TURBULENCE IN WORLD FINANCIAL ORDER: PROBLEMS AND PROSPECTS FOR CHINA

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Abstract

Current financial crises in United States indicate the vulnerability of its economy on the whims of capital scarcity. China's surplus wealth in capital market is harbinger of hope to bring stability in US economy. Although China is feeling the heat of crisis on account of its heavy investment in American capital markets. It may motivate China to look for other currencies (avenues) of investment. As US economy is underperforming in productive sector, world is concerned on its ramifications for world economy. This article is aimed to identify the reasons for financial instability in United States. It will also highlight the impact of these crises for China.

Introduction

The emergence of new international economic system after 1945 was dominated by United States of America. Dollar became dominant currency in world capital market. It became convertible currency into gold. As a matter of fact, Great Britain was replaced by America as hegemonic power in monetary affairs of world. It established US primacy in world capital markets. The numerous world financial organizations like International Fund and World Bank were created with head quarters in the United States.[1] These organizations were given task to promote world trade.

When capital market's function on the policy of liberalism was not regulated, it resulted into increase in US liabilities to foreign borrowing. For meeting this challenge American President Kennedy put constraints on foreign direct investment.[2] US government is overspending on borrowed money mainly from China. The latter is doing it to keep appreciation of dollar intact so as the flows of

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Chinese goods to American markets is not disrupted. In the after month of financial crises in South East Asia By the close of 20th century, these countries have learnt lesson to stock pile dollar reserves to meet any financial crises to them in future.

As American foreign liabilities in the wake of this situation grew US gold reserves were lowered. The more government expenditure created more inflation causing decline of dollar. In early1970s, American President Nixon's growth of devalued dollar, boosted economies of the Asian Tigers.[3] In subsequent decades-1980s and 1990s US economy witnessed boom and bust. In late 1980s Japan was main creditor to give boost to American economy and by mid 1990s, President Clinton's economic measures saved the economy from any major collapse.[4] In this whole process of economic reforms dollar was kept overvalued. The foreign investors sensing this situation converted their dollar holding in gold purchases.

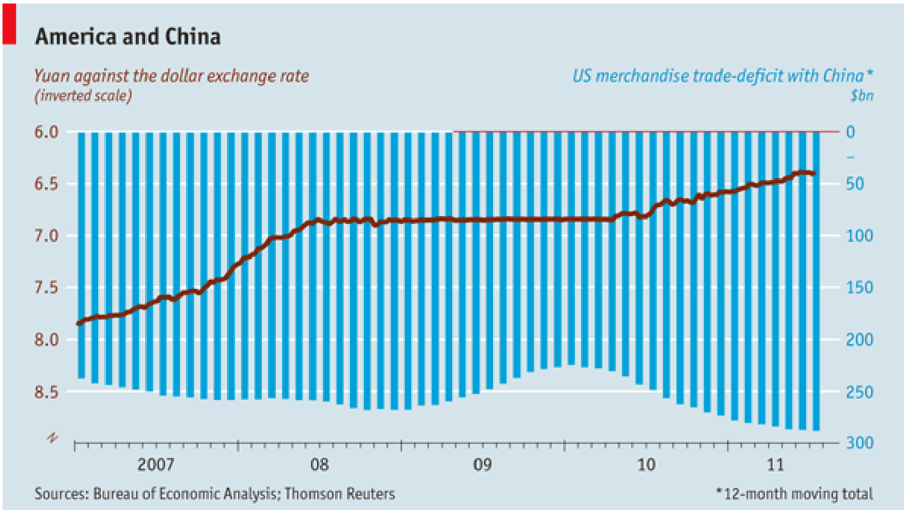
Instead of depreciating the American currency, US government kept overvaluation of its currency in global market. But as real worth was explicit to foreign capitalists, they made rush into converting dollars depleting American gold reserves. The Nixon government was left with the options either devalue the dollar or restrict trading gold for dollars which undermined the Breton woods system in shambles.

Onset of Financial Crisis

One of the main reasons for financial crisis is the availability of easy money on no interest rate it has made American people and firms addicted on borrowed money which was easily available to them due to introduction of plastic currency. China also played part by supplying as much money as was required in shape of purchasing T bills and investing in treasury bonds. It left US policy makers satisfied in neglecting the looking of a financial storm.[5]

The holdings of Chinese Capital investment in United States from 1994 onwards is increased in lieu of depreciation of the Yuan against the American dollar. China is viewed by USA as a currency manipulator of keeping the value of Yuan low to reap the benefits of its exports.[6]

Figure - I



Source: The Economist, Oct 11-17th 2011,

The tightening of monetary policy by China and US are viewed responsible for current financial crises in the world on account of their macroeconomic policies. Much onus lie on US regulatory policies but at same time china is being held responsible for high savings at national level.[7]

Overvaluation of Chinese currency and trade deficit are problems between China and United States, however China has incrementally appreciated Yuan against dollar by 21 percent, as Chinese Central Bank heavily invested in foreign exchange market. Still World Monetary experts are convinced that Yuan should be appreciated on the other hand Americans have been living beyond their means.

Impact of Financial Crunch on China

In the wake of huge trade surplus for China against United States has made US policy makers more demanding for China to bring reforms in exchange rate; besides, they are adopting protectionist tendencies by incorporating the 'buy American' goods, clause which will have wider implication for world in general and China in particular. Though American economy is not growing rapidly but it is still rich and provides a big consumption market for other trading states especially from East Asia. Any recession in its economy will carry a cumulative effect for global economy. As United States is major importer from China, latter is bound to suffer in that situation.

On the other side, one can understand Chinese fears on American capacity of repaying to huge amount of foreign debt. In the wake of financial crisis, China demands US government, to resolve the current account deficit and seek assurance of its capital investment in United State of America.[8]

The question how financial transition between China and United States will determine their relations is to be judged in future. Much depends on China could reduce its accumulating the foreign reserves and manipulation of its currency for the purpose of export driven strategy while at the same time not broadening the base of its own consumption. The consequences of the crisis in Western capitalism are also having repercussions on China, which was the biggest beneficiary of the prevailing trade before the financial crisis.

China recovered quickly due to a stimulus program worth about 14 percent of its GDP and the global economic bounce last year, but exporters now face a very different world dictated by anemic Western consumption and growth prospects. Moreover, the explosion of credit creation since 2008 and the unsustainable rise in investment and residential real estate spending are sowing the seeds of rising inflation. The instability that will likely follow may remain in abeyance until after the Chinese Communist Party's leadership change in 2012, but China's economy is already slowing to a growth rate of around 8 percent.[9]

China is a high-speed economy with (capitalist) design that, sooner or later, will result in a crisis. There are already strong signs that the quality of investment, and of investment financing, is deteriorating. These trends might well validate Marx's prediction that investment booms, endemic in capitalism, end up in overproduction and under-consumption, and then social conflict.

The great challenge for China remain how could it broader the base of domestic consumption to run its productivity and find alternate markets by US government towards import from China, in case of opening of protectionism policy it will be difficult task for China to reduce its dependence on export- led growth in foreseeable future.

China has limited time to affect a radical political and economic shift. It has to take power and privilege away from state-owned companies, coastal regions, and regional party elites. It must also de-emphasize capital investment, which currently accounts for an unprecedented 50 percent of GDP. And it has to prioritize a bigger economic weight for household consumption, which accounts for a mere 35 percent of GDP, a fairer income distribution, better employment for China's annual flow of 6 million graduates, the rights of rural migrants, and the neglected countryside.[10]

If this shift doesn't starts earnestly, the Chinese economy will succumb to a credit and investment bust from which significantly slower growth would follow. This will be especially sensitive in China where incidents of social unrest are increasing significantly in number, intensity, and breadth. In the absence of the rule of law and other critical social institutions, the state's assurance of steady and persistent annual growth of 8 to 10 percent represents a social contract. If it is broken, China could suffer significant political repercussions.[11]

The political unrest in China has so far remained manageable: The country's "jasmine" human rights protests earlier this year proved ineffectual, and food price-related disturbances have also fizzled out. Much bigger matters of economic stability and political legitimacy are stalking China, however. China's capitalist model has delivered unprecedented economic success over the last quarter- century. But it is a model that is now to be tested. The slump in Western demand caused China's export industries to shudder in 2008 and 2009, with exports declining by over a third in the year to the first quarter of 2009. Thousands of factories in the Pearl River Delta are shut down.[12]

There is a great uncertainty as to whether the Communist Party's reputation for pragmatism will stand up to this challenge, especially if China's "prince lings," the children of the revolutionary leaders, increase their influence in the new leadership. Should China fail, its economy is at risk of stalling out in a few short years--a development that would make this tumultuous year appear to be the calm before another storm.

However, direct impact of US financial turmoil on China is marginal. But indirect ramification could not be neglected. Huge Volume of export has employed enormous Chinese in work force. Any setback to it may cause social unrest in China especially in its western part where so many labor is already in surplus.

In spite of volatile position of US dollar, Chinese investment in American capital market is forthcoming. After 2008, China has made substantial investment in US treasury bills and bonds which augur a positive factor for the revival of US economy. China secured its economic interests with United States by a bargain in which China made capital investment in United States to enable its citizens to get easy money on nominal rates and consume. China clouts over United States has increased and latter is offering “Quantitative Easing”, to address debt problem.[13]

However, the likelihood of this scenario playing out is slim since a large sell-off by China could:

(a) Make limit in stock piling more foreign reserves and focus on investment.

(b) Reduce imports by raising interest rates or by raising Yuan rate by china against US dollar; or appreciate Yuan to discourage US demand for import from China.

(c) To stave off US adhere protectionist policy against China.

Decoupling of Chinese and US Economy

In the final analysis, both these countries are facing mutual dependence on each other. Decline of American economy has made it target creditor country in the world. One can argue that Chinese economy have become more competitive and pose challenge to US in the long term if not in foreseeable future.[14] This scenario could be replica of early 20th century. When European powers made huge borrowings from the United States and ultimately lost its grip on world economy. Can it happens with America in future is any body's guess. But American economic power could bounce back to revive its hold on global economy. There is convergence in American and Chinese policies on economic reforms in China, so as latter could sustain its economic growth productivity not only for itself but for world as well.[15] Irrespective of these problems China will sustain its growth to a considerable level.

Prospects

The prospects of China's economic growth are brighter. In this context, a Shanghai think tank has established following reasons:

China's economic growth is spontaneous and based on solid Principles of economics. The availability of cheap labor land and capital has boosted its productivity. Side by side there is rapid urbanization for which China needs inflow of foreign investment in primary sector and running its manufacturing base. One of remarkable achievement of Chinese leadership is that China's ride is safer in financial storm gathering in Western economies.

As China is major beneficiary of trade with the United States. One who is more beneficiary is more vulnerable to the termination of relations. Therefore, in the long term it will dissuade China's planners to explore other avenue of capital investment, for appropriate return on it surplus capital. China is already investing lion share of its capital accumulation on infrastructural development in 'interior' and 'heartland' of China. It will definitely broaden the base of domestic market within China.[16]

The rise of 'Middle Class' in emerging economics is likely to bring structural changes in world consuming markets shifting from capital deficits states, to capital surplus states. To address the problem of rising inflation in lieu of more economic growth, China needs to decrease the pace of its exports to the United States to avoid the consequence of economic overheating. American growth for many decades has worsened its position in current accounts which is mounting the level of foreign debit. Another blessing in disguise for China could be its leadership might be thinking how to reduce dependence on US dollar; China is looking to invest its surplus wealth in Euro Zone to mitigate dependence on dollar holdings.

Conclusion

China has always played a role of stabilizer in all financial crises in recent times. In 1997, when South East Asia was awash with financial upheavals, China played a positive role in strengthening the position of other states by keeping value of its currency intact.

Presently, in US financial turmoil, China is still pouring its due share in capital markets to bring financial stability in United States. China's decoupling on American economy has created a strategic interdependence on each other.

China has successfully averted the consequences of financial upsurge by managing to transform from export oriented economy to relying on domestic demands for sustainable development of its economy. Towards that end China needs to create a culture of more consumption by moving out its population from poverty line in a massive way in its hinterland and western parts of the country. How to broader the base of domestic consumption through raising the buying power of Chinese people remain a daunting task for incoming Chinese leadership in 2012.

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