

The coastal regions again became prosperous and closely tied to outside powers. Inexpensive products and trade produced wealth for the great coastal cities like Shanghai, but the interior remained impoverished. Tensions between the coast and the interior increased, but the Chinese government maintained its balance and Beijing continued to rule, without losing control of any of the regions and without having to risk generating revolt by being excessively repressive.

This has gone on for about thirty years, which is not very long by any standard (and certainly not by Chinese ones). The open question is whether the internal forces building up in China can be managed. And this is the point at which we begin our analysis of China and its effect on the international system in the twenty-first century. Will China remain part of the global trading system? And if it does, will it disintegrate again?

China is gambling at the beginning of the twenty-first century that it can carry out an indefinite balancing act. The assumption is that it will be able to gradually shift resources away from the wealthier coastal regions toward the interior without meeting resistance from the coast and without encountering restlessness in the interior. Beijing wants to keep the various parts of China happy and is doing everything in its power to achieve that end.

Underlying this is another serious, and more threatening, problem. China appears to be a capitalist country with private property, banks, and all the other accoutrements of capitalism. But it is not truly capitalist in the sense that the markets do not determine capital allocation. Who you know counts for much more than whether you have a good business plan. Between Asian systems of family and social ties and the communist systems of political relationships, loans have been given out for a host of reasons, none of them having much to do with the merits of the business. As a result, not surprisingly, a remarkably large number of these loans have gone bad—"nonperforming," in the jargon of banking. The amount is estimated at somewhere between \$600 billion and \$900 billion, or between a quarter and a third of China's GDP, a staggering amount.

These bad debts are being managed through very high growth rates driven by low-cost exports. The world has a huge appetite for cheap exports, and the cash coming in from them keeps businesses with huge debts afloat.

But the lower China sets its prices, the less profit there is in them. Profitless exports drive a giant churning of the economic engine without actually getting it anywhere. Think of it as a business that makes money by selling products at or below cost. A huge amount of cash flows into the business, but it flows out just as fast.

This has been an ongoing issue in East Asia, and the example of Japan is instructive. Japan during the 1980s was seen as an economic superpower. It was devastating American businesses—MBAs were being taught to learn from the Japanese and emulate their business practices. Certainly Japan was growing extremely rapidly, but its rapid growth had less to do with management than with Japan's banking system.

Japanese banks, under government regulation, paid extremely low interest rates on money deposited by ordinary Japanese. Under the various laws, the only option for most Japanese was to put money into Japan's post office, which doubled as a bank. The post office paid minimal interest rates. The government turned around and lent this money to Japan's largest banks, again at interest rates well below international levels. These banks lent it again cheaply to businesses with which they were linked, so Sumitomo Bank loaned the money to Sumitomo Chemical. While American companies were borrowing money at double-digit rates in the 1970s, Japanese companies were borrowing money at a fraction of that amount.

It was no surprise that Japanese businesses did better than American ones. The cost of money was much lower. It is also no surprise that the Japanese had extremely high savings rates. Japan had virtually no public retirement plan at the time, and corporate pensions were minimal. Japanese planned for retirement through savings. They weren't more frugal, just more desperate. And this pool of desperate depositors had no alternative but to make deposits at very low interest rates.

While high interest rates imposed discipline on Western economies, culling out the weaker companies, Japanese banks were lending money at artificially low rates to friendly corporations. No real market existed. Money was flowing and relationships were the key. As a result, a lot of bad loans were made.

The primary means of financing in Japan was not raising equity in the stock market. It was borrowing money from banks. Boards of directors con-