The Markets Are Pessimistic Because China Didn't Learn from Russia

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Despite the crash in energy prices and the rout in the stock market, most economists remain sanguine about the U.S. economy. Whether ABI members once again achieve full employment depends, I submit, on the honesty of the Chinese in reporting their own economic growth.

There is no occasion to fear worldwide contagion from a decline in the rate of growth in China, according to accepted dogma, because the Communist behemoth still reports almost 7 percent annual growth in GDP.

But what if China's numbers are phony? What if GDP seemingly grew in recent years only because China was and still is plugging investment capital down a rat hole?

A recent article in *The New York Times* asked whether the "markets could be pricing in some darker facts about the outlook for the world that economists don't fully understand." Perhaps the root of China's problems explains why the stock market is more pessimistic than your average economist.

China either forgot or never learned a lesson taught by Soviet Russia: Centrally planned economies ultimately don't work because investment decisions are made to coincide with political philosophy, not with good judgment.

China evidently thought it could avoid Russia's fate by investing in manufacturing to provide goods for consumers in the developed world. Where the Soviets didn't produce anything that the rest of the world wanted apart from oil, China though it had perfected the Communist model by becoming the world's garment factory and machine shop. It might have worked if Beijing had allowed bona fide investors to take the risk by investing their own capital.

Rather than make investment decisions from the bottom up, China financed new projects based on choices imposed from the top down. The result was ghost cities, factories without customers, and products severely lacking in quality control. Even if there were major boondoggles, so the theory goes, Europe and the U.S. have nothing to fear because China severely limited investment from abroad.

It's one thing to build a shopping center that has some tenants, although not enough to cover debt service. It's another when China today has unproductive assets that behave more like liabilities by sucking up capital that could be used for better purposes.

The potential repercussions are scary. China moved tens of millions of people from the countryside to the cities to populate factories and new towns. If businesses flop on a wide scale, workers can't fall back on subsistence farming to feed themselves and their families.

The people of China are adept at fomenting civil unrest and revolting when the time is ripe. We should hope China keeps its citizens fed so they don't take to the streets. With much of the Middle East and Africa already in flames, we don't need civil unrest to stop China from importing anything at all and plunging the entire world into depression.

Let's hope that Chinese leaders properly husband their remaining foreign exchange. Russia made a comeback after the fall of the Iron Curtain, not from restructuring its economy, but only because the price of oil went through the roof. China needs fundamental economic reform because it lacks a similar fairy godmother to prop up corrupt leadership.

In sum, whether we see a deluge in consumer and corporate bankruptcy in the U.S. may depend more on China than on any domestic factor.