China’s economic turbulence

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The canvas of China’s shaky economic situation has been painted in two prominent tones. On one hand are the vibrant colors splashed with a mixture of optimism, based on the premise that Beijing will not be affected substantially. On the other hand, are the gloomy contours stroked with an abundance of dark pessimism hinting at the possible economic collapse in the long term with far reaching global repercussions.

The pessimists argue that Beijing is bearing the brunt of its actions that has only complicated and worsened the current situation. They believe that China’s eagerness to internationalize the Yuan even before the formalization of institutional mechanism heightened the risks.

The rules chalked out by IMF for the inclusion of Yuan in the basket of reserve currencies was clear and simple. It implied that the transfers of currency couldn’t be restricted by capital controls; a rule China follows very stringently on its own economy. In lieu of this, firms and households are interested to move their funds abroad as the transformation from the state planned economy dependent on capital controls to a market-based economy based on diversification occurs. The problem emanates from the situation, where at present the economic growth has slowed down, the interest rate differentials have contracted and property prices have waned leading to enhanced unpredictability in the markets. This coupled with government interventions on China’s equity markets dominated by state owned firms has aggravated the situation further. Optimists on the other hand argue that this is unlike China’s 1929 moment and if China could survive the global recession of 2008, it has the ability to survive the current situation with stronger resilience. Their argument is based on the premise that China has resources at its disposal to cure the diseased economy. The medicine, in essence, would be energizing syrup composed of trillions of foreign exchange reserves utilized to bolster the economic setback. According to them, the low level of debt opens avenues of exploring other fiscal options for the Chinese government.

But can the future of Chinese economy be characterized only in shades of black and white? In the middle of the two contrasting pictures, stands the somewhat amalgamated grey area, which mocks the two canvases and believes that they are misrepresentations to a certain extent. To deal with the unpredictability of the markets, the grey canvas symbolizes the time that Beijing should give its market to reach its equilibrium while placing emphasis on solidifying its regulatory and institutional framework. This, in the long term would enable the vacillations to be driven by financial rudiments. China should also focus on creating a mechanism that links the Yuan to a basket of currencies. This could lead to stabilization of Yuan relative to the basket and fluctuation relative to the dollar in the longer run. What remains to be seen is the extent to which the currency devalues. If the level is modest then steady alterations can work effectively but if the gap is immense, it will further cause problems for the Chinese economy.

The real challenge that China faces currently is the process by which it upgrades its industrial base and other labor-depended low-skill products into more capital-concentrated products. This process is not easy and would require three critical steps. These involve the removal of constraints present on the private sector, growing the services sector and carrying out the necessary reforms of state-owned enterprises.

Not much progress has been made in improving the effectiveness of State Owned Enterprises that contribute to the forty percent of China's Gross Domestic Product. China must formulate a three pronged stratagem to improve the effectiveness of SOE. Firstly it needs to carry out a rationalization process similar to one carried out by Premier Zhu Rongi in 1999. In those days, it triggered China's entry into the World Trade Organization and resulted in economic progress. While the feasibility of such rationalization programs can be challenged in today's era, they are not impossible. Secondly, the management of SOE's must be revamped with incentives focused on enhancing the competitiveness of the firm rather than meeting political objectives. Finally, capabilities of SOEs must be strengthened by developing it to the level of highest standard and integrating them into the capabilities system.

A grey canvas of cautious optimism and reduced pessimism can emerge if political courage and business acumen of Chinese leaders is amalgamated to tackle this volatile situation.

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