

sisted of company employees and bankers who were not interested in profits nearly as much as they were in cash flow that would keep their companies afloat and pay off their debts. So Japan had one of the lowest rates of return on capital in the industrialized world. But it had a fabulous growth rate in terms of size because of the way the Japanese structured their economy. They lived by exporting.

The Japanese had to. With an extremely high savings rate driving the system, average Japanese citizens were not spending money, and therefore Japan could not build the economy on domestic demand. And since Japanese companies were controlled not by investors but by insiders and bankers, what they wanted to do was increase the cash coming in. How much, if any, profit was generated mattered less. Therefore, low-cost exports surged. More money was lent, more cash was needed, and more exports were sent out. The economy grew. But underneath it, a crisis was brewing.

The casual ways in which Japanese banks made loans increased the number of nonperforming loans—loans that were not being repaid. A lot of bad ideas were funded. Rather than write these off and let the businesses involved go into bankruptcy, Japanese banks covered up with more loans to keep the companies alive. Loans surged, and since depositors' money was spent maintaining the system, exports to bring in even more money were essential. The system was awash with money, but underneath it a vast array of companies on life support—and companies struggling to increase cash without regard for profit—were undermining the entire financial system. Massive surges in exports were producing very little profit. The entire system was churning just to keep itself afloat.

From the outside, Japan was surging, taking over markets with incredible products at cheap prices. It was not obsessed with profits like American firms were, and the Japanese appeared to have a hammerlock on the future. In fact, the opposite was true. Japan was living off a legacy of cheap, government-controlled money, and low prices were a desperate attempt to keep the cash coming in so the banking system would hold together.

In the end, the debt structure grew too massive and it became impossible to stay in front of it with exports. Japanese banks began to collapse and were bailed out by the government. Instead of permitting a massive recession to impose discipline, Japan used various salvaging means to put off extreme pain

in return for a long-term malaise that is still lingering. Growth plunged, markets plunged. Interestingly, while the crisis hit in the early 1990s, many Westerners did not notice that the Japanese economy had failed until years later. They were still talking about the Japanese economic miracle in the mid-1990s.

How is this relevant to China? China is Japan on steroids. It is not only an Asian state that values social relations above economic discipline but a communist state that allocates money politically and manipulates economic data. It is also a state in which equity holders—demanding profits—are less important than bankers and government officials, who demand cash. Both economies rely heavily on exports, both have staggeringly high growth rates, and both face collapse when the growth rate begins even to barely slow. Japan's bad debt rate around 1990 was, by my estimate, about 20 percent of GDP. China's, under the most conservative estimate, is about 25 percent—and I would argue the number is closer to 40 percent. But even 25 percent is staggeringly high.

China's economy appears healthy and vibrant, and if you look only at how fast the economy is growing, it is breathtaking. Growth is only one factor to examine, however. The more important question is whether such growth is profitable. Much of China's growth is very real, and it generates the money necessary to keep the banks satisfied. But this growth really does not strengthen the economy. And if and when it slacks off, for example because of a recession in the United States, the entire structure could crumble very fast.

This is not a new story in Asia. Japan was a growth engine in the 1980s. Conventional wisdom said it was going to bury the United States. But in reality, while Japan's economy was growing fast, its growth rates were unsustainable. When growth slumped, Japan had a massive banking crisis from which it has not really fully recovered almost twenty years later. Similarly, when East Asia's economy imploded in 1997, it came as a surprise to many, since the economies had been growing so fast.

China has expanded extraordinarily for the last thirty years. The idea that such growth rates can be sustained indefinitely or permanently violates basic principles of economics. At some point the business cycle, culling weak business, must rear its ugly head—and it will. At some point a simple