

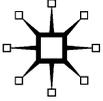
ANIMAL SPIRITS WITH CHINESE
CHARACTERISTICS

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INVESTMENT BOOMS AND BUSTS IN THE WORLD'S
EMERGING ECONOMIC GIANT

By Mark A. DeWeaver

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ANIMAL SPIRITS WITH CHINESE CHARACTERISTICS

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For my parents

Yi fang jiu luan, yi luan jiu shou, yi shou jiu jiao, yi jiao jiu fang, yi fang jiu luan.

[When policy is relaxed there is chaos; when there is chaos policy is tightened; when it is tightened people complain; when they complain policy is relaxed; when it is relaxed there is chaos.]

—*Chinese saying*

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PREFACE

A Chinese investment boom was in full swing in 1988. As a new student at Sun Yatsen University in Guangzhou, a few hours up the Pearl River from Hong Kong, the signs were all around me. Food prices were soaring at the local farmers' markets just outside the walls of our bauhinia-shaded campus. So were the black market foreign exchange rates available at the small dry-goods stores opposite the main gate or from the touts that hung around in front of all the big hotels.

Several years later I realized that these symptoms of excess demand had been the result of overinvestment. But this realization gave rise to another question: How could the economy of China—a socialist country—experience such wild gyrations? Following the start of the “reform and opening” policy in 1978, the state had relaxed its grip somewhat. But it was obviously still calling the shots.

I had not imagined that dramatic fluctuations in investment could occur under socialism. The state's firm hand, guided by the wisdom of its central planners, was supposed to keep economic activity on an even keel. Investment booms and busts were for capitalist countries.

Back then it seemed unlikely that anyone in the twenty-first century would still be analyzing trends in socialist economies. Socialism was on its way out. The successes of the Solidarity Movement in Poland and the progress of glasnost in the Soviet Union suggested that Leninist dictatorships would soon be a thing of the past. Enterprise reform and democratization were the wave of the future.

This impression was only confirmed by the student protests that began in Beijing in the spring of 1989 and quickly spread to Guangzhou and various other big cities. The Chinese Communist Party seemed destined to join its Polish counterpart in the dustbin of history.

As it turned out, of course, no transition took place. The students were crushed by the People's Liberation Army, which did not “love the people” as much as had been hoped. The Party remained very much in control.

Since then “socialism with Chinese characteristics” has kept analysts as busy as ever. Far from fading into irrelevance, the topic is becoming increasingly important as China’s role in the world economy continues to expand.

I began to pay more attention to the cyclical character of Chinese investment during the early 1990s. At that point I was writing research for Peregrine Brokerage, a rising star in the Hong Kong financial firmament during the go-go years before the 1997 Asian financial crisis. As Hong Kong-listed companies began making big bets across the border, China’s investment swings became a topic of considerable interest to Peregrine’s foreign institutional clients.

There was plenty to write about. Following Deng Xiaoping’s famous “Tour of the South” in January 1992, investment took off—as did China’s nascent stock and property markets—only to come crashing back to earth in the middle of the following year. As had been the case in 1989, rapidly rising inflation left the government with no choice but to impose draconian austerity measures.

Ten years later, I watched yet another cycle unfold—this time as a fund manager. Once again the asset markets soared as an investment mania took shape. In this case, the inflationary effects were less severe and the currency was strengthening. Yet for all the dramatic changes that had taken place in China since my student days, the 2003 boom actually had more in common with the 1958 Great Leap Forward than with those of 1988 and 1992. Local government-sponsored investment in heavy industry was now the driving factor, just as it had been in Chairman Mao’s time. The policy of “reform and opening” that had seemed so exciting in the 1980s had somehow taken the country back to square one.

One of my favorite books during my time at Sun Yatsen University was a 1980s Chinese bestseller titled *Sun Tzu’s Art of War and Enterprise Management*. Like many modern-day applications of Sun Tzu’s 2,000-year-old classic to nonmilitary fields, it began with the famous admonition to “know the other, know yourself” (often inaccurately translated as “know the enemy and know yourself”). Enterprise managers seeking the path to success in China’s post-command-economy era of market competition were advised to begin by making a thorough analysis of business rivals, customers, and their own organizations.

Today, China itself is often the “other” that competitors in the global marketplace need to understand. To those with such a purely practical motive, the importance of the Chinese investment cycle will be obvious. But the average reader can find the subject equally rewarding.

China’s socialist system reminds us of the foundations of prosperity in free market economies—private ownership of the means of production,

free contracting, and an impartial legal system. The dynamics of Chinese booms and busts, which result from an absence of these features, make it easy to appreciate why a strong private sector, accompanied by the checks and balances of democratic political institutions, is desirable.

Knowing the other may be worthwhile for the sake of winning wars and making money. But it also contributes to knowing yourself. I hope that this book will help non-Chinese readers gain a better understanding not only of China but of their own countries as well.