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A Risk Scenario for Global Financial Markets

The growing struggle about the future direction of China may spark a fight for control

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Caution rises about stock prices worldwide, but there is little basis for these concerns

Pessimism about stock prices is increasing around the world. Well-known investors like Stanley Druckenmiller and Carl Ichan are worried about the possibility of a stock market shock similar to what happened during the global financial crisis. Global stock prices have plummeted several times since the summer of 2015. We cannot reject the position that instability in the markets of China and emerging countries may be the precursor of a major bear market. However, the most important basis for adopting a pessimistic stance is the belief that a cyclical downturn is imminent. According to this view, which is based on stock market chart analysis, the world's stock markets are due for a long-term decline because stock prices have been climbing for six years since the global financial crisis. But if we ignore the charts, there are almost no economic or political reasons to expect stock prices to fall.

There are a number of economic and political reasons for pessimism. Examples include the maturing of US economic growth; the possibility of a negative cycle sparked by higher US interest rates; insufficient demand in relation to a surplus of global production capacity; worries about upcoming political events, notably the UK "Brexit" referendum and the US presidential election; a declining momentum of earnings growth at US companies; and overvalued stock prices. But all of these concerns are minor and nothing at all like what happened during the global financial crisis. G7 and other countries are implementing policies aimed at supporting economic growth. This situation is obviously the exact opposite of the type of environment that would lead to excessive optimism and the formation of an asset bubble. As a result, there is no reason for the sentiment of extreme caution in financial markets today. Most significantly, there is very little to no possibility of a recession in the near future in the US economy, the nucleus of the global economy.

Only China's destructive power cannot be overlooked

However, a growing economic crisis in China could trigger a global financial crisis. If this happens, we cannot dismiss the possibility of China's massive surplus of production capacity along with its potentially immense volume of non-performing assets quickly turning into a destructive force. For many years, the world has been able to downplay China risk factors with regard to shrinking global trade, falling prices and an oversupply of petroleum and other commodities, and instability in the world's economies and stock markets. But now China has advanced to a new phase that requires the most caution of all: the emergence of a struggle for power and the determination of the country's political direction.

A long period of liquidation has started in China

The steady decline in microeconomic indicators (electricity use, railroad cargo volume, crude steel output, etc.) in China has stopped for the time being because of monetary easing and economic stimulus measures that started early in 2016. But ending the slowdown in economic growth will probably be impossible. An article in the May 7-13 issue of the British magazine *The Economist* says that a debt crisis in China is inevitable. The only question is when it will begin. Debt has increased from 150% of China's GDP to the current crisis level of 260% this last decade. Until recently, China held loans to 75% of deposits. But now loans have grown to about 100% of deposits. The article concludes that a money shortage and classic financial crisis is becoming increasingly likely.

China has been making excessive investments on a breathtaking scale. For example, China's consumption of cement during about the past two years is about the same as all cement used in the United States during the past century. Investments have produced a massive surplus of capital goods and unsold housing as well as highly inefficient infrastructure projects. All of these surplus investments have the potential of becoming an enormous volume of non-performing assets.

Having made excessive investments on the largest scale the world has ever seen, China must now accept the fact that an extended period of liquidation has started. This liquidation process will probably be accompanied by a deepening crisis that has three stages. Stage one is a financial crisis, which will advance from a currency crisis to a widespread credit crunch. Stage two is an economic crisis, which will include the bursting of the real estate bubble and a sharp rise in unemployment as many companies fail. Stage three is a political crisis as China advances from employment problems to an institutional crisis. If all three of these stages happen at once, there would immediately be turmoil on a global scale. The result would probably be a deep worldwide recession. This must be avoided at all costs. Consequently, the world has reached the point where powerful joint international initiatives will be needed in order to minimize the damage created by China's long liquidation process.

Policy conflicts surface – Will there be a power struggle?

As tensions about China increase, the significant risk of a dispute about the country's future direction is starting to appear. A rivalry is emerging between President Xi Jinping and Premier Li Keqiang. The premier gave a very long speech at the National People's Congress in early March, but the president did not applaud or even shake hands afterward. In front of everyone, President Xi Jinping ignored the premier. In Japan, an article in the May 19 issue of the Sankei Shimbun stated that the struggle between the president, who controls a group of influential members of the Communist Party, and the premier, who leads a Communist Party faction consisting of the younger generation, will inevitably grow into a fight between factions that splits the leaders who rule China.

At the same time, there is a confrontation between the Jinping administration, which wants to enact economic structural reforms, and the old guard that wants to prop up the economy with public-works projects and other spending. On May 9, the *People's Daily*, the official newspaper of the Chinese Communist Party, hinted at the president's statement by criticizing the old guard. The newspaper warned that trying to revive the economy would create another bubble. The article said that a U or V-shaped economic recovery is impossible and an L-shaped recovery would take place. But the paper said more than one or two years will be needed. China must accept the fact that it is entering a period of slow growth.

On May 18, an editorial in *The Wall Street Journal* stated that supply side structural reforms (tax cuts, deregulation, elimination of zombie companies, limited use of government financing to stimulate the economy) that President Xi Jinping wants to enact are what China needs from a long-term perspective. But bureaucrats are placing more emphasis on economic stimulus measures. Although Premier Li Keqiang supports these reforms, he is also open to the use of Keynesian policies (government spending to stimulate the economy). So the supply-side structural reforms of the Jinping administration will encounter problems. The president's supply-side reforms have received a negative response. Critics say the reforms are fundamentally contradictory because they attempt to use a Lenin-style single-party totalitarian government to build a free-market economy.

State owned enterprises and Communist Party rule should be the biggest targets of reforms. But they are vested interests. It will be difficult to combine more power for the party with the implementation of reforms. Therefore, the only solution is to build a new ruling organization that can reject and dismantle the current Communist Party organization. This is what happened during the Cultural Revolution of Mao Zedong. Now there are signs that the Jinping administration is attempting to limit free speech and foster a cult of personality around the president.

No one knows what lies ahead for China's Communist Party rule

In China today, the Internet and benefits of a market economy will probably make it impossible to create a dual structure of authority like the one seen at the time of the Cultural Revolution. Supply-side reforms of the president are very likely to end in failure because of China's worsening economy and the resistance of those who oppose the president. Once this happens, the power base of the president, who has made many enemies by relentlessly pursuing corruption and the suppression of free speech, will start to crumble. Will the president remain in power or will the premier take over? Perhaps the central government will become weaker. In any case, it appears that China's system of totalitarian rule by the Communist Party is about to reach a turning point.

These events will create enormous uncertainty about China's policy options. The global geopolitical picture will be greatly altered as a result. We will also see shifts in the performance of the global economy and markets. The United States and other countries with liberal democracies will hope to see Premier Li Keqiang become more influential because of his political liberalism. Although this would be good news for the world's stock markets, the process leading up to this point is extremely difficult to predict.