

Banking on China

By KYLE HUTZLER

Review of Dealing With China: An Insider Unmasks the New Economic Superpower, by Henry M. Paulson, Jr. Twelve, 2015

Years after the conversation happened, a senior Western executive still relished telling me how much the compliment meant to him when a high Communist Party official told him “the words that all of us who have worked in China long to hear: that I was 'a friend of China.'” That friendship is not without a certain price. Sometimes, the longer one knows someone, the less one truly understands him at all.

Count possibly among these blinded friends Hank Paulson, former chief of Goldman Sachs and U.S. Secretary of the Treasury, who has recently published his account of more than three decades *Dealing With China*. The China Paulson knows is a deeply pragmatic one, committed to economic reform. But the China Paulson professes to know is an incomplete one, one that excludes the undercurrents of nationalism and ideology that so many other China watchers consider grave risks. For Paulson, they are little more than impediments to the next deal.

Paulson’s relationship with China came about as one of those consequential accidents of fate. Goldman Sachs gave him oversight for Asia because the New York bankers considered Paulson, who lived in Chicago, “closer” to the region, a revealing anecdote of how far China was off the radar even as late as the 1990s. During that time, the Chinese government sought the expertise of Western bankers to accelerate economic reforms and bring in new capital. Simply educating Chinese officials and business leaders on the intricacies of finance and capitalism was a major part of the bankers’ work. Goldman was one of the leading houses tasked with restructuring China’s state owned enterprises. These enterprises were - and remain - sprawling and inefficient, with little in the way of proper corporate governance or competition, and responsibilities that spanned from industry regulation to presiding over a mini-welfare state for their employees. Goldman Sachs would do a number of major early deals including the IPO of China Telecom and oil giant PetroChina.

These early experiences gave Paulson unique access to Chinese officials who are now in positions of significant authority in Xi Jinping’s administration. Among them is Wang Qishan, who Paulson first met in his role as head of China Construction Bank and continued to work with as both transitioned into political roles. Wang is now the enforcer in Xi’s anticorruption push as head of the Communist Party’s internal discipline body. Zhou Xiaochuan, China’s central banker, was also an early partner. Many of the individuals with whom Paulson dealt are protégés of Zhu Rongji, the former crusading and principled premier whose presence is a near constant in Paulson’s narrative. Paulson’s book will likely help reorient Western understanding of Zhu’s centrality in China’s “Reform and Opening Up.” Deng Xiaoping may have provided the political cover that made reform possible, but without Zhu it would not have been realized. Zhu was an early voice against corruption and remains widely admired among the Chinese people.

“Dealing with China” is unique in that it personalizes a broad set of Chinese leaders. However expressionless they may appear in public, behind closed doors with Paulson they come alive as distinct individuals with whom he forged a real connection. Indeed, Paulson acknowledges the encouragement of Zhou Xiaochuan as a factor in his decision to accept the offer to become Treasury Secretary. At the same time, Paulson sheds little new insight on China’s complicated political and governance system.

Paulson’s great contribution to US-China relations as Secretary of the Treasury came through his efforts to translate his personal relationships into a more lasting institutional one between the two countries. The establishment of the Strategic Economic Dialogue, now rebranded as the Strategic & Economic Dialogue under the Obama administration, has been a profound step forward toward this aim.

Where bilateral issues were once lost in a sea of low-level commissions - or not discussed formally at all - Paulson sought to unite them in a single forum that would have direct access to the highest levels of each country's leadership. It would serve as a platform to accelerate decisionmaking on important issues and, no less important, weave a set of enduring formal and informal intergovernmental ties that may ultimately make the difference in the successful resolution of a future crisis. Already, it has brought results or made progress on new commitments on bilateral investment, improved military communication, and a host of other issues.

In his earlier book, *On the Brink*, Paulson recounted his role in the effort to save the global economy from implosion during the 2007-9 financial crisis. His relationships with China's senior economic officials may have proven crucial in preventing the understandably skittish Chinese from flooding the market with their Treasury holdings, an event that would have exacerbated the crisis. (Paulson notes that the US had received reports that Russia had approached China about a coordinated selling of their Treasury assets.) Paulson reveals that the consequences of the financial crisis on the US-China relationship have been more significant than many appreciate. America's humbling emboldened China's nationalist wing and stalled further Chinese economic reform as Beijing attempted to limit repercussions to its own economy. A loss of confidence in the US economic model was no less a casualty, with Paulson quoting Wang Qishan as saying, "We aren't sure we should be learning from you anymore." Only just beginning to be felt are the economic and political consequences of China's massive debt-driven stimulus as a tsunami of bad loans now come due.

Not all of Paulson's dealings with China involved economic relationships. When he received word that the US Navy was set to sail through the Taiwan Strait while he was in Beijing, a sure provocation to the Chinese, he woke Secretary of Defense Bob Gates in the middle of the night to successfully demand that the fleet change course. His efforts to secure the release of a democracy activist in China through quiet diplomacy stands in stark contrast to former Secretary of State Hillary Clinton's noisy experience a few years later with the activist Chen Guangcheng. The effectiveness of quiet diplomacy with China challenges the impulse of Congress - and soon the 2016 presidential candidates - to shout loudly when they want results from China. The effect is often to harden Beijing's resolve.

Indeed, from Paulson's perspective, the toughest challenges in managing US-China relations came from Washington, not Beijing. A significant portion of Paulson's time at Treasury was spent convincing Senators Charles Schumer, Max Baucus, and others that legislation designed to punish China for its artificially low currency would do more harm than good. The threat of the legislation, however, did give Paulson the cover to quietly and explicitly demand specific targets for improvement in the exchange rate from the Chinese. On the China side, he repeatedly characterizes the country's leaders as a nation frustratingly slow to reach consensus on decisions, but startlingly quick to act once they have.

Where does Paulson believe the Xi administration is headed? It was not until 2006 that Paulson met Xi, first in New York, and then again in Hangzhou on his first trip to China as Treasury Secretary. Like Kissinger before him Paulson has become a regular interlocutor for Chinese officials seeking to understand America's intentions. His long and continued relationships with many of its leading figures, including Xi Jinping himself, has convinced Paulson that China's leaders are both aware of the extent of the domestic challenges that confront them and are committed to solving them.

China's leadership is constrained in acting by the risks the country's economic slowdown presents for its indebted and unbalanced economy. [\\$2.6 trillion in local debt](#), a significant amount of which is believed to be insolvent, is central to this story. At the same time, China's leaders are cognizant of the need to create some [10 million new jobs annually](#) or face instability among a population whose expectations may be outpacing the government's ability to deliver. At previous moments of weakness, China's leaders have chosen an approach that favored growth at all costs over sustainable rebalancing of the economy, delaying the pain of an inevitable reckoning. Unwinding these risks must come before more liberalization.

Paulson attempts to lay out these challenges in the final third of the book. Since leaving Treasury, Paulson has founded a self-styled “think and do tank” based at the University of Chicago, focused on advancing US-China collaboration, particularly on the environmental, conservation, and urbanization issues that have long been a personal passion. The compelling personal narrative that animated the first two sections is lost in rather conventional summations of China's economic and ecological issues. Like many other commentators, Paulson expresses the truism that America can best respond to China's rise by solving its own political and economic challenges at home.

Paulson holds fast to the belief that economic development will inevitably lead to democratization in China. “The desire for freedom, for life, liberty, and the pursuit of happiness, is, I think, universal and inherent in mankind,” he writes. “The bargain the Chinese Communist Party made - prosperity for stability - must be calibrated once people take that prosperity for granted. I am not saying that China, which is such a different country, with such a different history and culture from ours, must have the same political system that we do... Just so, change will come for the Chinese.” Strikingly, in all his years with China's leaders, he recounts not a single conversation with those leaders about political reform nor does he speculate on what that reform could look like.

Many China “hawks” have agitated for a Cold War-style strategy of containing China's presumed bid for regional and, perhaps, global hegemony. Paulson believes that such an approach would do more to provoke conflict than prevent it, but the relative lack of sophistication with which he deals with matters of Chinese nationalism, ideology, and security issues weakens what should be a strong hand in favor of deeper engagement. In a telling moment, he confesses to laughing at an unexpectedly pointed question from a Chinese guide about the territorial disputes in the South China Sea. Paulson also misses the opportunity to use his personal relationships with Chinese leaders to communicate to the American side Chinese leaders' deep insecurity that the United States will attempt to thwart China's rise.

There are implicit criticisms of the Obama administration's handling of China. Paulson recounts having been asked several times since leaving office by Chinese leaders who in the Obama administration has the mandate for China. It is a fair criticism of President Obama that he tried to “pivot to Asia” without appointing someone to take the lead on China. One hopes that the institutional relationships fostered through the Strategic & Economic Dialogue will ultimately make US-China diplomacy more regular and broad-based. We get the hint that were Paulson still Treasury Secretary, he would have made a more aggressive effort to restructure the IMF and World Bank to give China a bigger say, potentially keeping Beijing from setting up the Asian Infrastructure Investment Bank that is perceived by some as a rival.

Despite his achievements as Treasury Secretary, Paulson's understanding of China is a limited one. By neglecting how much China's “century of humiliation” at the hands of Japanese and Western powers still resonates with the country's leaders and people, Paulson underestimates the trust gap between the US and China. A superficial read of the thoughts of ordinary Chinese also obscures how the flames of nationalism China's leaders have fanned actually constrain their ability to reach compromise in foreign affairs, lest they [risk protest](#) from their own people. He misses the parallels between Russia and China's desire to reassert positions of regional hegemony in their near abroad, and so fails to recognize that authoritarian regimes have a historical record of being willing to subjugate economic progress to advance nationalistic aims.

Kissinger has written previously of the exceptional ability of the Chinese to co-opt outsiders. While one hopes Paulson's judgments are correct on China's trajectory, there is more than ample reason for doubt. In the Epistles, Horace observed that “to have a great man for an intimate friend seems pleasant to those who have never tried it; those who have, fear it.” Paulson doesn't fear his friends in China. We should hope that he is right.

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