China's Creative Accounting: Using Debt as an Instrument of Economic Development

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China may be as heavily in debt as we are. It just has a different way of keeping its books — which makes a high-profile political ad sponsored by Citizens Against Government Waste, a fiscally conservative think tank, particularly ironic. Set in a lecture hall in China in 2030, the controversial ad shows a Chinese professor lecturing on the fall of empires: Greece, Rome, Great Britain, the United States . . . .

"They all make the same mistakes," he says. "Turning their backs on the principles that made them great. America tried to spend and tax itself out of a great recession. Enormous so-called stimulus spending, massive changes to health care, government takeover of private industries, and crushing debt."

Of course, he says, because the Chinese owned the debt, they are now masters of the Americans. The students laugh. The ad concludes, "You can change the future. You have to."

James Fallows, writing in the *Atlantic*, remarks:

"The ad has the Chinese official saying that America collapsed because, in the midst of a recession, it relied on (a) government stimulus spending, (b) big changes in its health care systems, and (c) public intervention in major industries — all of which of course, have been crucial parts of China's (successful) anti-recession policy."

That is one anomaly. Another is that China has managed to keep its debt remarkably low despite decades of massive government spending. According to the IMF, China's cumulative gross debt is only about 22% of 2010 GDP, compared to a U.S. gross debt that is 94% of 2010 GDP.

What is China's secret? According to financial commentator Jim Jubak, it may just be "creative accounting" — the sort of accounting for which Wall Street is notorious, in which debts are swept off the books and turned into "assets." China is able to pull this off because it does not owe its debts to foreign creditors. The banks doing the funding are state-owned, and the state can write off its own debts.

Jubak observes:

"China has a history of taking debt off its books and burying it, which should prompt us to poke and prod its numbers. If we go back to the last time China cooked the national books big time, during the Asian currency crisis of 1997, we can get an idea of where its debt might be hidden now."

The majority of bank loans, says Jubak, went to state-owned companies — about 70% of the total. The collapse of China's export trade following the crisis meant that its banks were suddenly sitting on billions in debts that were clearly never going to be paid. But that was when China's largest banks were trying to raise capital by selling stock in Hong Kong and New York, and no bank could go public with that much bad debt on its books.

The creative solution? The Beijing government set up special-purpose asset management companies for the four largest state-owned banks, the equivalent of the "special purpose vehicles" designed by Wall Street to funnel real estate loans off U.S. bank books. The Chinese entities ultimately bought $287 billion in bad loans from state-owned banks. To pay for the loans, they issued bonds to the banks, on which they paid interest. The state-owned banks thus got $287 billion in toxic debt off their books and turned the bad loans into an income stream from the bonds.

Sound familiar? Wall Street did the same thing in the 2008 bailout, with the U.S. government underwriting the deal. The difference was that China's largest banks were owned by the government, so the government rather than a private banking cartel got the benefit of the arrangement. According to British economist Samah El-Shahat, writing in *Al Jazeera* in August 2009:

"China hasn't allowed its banking sector to become so powerful, so influential, and so big that it can call the shots or highjack the bailout. In simple terms, the government preferred to answer to its people and put their interests first before that of any vested interest or group. And that is why Chinese banks are lending to the people and their businesses in record numbers."

In the US and UK, by contrast:

"[B]anks have captured all the money from the taxpayers and the cheap money from quantitative easing from central banks. They are using it to shore up, and clean up their balance sheets rather than lend it to the people. The money has been hijacked by the banks, and our governments are doing absolutely nothing about that. In fact, they have been complicit in allowing this to happen."

Today, Jubak continues, China's debt problem is the thousands of investment companies set up by local governments to borrow money from banks and lend it to local companies, a policy that has produced thousands of jobs but has left an off-balance-sheet debt overhang. He cites economist Victor Shih, who says local-government investment companies had a total of $1.7 trillion in outstanding debt at the end of 2009, or about 35% of China's GDP. Banks have extended $1.9 trillion in credit lines to local investment companies on top of that. Collectively, the debt plus the credit lines come to $3.8 trillion. That is about 75% of China's GDP, which is proportionately quite a bit smaller than U.S. GDP. None of this is included in the IMF's calculation of a gross-debt-to-GDP figure of 22%, says Shih. If it were, *the number would be closer to 100% of GDP*.

Proportionately, then, China may be more heavily in debt than we are. Yet it is still managing to invest heavily in infrastructure, local businesses and local jobs. Its creative accounting scheme seems to be working for the Chinese. It may be sleight of hand, but it was a necessary ploy to harmonize their economic realities with Western banking standards.

For China to join the World Trade Organization in 2001, it had to revise its accounting methods to conform to Western requirements; but before it joined, it did not consider grants to its state-owned enterprises to be "non-performing loans." They were what the IMF calls "contingent grants." If they paid off, great; if they didn't, they were written off. There were no creditors demanding payment from the state-owned banks. The creditor *was* the state; and the state, at least in theory, was the people. In any case, the state owned the banks. It was lending to itself, and it could write off its loans at will. It was better to sweep the "NPLs" into "SPVs" than to cut back on services and impose heavier taxes on the people. The Chinese government did cut back on services and raise taxes, to the detriment of the struggling masses, but not to the extent that would otherwise have been necessary to balance their books by Western standards.

While the rest of the world suffers from an unrelenting credit crunch, today China's banks are on a lending binge. The rush to make new loans is a direct response to the government's economic stimulus policy, which emphasizes infrastructure and internal development. The Chinese government was able to get its banks to open their lending windows when U.S. banks were being tight-fisted with their funds, because the government owns the banks. The Chinese banking system has been partially privatized, but the government is still the controlling shareholder of the Big Four commercial banks, which were split off from the People's Bank of China in the 1980s.

We might take a lesson from the Chinese and put our own banks to work for the people, rather than making the people work for the banks. We need to get our dollars out of Wall Street and back on Main Street, and we can do that only by breaking up Wall Street's out-of-control private banking monopoly and returning control over money and credit to the people themselves.

We could also take a lesson from the Chinese and dispose of our debt with a little creative accounting: when the bonds come due, we could pay them with dollars issued by the Treasury, in the same way that the Federal Reserve has issued Federal Reserve Notes to save Wall Street with its "Quantitative Easing" program. The mechanics of that process were revealed in a remarkable segment on National Public Radio on August 26, 2010, describing how a team of Fed employees bought $1.25 trillion in mortgage bonds beginning in late 2008. According to NPR:

"The Fed was able to spend so much money so quickly because it has a unique power: It can create money out of thin air, whenever it decides to do so. So . . . the mortgage team would decide to buy a bond, they'd push a button on the computer – 'and voila, money is created.'"

If the Fed can do it to save the banks, the Treasury can do it to save the taxpayers. In a paper presented at the American Monetary Institute in September 2010, Prof. Kaoru Yamaguchi showed with sophisticated mathematical models that if done right, paying off the federal debt with debt-free Treasury notes would have a beneficial stimulatory effect on the economy without inflating prices.

The CAGW ad is correct: we have turned our backs on the principles that made us great.

But those principles are not rooted in "fiscal austerity." The abundance that made the American colonies great stemmed from a monetary system in which the government had the power to issue its own money – unlike today, when the only money the government issues are coins. Dollar bills are issued by the Federal Reserve, a privately owned central bank; and the government has to borrow them like everyone else. But as Thomas Edison famously said:

"If the Nation can issue a dollar bond it can issue a dollar bill. The element that makes the bond good makes the bill good also. The difference between the bond and the bill is that the bond lets the money broker collect twice the amount of the bond and an additional 20%. . . . It is a terrible situation when the Government, to insure the National Wealth, must go in debt and submit to ruinous interest charges at the hands of men who control the fictitious value of gold."

China's government can direct its banks to advance credit in the national currency as needed, because it owns the banks. Ironically, the Chinese evidently got that idea from us. Sun Yat-sen was a great admirer of Abraham Lincoln, who avoided a crippling national debt by issuing debt-free Treasury notes during the Civil War; and Lincoln was following the lead of the American colonists, our forebears. We need to reclaim our sovereign right to fund the common wealth without getting entangled in debt to foreign creditors, through the use of our own government-issued currency and publicly-owned banks.

Ellen Brown is an attorney and the author of eleven books. In Web of Debt: The Shocking Truth About Our Money System and How We Can Break Free, she shows how the Federal Reserve and "the money trust" have usurped the power to create money from the people themselves, and how we the people can get it back. Her websites are webofdebt.com, ellenbrown.com, and public-banking.com.

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