold ... sold by the bank, but it's not [00:41:30] the bank's product. Maybe it's some dodgy cold firm that actually went bust two years ago. You're not gonna lose on that because the government won't let you. All of the investor managers know that. They take risks accordingly.

Demetri Kofinas: Do you spend any time thinking about ... I'm sure to some extent you do ...the context of China within the global economy?

Anne Stevenson-Yang: Sure, of course.

Demetri Kofinas: Yeah, it would make sense. I'm just throwing it out there because we're so bogged down here on China itself. What do you see as the effect of FED policy, for example, [00:42:00] and any type of contraction in US GDP, or if we have any kind of recession here. What would be the knock on effects in China, and even emerging economies. How does that all sort of play itself out. At some point we're going to have recession. There's nothing wrong with it. It's a normal healthy thing to have recessions. The FED is supposedly trying to raise interest rates and contract the size of their balance sheet. If they continue to go down that path, there is, of course the dollar carry trade. There are many things that can impact [00:42:30] a company like China. What is ...

Anne Stevenson-Yang: It's interesting that you call it a company. I wouldn't argue.

Demetri Kofinas: A country. No, did I call it a company? It may have been a Freudian ...

Anne Stevenson-Yang: I mean that leads to a lot of inestimable. Will the FED really raise how many times, and will it really contract its balance sheet? We hope so. As the United States demonstrates, once you have a fiat currency, it's very, very tempting to use it to fund all [00:43:00] sorts of liabilities. We have plenty of liabilities going forward. That is really the biggest question for China. If the US dollar does strengthen, then China is cooked. If the United States relents, turns around and puts more cash into the world economy, then you could have another, I don't know how long, of this in China.

Demetri Kofinas: Do you ever think about how the Chinese government would react if in fact they lost control of the economic levers? Not able to hit that target and unrest [00:43:30] began to come out. I say that why? I say it because again, looking at the history and thinking about the totality of the decades that have preceded this and also the way in which the Chinese government and Chinese society tends to think of itself in much grander sort of larger scale terms. Would it be an exaggeration to image that the Chinese government may turn inward in a much more repressive manner than anything we've seen for decades?

Anne Stevenson-Yang: I think it will certainly try. I think that we've already [00:44:00] seen that going on for the last several years. The attempts to restrict the capital account and make it harder to get money out. The attempts to control the internet with much greater force than was true in the past. The really, almost complete lack of cultural sort of development and exchange. Really the only cultural events that are available in China are the big international events that come for a day or two. But there's really no room [00:44:30] anymore for the development of Chinese arts. For people to gather and exchange ideas, politically, has become much harder than it used to be.

We've already seen that happen. Could they go back to 1975. I don't know. Certainly that will be the preferred path of the party, rather than dissolution. But there are many other paths that could be taken and it's impossible to know which one will be more likely.

Demetri Kofinas: Do you ever imagine [00:45:00] how long this could go on further? In other words how much longer they can maintain this sort of a loser growth.

Anne Stevenson-Yang: I think that question is really the Japan question. Can you keep putting money into the economy to keep the debt rolling over. Never recognize the debt, what happens to the economy in those circumstances. In some sense that's been already going on since 2011. You [00:45:30] see it in the sort of decline of spending power domestically in the average Chinese person, and the decline in the standard of living. There's a key element that still needed that Japan went through that China has not gone through which is a significant depreciation of the value of assets.

So if the Chinese government is willing to see the Chinese people. See their apartments. Go from 100,000 a square meter to 20,000 a square meter then yes, that could happen. [00:46:00] You could have a long, long grind. I think that's not very likely. Much more likely, China is going to hit a wall. The currency will suddenly depreciate and assets will drop much faster than people will like.

Demetri Kofinas: They've never seen that. The people that have seen the depreciation in prices in China, they've never seen a price decline before, right?

Anne Stevenson-Yang: The property market has only existed since 2000. In reality, it's one generation. Also, it's [00:46:30] despite the phenomenal construction and development of commercial property, the proportion of Chinese population who really live in the commercial property economy is kinda small.

There are a lot of people that own these apartments. Most people have either rural dwellings that they inherited from their parents. One way or another, that don't really belong to them, but they have the right to live in. Or, urban apartments that came from the work organization of themselves or [00:47:00] their parents.

Demetri Kofinas: Let me ask you this about the real estate. You touch on it a little bit before. What is the mechanism through which ... because the way I understand it ... the real estate market in China is particularly inflated due to the fact that it was one of the early parts of the economy to be liberalized, right?

Liberalized. To be privatized rather. There are other also, some weird mechanics and dynamics around who can have property. What type of property constitutes investible.

Anne Stevenson-Yang: In the technical sense, [00:47:30] all the land is owned by the government. The major distortion is that land is owned by the government, local governments, on the local level. So the government has a key interest in high land values.

Demetri Kofinas: How does that work. Say you, if you're in China and you want to own something. How does that work. I still don't understand it.

Anne Stevenson-Yang: The government issue leases on the land, so you get a lease on the land for 20 years, 40 years, or 70 years. Most residential property will be 70 years. Then you own the building that's built [00:48:00] on top of the land, but the government will have the right theoretically to take back that land at the end of the lease. It hasn't happened in most localities. In a few it has. A couple of them have tried to impose new fees and the people who own the houses got really upset. They retracted it or they imposed much lower fees. It's kind of a negotiation.

Demetri Kofinas: There's a quality like imminent domain but it's obviously much more engage.

Anne Stevenson-Yang: Yeah. That's right. That's the chief distortion [00:48:30] that the governments on the land, but there's also types of property rights. Basically every long term urban dweller in China owns an apartment in one way or another, but that apartment very likely may not be saleable because of the different shades and gradations of rights that are attached to that apartment.

Demetri Kofinas: So, I'm not gonna push you any more about making projections. I mean I'm curious. To me ... I'll tell you another reason why. I have many friends who are very pessimistic [00:49:00] as I have been for a very long time on the US dollar, and on the US bond market and et cetera, but I don't see that being a problem any time soon.

When I look at the countries like China, or when I look around the world, I still feel that in the next crisis the US bond market would still appear rather attractive to a lot of people. Another great example is you mentioned this question around property rights, the Chinese citizens don't have a Bill of Rights. They don't have the same right over their property that [00:49:30] we do. That's sort of reflected in a way the capital flight that is leaving the country. They know ... many wealthy people who have made a lot of money in China know that they're not initially going to be able to keep that money, and they're looking to get it out. Right?

Anne Stevenson-Yang: Yeah. I think that's right. I think that's a key and underappreciated point that everybody ... remember all the columnist who starting from 2009 were warning about the US dollar. How we were going to induce this terrible inflation. The US dollar was going [00:50:00] to be ... Well that hasn't really happened. You don't see Americans trying to buy assets overseas. Or try to emigrate. That's because in the end, it's about the degree of trust in the government. It's about the quality of life within the country. On a relative basis the US is still looking pretty good.

Demetri Kofinas: Yeah. Relative. Exactly. That's the key.

Anne Stevenson-Yang: Relative is key. Right. That may change with the current political situation.

Demetri Kofinas: Right. And though we've had inflation certainly in asset [00:50:30] prices, that can quickly turn to deflation, and we've been fighting deflation, or the federal reserve and the federal banks in the west have been fighting that with their monetary policy.

Anne Stevenson-Yang: Yeah. That's right. Probably with less effect than they really think.

Demetri Kofinas: I would say ...

Anne Stevenson-Yang: I'm not sure we solved anything.

Demetri Kofinas: No, I mean, I was basically ... I wanted to see if we could try and sort of create some hypothetical scenarios here about where things would go. There are so many factors. There's so many variables. There's North Korea of course. Which is [00:51:00] a big variable and our president is another variable. A walking and talking and tweeting variable.

Anne Stevenson-Yang: I'm trying not to take that bait.

Demetri Kofinas: No, I don't want you to take the bait. I actually don't talk about Donald Trump on the program, because I find that it's very difficult to do so effectively and usefully. I mean a lot of times ...

Anne Stevenson-Yang: Without having people's blood pressure rise.

Demetri Kofinas: And also, I just think most of the commentary around him is not very useful. There is actually ... I don't know if you're familiar with Sam Harris ... he talks about him too much. But, there are times in which he describes his criticisms [00:51:30] in a way that I find useful. But I think for the most part, conversations around him are not very useful.

I want to mention one more point I'm bringing back to China before we end. Which is, we were talking about loan growth. I've got two charts here in front of me. One is of loan growth in China, and the other one is of percent year over year annual GDP growth since 2007. What is indisputable based on these charts ... the trend for annual GDP growth has been down. Whereas, [00:52:00] loan growth looks pretty flat but it had a huge jump in 2008. Are we gonna continue to see every year is gonna be much more challenging to generate growth in China?

Anne Stevenson-Yang: Yeah. If you were to draw that top chart including corporate bonds and including all sorts of quasi-loans, like short term private equity. Then you would find the two lines are in opposition to each other. The reason is simply you require more capital every year [00:52:30] to drive the same amount of GDP growth. You have a target, so you just have to put in more capital. That's why I think they're going to hit a wall. Because it's very important politically for whatever reason to fulfill the promise to the

Chinese people that GDP will double by 2020. I think the starting point was 2010. I don't know.

What that means is that you have to have 6.53 percent GDP growth every year. So they're just damn well gonna [00:53:00] hit that target. That's unfortunate because the quality of growth ... it's kinda like, people talk about digging holes and filling them in again. Building a Mexican wall. But essentially, that's what you're doing. You're putting a tax on every Chinese citizen.

Demetri Kofinas: Well supposedly, the Soviet Union in its heyday produced cars that had negative equity because they actually had to take the cars apart for the parts. The actual commodity that went into creating the car was worth more than the final product.

Anne Stevenson-Yang: Exactly. [00:53:30] You get a lot of that with Chinese comparison between steel that's of less value than cabbage. Things like that. Think of the amount of energy and resources that were required to dig all that iron ore out of the ground in Western Australia. Stick it on barges. Haul it up to China. Put it into these towers and then you're going to ... I'll tell you, there's a city in Ordos county in Inner Mongolia, which is the biggest county for coal in China ... where their solution to the bubble [00:54:00] breaking was actually to blow up the buildings. To rebuild them.

Demetri Kofinas: That's very funny.

Anne Stevenson-Yang: That was proposed. I don't know if they eventually did it. They ended up with these huge ...

Demetri Kofinas: There were some similar proposals, less serious, here in the United States, and in fact, I opened one of my early television shows years ago by having a bulldozer bulldozing a house, and it was a mock solution to the housing crisis.

Anne Stevenson-Yang: Yeah.

Demetri Kofinas: The idea was, you create jobs by putting people in bulldozers. Then you create jobs by rebuilding the house.

Anne Stevenson-Yang: Exactly. They've done that. There's another [00:54:30] county in Ordos where they had built all these towers and they couldn't find people to live in them. They actually ... I swear to God this is true ... they actually exploded, blew up, schools in neighboring counties ... nobody in them of course ... so that the kids would have to go to that county to go to school.

Demetri Kofinas: Are you serious?

Anne Stevenson-Yang: Yeah.

Demetri Kofinas: That's a real story?

Anne Stevenson-Yang: Yeah. And then you'd find these kids ... of course for them it was a dream because they were living 50 miles from their parents. They were like 14 years old. They have their own little moto scooters. [00:55:00] They're squatting in these dark towers, with maybe a hot plate. Battery run. With four students living in this weird empty apartment together.

Demetri Kofinas: And where were they going to school?

Anne Stevenson-Yang: In the model school. In this new county. Because they'd built a model school, so they were damn well gonna enroll in it.

Demetri Kofinas: Totally insane.

Anne Stevenson-Yang: Yeah.

Demetri Kofinas: And that is the extreme version of what many in the United States propose. The idea of digging holes and filling them back up. That's not a radical idea in certain sorts of Keynesian circles.

Anne Stevenson-Yang: Well, [00:55:30] let's not go overboard. The US infrastructure does look ... it is decrepit. People are dying in train accidents. That look 60 years old because it is 60 years old. Whereas in China, it's all brand, brand, brand new. That's the difference. But in the same way, if we were to raise three trillion dollars to build a wall around the perimeter of the United States, yes that would raise GDP. How would that raise the quality of life?

Demetri Kofinas: Also, but I'm remembering specifically, when I was living in DC, there [00:56:00] were people coming out in the New York Times saying that the snowstorm would actually be good for the economy because it employs people. This is an asinine idea.

Anne Stevenson-Yang: People say the same thing about war all the time. Whereas, Adam Smith believed that the defense industry should not count toward GDP because they were detracting from GDP.

Demetri Kofinas: From wealth. They destroy wealth.

Anne Stevenson-Yang: Exactly.

Demetri Kofinas: I mean, and that's something that many people fail to recognize that again, we talk about Goodhart and the notion that just because [00:56:30] we can measure GDP doesn't mean it's a useful measure for any of the things that matter to us. And we can be growing an economy just like we can be growing cells in our body. But whether those cells are malignant or benign is a completely different question. And I think that, that's what's so frightening about, to me, looking at China, looking at these ghost cities. These hundreds of ghost cities. It's just this terrifying ... the fact that they've deployed capital

resources and labor to generate massive amounts of so-called wealth, but in fact, in a contraction, that [00:57:00] could turn out to be that huge amounts of land that was once heir able, is no longer heir able because they've built slabs of concrete on it. They've polluted their environment tremendously. It's just a frighten sort of picture. I think in some ways, in the Chinese economy, to me, is sort of a national representation of the human animal. In some ways very out of balance with its ecosystem. I think it represents in some ways what we do collectively to the planet. Maybe I'm going off the rails a little bit, but it sort of reminds me of that in a way.

Anne Stevenson-Yang: [00:57:30] I understand what you mean. To me, it's a representative of how political systems, excessively centralized go off the rails.

Demetri Kofinas: I agree with that as well. Anne it was great having you on.

Anne Stevenson-Yang: Thanks Demetri.

Demetri Kofinas: Thank you.

And that was my episode with Anne Stevenson-Yang. I want to thank Anne for being on my program. Today's episode was produced by me and edited by Stylianos Nicolaou. For more episodes you can check out our website at [00:58:00] HiddenForces.io. Join the conversation at Facebook, Twitter and Instagram at @hiddenforcespod or send me an email.