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THE ROOTS OF CHINA'S ECONOMIC SLOWDOWN

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Abstract *The mainstay of the paper is formed by an analysis of the effects of China asset rate changes on Asian financial markets, China's decision-making process, the impact of China's economic development on global trade and production connections, and China's ability to maintain a sustainable level of growth. Applying new conceptual and methodological approaches, this study advances to the next level research on China's cautious opening to capital flows, its openness and high investment rate, its decentralized fiscal system and gradual reforms, and the gradual process of China's domestic financial development.*

Key words:
Chinese economy; global trade; financial markets

JEL Codes:
D53; E44; F36

1. Introduction

Research on has China's capacity to withstand economic crises, its gradual development of financial markets, and its huge size and daunting array of structural challenges yielded fairly consistent findings over the past decade. The theory that we shall seek to elaborate here puts considerable emphasis on the effects of the financial crisis on China, the size and dynamism of China's economy, the size, depth, and liberalization of China's domestic financial markets, and the potential growth rate of the Chinese economy.

2. China's Growing Role in Global Trade and Financial Markets

China seeks to sequence capital-account opening and currency internationalization with other policies (a myriad of regulations and controls affect international financial transactions). On the real side, trade linkages may link economies' financial sectors via the transmission of business cycle fluctuations, whereas on the financial side, the increased size and depth of Chinese financial markets, the ongoing domestic financial liberalization, and the deregulation of international capital flows to date may foster stronger financial sector linkages. The onset of the global financial crisis (GFC) boosted the role of China both as a destination and source of financial capital, and the "attentiveness" of international investors to financial developments in China may have increased. China has liberalized its domestic equity markets and outward foreign direct investment much more than it has liberalized its bond markets. The GFC increased investors' awareness of China and "attentiveness" to its role as an origin and destination of equity finance. Securities markets play a much smaller role than does bank finance in China. Equity markets have played the role of a supplemental source of finance for large state-owned enterprises. The bond market is relatively undeveloped and dominated by government issuers. Private bond market capitalization is dominated by state-owned companies. (Glick and Hutchison, 2013)

Significant growth slowdowns in China will have a major impact on the global economy. The large and fast-growing Chinese economy is a key engine of growth for the world economy. Demand from China contributed substantially to recovery in East and Southeast Asia (China recovered faster than expected from the global crisis). Rebalancing growth toward domestic sources of growth has become a priority for Chinese policymakers. A sharp slowdown in Chinese growth could have important implications for global expansion (there could be implications for social stability in China). Chinese growth has been associated with a chronically undervalued exchange rate. The fact that China's inflation rate has been rising heightens the likelihood of a slowdown. China's huge size and geographical diversity differentiate it from earlier fast growers. China and other emerging markets have come to account for the majority of the growth of global demand (emerging markets like China are energy-intensive economies). China alone is accounting for 30 percent of global demand growth. China will have a higher old-age dependency ratio in the not-too-distant future. An undervalued exchange rate may be a driver of China's imbalances. China may avoid the middle-income trap and jump to upper-middle-income-country status. (Eichengreen, Park, and Shin, 2012)

China should alleviate the coming growth slowdown on the path of development (Nicolăescu, 2013a) and avoid impending social instability. The changing age structure of the population and its impact on the underdeveloped fiscal and welfare system may affect China's future growth. Factors such as the underdevelopment of the health system have resulted in a low proportion of seniors. To deal with the demographic changes, China must raise dramatically its revenues for welfare and education. China should develop tax systems to finance the increasing dependency rate. China's grossly inadequate fiscal arrangements face growing challenges. China's fiscal and social security institutions are ill-equipped to deal with the rise in the dependency ratio. The Chinese government faces the problem of reforming and expanding the pension and benefits system. Private and shareholding Chinese firms are punching below their weight in export markets, whereas the foreign firms in China have a higher export share than their share of the GDP. Clan-based business hinders the development of a modern competitive market economy. China lacks coherent, uncorrupt, and impartial legal mechanisms for private businesses. Many dynamic and private firms in China are part-owned or controlled by the state. The development of corporate governance and corporate law are necessary for future development (Naito, 2013) with a secure and innovative private sector. Institutional residues of the collectivist period have profound and sometimes deleterious effects on China's economic and social development. Rights of sale and transferability are unambiguously in the hands of local or national state institutions. (Hodgson and Huang, 2013)

3. The Effects of the Financial Crisis on China

China has pursued a cautious path towards greater financial liberalization and openness (Nicolăescu, 2013b), and has liberalized controls on non-FDI capital flows very slowly. Permitted cross-border flows have likely reduced the effectiveness of China's remaining capital controls. A greater part of the permitted internationalization process in China has focused on equity markets and FDI flows, as opposed to debt instruments. Greater financial openness and internationalization of the rmb has repercussions for the global economy. China has made strides in terms of achieving a major role for the rmb in international trade through the establishment of rmb settlement mechanisms and swap lines. Global financial factors and national financial turbulence may have influenced the extent to which interest rate and equity price changes have been transmitted from China across Asia (the transmission of equity prices changes from China across Asia increased markedly during the GFC). The Chinese bond rate coefficients are statistically significant only for Indonesia and Korea. The transmission of Chinese equity rates rose markedly during the GFC. China's reserve rate increases had a negative and significant effect on equity prices. Countries with greater sensitivity to the rmb have much stronger linkages to China's bond markets in the GFC and post-GFC periods. Market forces and rising global uncertainty have increased the importance of China in transmitting equity price changes abroad. (Glick and Hutchison, 2013)

China's rapid growth has led to the accumulation of more than $3.5 trillion in foreign exchange. China's decades of 9.5% annual growth constituted catch-up growth. China's per-capita GDP in 2012 in purchasing power parity (PPP) terms was between $9,000 and over $12,000. The labor surplus in China's rural areas is beginning to come to an end, the growth rate of exports slowed to 9.2% through 2012, China has an investment rate as a share of GDP of nearly 50%, and the major uncertainty in the short run is how much stimulus the government will pursue to maintain or manage the growth rate. The slowdown is not building to a crisis (Prager, 2013) that is likely to stop growth altogether. China will likely increase its huge foreign-exchange holdings in U.S. The size of the Chinese market will continue to experience large increases in dollar terms (growth is now from a much higher base). China will increasingly depend on its own R&D. (Perkins, 2013)

China was the first among the world's major economies to recover from the recent economic downturn, possessing enormous capacity for crisis management (Hunter, 2013a) and for stimulating economic growth. The Chinese economy is neither an American style liberal market economy, nor a planned economy. The Chinese government has been dominant in the use of land and other natural resources. China's economic growth during the financial crisis has been a substantial contribution to the recovery of the world economy. The Chinese-style resource-allocation system, decision-making process (Pera, 2014a), consists of an economic environment that is conducive to effective implementation of various measures for crisis management. China's macro-economy bounced back rapidly after touching the bottom, showing signs of full recovery from the second quarter in 2009 (Chinese development policies and macro-regulations had made the economy largely immune to massive market failures). From 1978 to 2008, China accumulated wealth at an amazing speed and provided a material foundation for coping with economic crises. China's banking sector has withstood the impact of declining profits (Zaharia et al., 2013), narrowing interest spreads and unfavorable lending conditions (China implemented expansionary fiscal and monetary policies that stimulated consumption during the economic downturn). (Ji, 2010)

4. China's Outstanding Economic Performance

China is experiencing the largest mass migration from the countryside to the cities in any country in history, the expanding cities providing many opportunities for work on construction sites and heavy industry. Estimates of the number of protests and demonstrations in China have increased dramatically in number. The *hukou* system excludes much of the Chinese population from adequate education and health services. Farming output has to deal with a growing and more prosperous population under the constraint of a limited supply of suitable agricultural land. Any Chinese citizen advocating the further privatization of property rights in land would be in violation of the Chinese constitution. The home-grown private corporate sector in China is underdeveloped. The Chinese legal system is too tied up with the central political and administrative authority. China needs to develop adequate welfare and pension provision for an ageing population. Much of China's economic success is attributable to the strategic role of the state (Hunter, 2013b) in the economy. China may slow down by about 2025 to an annual growth rate of five percent, whereas by 2040 its growth rate may be closer to that found in developed countries. (Hodgson and Huang, 2013) China prevented the spread of the crisis with its special pattern of economic development and institutional arrangements (Corsani, 2013), mitigating the adverse impacts of the world economic crisis (the Chinese government made a rapid full-scale readjustment of its macro-economic policies). In a decentralized fiscal system, China's local governments can make decisions according to local situations. China is a market economy with a rather influential public sector including state enterprises. China's banking system has effectively executed the decisions made by the monetary authority, providing a rapid transmission mechanism for expansionary monetary policies (the activities of China's state economy exhibit a countercyclical pattern). China managed to coordinate crisis management, structural adjustment, and deepening reform to serve the purpose of sustainable economic recovery, and has provided the world with an economic miracle of sustained high growth and handled well the current economic crisis, achieving a rapid economic recovery. (Ji, 2010)

A reversal of the growth trend of the working age population in China will slow its economic growth. The government should not seek an actual growth rate exceeding the potential growth rate (Makó and Mitchell, 2013), and the potential growth rate can be enhanced through the application of measures to enlarge the supply of labor and capital (Pera, 2014b), and to improve productivity (economic reform is the key to sustaining China's economic growth). The slowdown of the potential rate of China's future economic growth is in accordance with the trend of population structure changes. Relatively slower growth of capital formation (Hunter, 2013c) will help China transform its growth pattern that relies on domestic investment. Economic growth is accompanied by a constant decline in the agricultural share in terms of both output value and employment. The present labor force participation rate in China is high, but will change dramatically as population aging accelerates. To increase labor force participation, China may postpone the retirement age so that the labor force participation rate of workers at older ages can be increased, further promote labor migration from rural to urban areas, or raise the employment rate or lower the unemployment rate. The Chinese economy is entering a phase of transition from dual economy development to neoclassical growth. (Cai and Lu, 2013)

5. Conclusions

This research makes conceptual and methodological contributions to China's outstanding economic performance, the emergence of China as a regional economic power, China's growing role in global trade and financial markets, and its pace of real growth and transformation into a global economic power. Our paper contributes to the literature by providing evidence on China's fast economic recovery during the global financial collapse, the advent and aftermath of the global financial crisis (GFC) that pushed China to the fore of the world economy as an engine of growth, and the determinants of China's economic growth.

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