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China's Enron moment? by Robert Blohm

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If only the market would recover in time and bail out the company from the risk it's been taking on to survive! These are the famous last words in 2001 of the legendary "smartest guys in the room" from Enron Corp. It is also the mantra of China's governance since the 2008 financial crisis that I contend was a crisis not of capitalism but of socialism – and triggered by China itself.

As former World Bank chief economist Justin Lin Yifu has put it, China's socialist market economy has been a combination of low-input-cost "policy" industries at the core of China's economy (socialism) and the "tradeable sector" (export and retail) driven by marketization. "Low" basically meant "subsidized," and "input" basically meant commodities, many of them imported, like oil, to the tune of half of China's need. Subsidization meant excess or artificial demand when China accounted for half the world's new demand for oil, which sets the world price for everyone. If China had not subsidized oil products, I reckon the world price would have peaked at $100 instead of $150 per barrel of crude.

Thus, artificial Chinese demand prompted the inflation fear that drove the tightened Fed policy that made subprime mortgages with interest rates reset annually suddenly unaffordable and trigged the 2008 financial crisis. Nobel Laureate Sir James Mirrlees stated at the time that the commodities market drove the 2008 financial crisis. In its resolutions for remedying the financial crisis, the September 2009 G20 Pittsburgh Summit specifically called on China to quit subsidizing energy usage, the world's only net oil importer to be doing so.

China has used credit to keep the economy going ever since, with diminishing return, and now overcapacity and over-indebtedness. China has been a low-labor-cost construction economy, with usage an afterthought, a concept deeply embedded in the post-War "China Reconstructs" mantra, a kind of "build it and they will come" mentality. In this sense, some of China's economic growth has been artificial. Payback time has come for the artificial portion of GDP growth to be recognized by writing off bad debt and deducting it from lenders' income and, so, from GDP. When China was in supergrowth mode, debt writeoffs were affordably swamped by new lending, somewhat Ponzi-like, with income from new loans more than making up for losses from old ones. By the same token, ending commodity price subsidies means lower demand and output than otherwise until greater efficiency restores output.

The social collateral damage in this process has animated China's "New Left" of hide-bound ideologues, culturalists and militarists who have, with the support of Princeling oilgarch families, taken over governance since the 2011 Party Plenum and managed to reverse reform after having deadlocked it. Their cause, Marxist nationalism and anti corruption-by-capitalism, was tested, proven, captured, and personified by Bo Xilai who used it to promote himself rather than to preserve and protect the Party.

China's economic Achilles heel is capital flight. The broad business community is opposed to the Xi regime but expecting, as a bottom line, the same protection from Xi's failures that State-Owned Enterprises (SOEs) would get. This was, maybe for the last time, on vivid display at the annual Caixin magazine conference at the end of 2012 just as Xi was taking over: Chinese CEOs and economists lambasted the delay in marketization and reform. At this year's annual conference of "The China Economy 50 People Forum" of leading young Chinese economic policy leaders, China's most outspoken property tycoon, Ren Zhixiang, founder of Beijing Huayuan Property Group and Executive Chair of the All-China Federation of Industry & Commerce's China Real Estate Chamber of Commerce, exhorted and extorted government bailout of his industry by stating in his speech that "in the West government protects the private sector rather than disadvantages it; the Western value system isn't toxic and is quite stable, for example in Sweden where a capitalist party and a socialist party alternate in power but the value system hasn't changed." Meanwhile, China's next Five-Year Plan calls for merger of SOEs into even bigger behemoths subsidized by increased issuance of new shares to would-be patsy Chinese citizens.

China's summer stock market crash is a mere disproof-of-concept that, since a stock market thrives on information, Leninist information control and propaganda can successfully be used to pump it up and keep it there. The Hu administration handled quite differently the March 2007 Chinese stock market crash, the first in the series of market crashes that culminated in the early October 2008 New York stock market crash that crowned the financial crisis. Rather than promote, they were deathly afraid of, stock market investment by the masses. Cheng Sewei, China's regular technocrat spokesman, China's "father of venture capital" and then vice-chair of the Standing Committee of the National People's Congress, warned throughout State media well before the crash that the Chinese stock market was overbought.

The turning point in what I call the Great Reversal was marked by this summer's RMB devaluation, triggered by accelerating capital flight that is abetted by the stock market crash and that already depleted China's foreign currency reserves by 10 percent in the year-to-date. Fewer cents per yuan mitigates the depletion until it incents even more of it, as it did by the end of August when the depletion rate nearly quadrupled to a 37 percent annual rate that would eliminate the reserves in 2 years and 8 months or reduce them to the IMF's preferred minimum in only 8 months from now, That in turn crimps the enlarged SOEs' intended "going abroad" investment. A Federal Reserve rate hike will further accelerate capital flight to US interest rates. Reserve depletion would push China into third-world basket case mode of borrowing US dollars abroad to defend its currency and, ultimately when that became pointless, going hat-in-hand to the IMF for bailout and conditionality guaranteed to overturn Chinese governance. At a certain point the choice becomes: is it capital or Communist Party leadership that flees? A peace dividend might even be expected with demise of the economic and policy engine of China's National-Socialist military enterprise.

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