China's Market Crash

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The recent market crash in China has sent shockwaves throughout the stock and commodity markets across the globe, raising existentialist doubts over the future of the communist nation ruled with iron hand for 67 years by the Communist Party of China (CPC). So far a story of unprecedented success, China had registered unhindered double digit growth for more than a decade to transform itself from a low-income to upper-middle income country, becoming almost an economic superpower. Success of the Chinese model within the short time-span that it took to transform the country's economic landscape has been nothing short of miracle. Through sustained double-digit growth, China has created world class infrastructure. Prosperity had spread rapidly, creating a sizeable and supportive middle class which today constitutes about 25% of the population.

China's growth rate had averaged 10% in 1980-2010, and then fell to 7-8% in 2012-2014, after which it has been slowing further. Pundits have identified many factors behind it: the diminishing returns on capital investments, high levels of state control and corruption, environmental factors, demographic challenges arising from China's one-child policy, rise in wages after continued high growth, and also the absence of democracy. As Jeffrey Frankel, a Harvard professor, pointed out, China is caught in the 'middle income trap', and the transition to high income will be a great challenge. China has just rescinded its one-child policy to correct the demographic distortions that has burdened it with an aging population, but needs to do much more. As Frankel points out, China's competitive advantage in labor-intensive manufacturing has weakened and its economy has shifted from manufacturing towards services, where there is less scope for productivity growth. The risk for the global economy is that the excess unutilised capacity may lead to financial crisis, leading to plummeting growth and dragging the rest of the world along with it, a world in which economies are more integrated and interconnected than ever before.

The stock market crash may be just an offshoot of this slowdown process. People's Bank of China had started cutting the interest rates since November 2014 to stimulate growth, and in June, 2015, Shanghai index had peaked, after which the fall was only to be expected. Shanghai Stock Exchange Composite Index has declined by more than 40% since then and trading was suspended twice in January 2016. The Chinese currency, renminbi or yuan, already an international reserve currency at par with major global currencies and one in the basket of currencies that determines the value of the Special Drawing Right, the unit used by the IMF in dealing with its 188 members – has also lost much of its value and sheen since then.

Obviously, Chinese leaders have not been sitting still while the growth has been slipping by. In 2013, the 370-member Central Committee had adopted far-reaching reforms in areas ranging from health-care, social-security and taxation to environmental regulation in what the People's Daily called "China Model 2.0 Edition", reforms that involved structural changes in the economy rather than massive state-led investment. Most of these reforms are being implemented with the seriousness characteristic of Chinese governance. These reforms seek to accelerate the shift from an export-oriented, environmentally damaging growth model based on heavy manufacturing to one based on domestic household consumption and services to support growth.

Riding piggyback on global demand and helped by a cheap currency as well as cheap rural labour ever willing to migrate to urban areas for better prospects, China had vastly expanded its manufacturing capacities during the last decade. But once recession had set in in the West following the 2008-crisis, Chinese companies were finding it difficult to sell their products abroad in profitable quantities. As growth slogged, unemployment soared, credit became distressed and banks became loaded with toxic assets. The quick-fixes like devaluing the renminbi to boost exports and import substitution to boost domestic growth were no longer working. The renminbi has been devalued several times now since August 2015, each devaluation sending fresh shockwaves throughout the world, amplifying the anticipation of global financial instability in the event of failure of the world's second-largest economy.

China's growth model so far has been based more on investment and external demand rather than on domestic consumption, but since 2008, China has been trying to correct it. Negotiating such a huge structural transition in a country as large and complex as China, in the backdrop of sluggish global growth, is always difficult. Some turbulence was therefore, not unexpected, and leaders were not unaware of this. What has taken them by surprise is the extent of the shock.

The challenge the Chinese economy faces today is about striking a balance between the market forces and control by the all-powerful Communist Party of China (CPC), as well as between its domestic and international economic obligations. It has no option but to gradually internationalize its financial system rather than aggravate the global financial instability any further, even if that means adjusting to the new normal of lower growth.

But the real problem lies elsewhere. Renminbi still lacks full convertibility, which cannot come without transparent financial systems in an open economy, which in turn cannot come without democracy, an idea that is still an anathema to the CPC. They fear that it will lead to civil war and disintegration of China. The Middle Kingdom in fact had always been one of the bloodiest of places on Earth, and even after takeover by the CPC in 1949, not a small quantity of blood had been spilled by its policies dictated by Mao. CPC is not yet ready to let loose its iron-grip on the economy and surrender itself to the vagaries of the market, even though it had cautiously opened its markets. But as Joseph Stiglitz pointed out, once markets are freed, they acquire a life of their own and the journey to a domestic consumption-based economy hence may be bumpier than anticipated. Markets certainly are more powerful than CPC's diktats as the recent market crash has shown. The only way they can be controlled is through setting the rules of the game in a transparent manner. That means more democracy, where China faces the real challenge.

Rising social conflicts between urban and rural populations, tension between the private and state sectors, rising levels of mass protests and civil unrest against corruption in its powerful bureaucracy and party-elites require an overhauling of its governance system and allowing a lot more democratic rights to its citizens than the Chinese leadership is prepared to yield today without triggering excessive social instability. From China's past history, they fear this might lead to widespread unrest and a possible meltdown of the party, dilution of its powers and ultimately, disintegration of China as we know it today. The unrest in Tibet and Xinxiang are pointers to that possibility. How much openness to allow is the challenge they face, but that is possibly the only way to circumvent the middle income trap.

Francis Fukuyama, who predicted the End of History at the collapse of the Berlin Wall and the subsequent disintegration of USSR, perceives in the declining growth of Chinese economy the forebodings of an historic contest over competing development models followed so far by China and the West, the outcome of which in his opinion will determine the fate of much of Eurasia for decades to come. According to him, China's development model based on massive state-led investments in infrastructure – roads, ports, electricity, railways and airports is fundamentally different from the Western model of large investments in public health, education, women's empowerment and anti-corruption measures. The comparison is a no-brainer, as realities of the developed world is quite different from those of low or middle income countries. It is not really a contest between China and the West as Fukuyama would have us believe, but between China's own shifting priorities and ground realities.

For one thing, Chinese economy is nowhere near collapse. It is resilient and strong enough to withstand quite a few more shocks. True, it has seen an exodus of foreign capital since the stock market crash - about $ 100 billion had left the country every month during the last 8 months, the government and private debt has soared to 240 percent of its GDP to $ 25 trillion. But despite falling demand, China's exports in 2015 declined by only 2.5 per cent over 2014. In 2015, it had a record trade surplus of $ 595 billion. It still has $ 3.3 trillion forex reserves, enough to cover more than four times its short-term external debt, providing sufficient cushion against any crisis of currency or liquidity. A sizeable chunk of the currency reserves of many countries has been shifting towards the yuan. The Government expects the growth to be maintained at 6.5 percent for the rest of the decade, but even if it becomes lesser, for an economy the size of China's, it will still be huge.

In the past, China had demonstrated its capacity and resolve to implement radical reforms, like in the late 1980s, when falling GDP growth and rising volumes of non-performing loans of its public sector companies were threatening a meltdown. China arrested the slide by introducing far-reaching reforms, including large-scale privatization of industry and elimination of price controls, protectionist policies and regulations. Even in the face of growth deceleration, China in 2014 had created 11 million jobs, against the target of 10 million, most of these in the services sector which constitutes half the country's GDP. This sector grew by 8.3 percent last year, against a 6 percent growth in the combined construction and manufacturing sectors. China must and certainly will take bolder steps to reduce state control, unleash the dynamism of the private sector and boost household demand. Aligning its policies to the market will surely cause some pain, and China may have entered a critical phase in its economic transition. But it does not spell any imminent crisis for either its economy or its polity.