Is China's economy a cause for concern?

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Questioning China's remarkable economic performance over the last 30 years seems to fly in the face of wisdom honed by decades of double digit growth. However, it is perfectly possible to explain China in the context of standard models of economic growth. Immigration of low-wage labour into the Eastern seaboard along with transfers of capital from Chinese Diaspora in Hong Kong, Taiwan and further afield, created the conditions for the 'miracle'.

This does not imply that China has not been an economic success story but puts the emphasis on standard factors rather than some special Chinese characteristics. China's policy-makers have been generally clever (or perhaps are fortunate to be able) to take a long-term view. They have also been sensible to limit the degree of economic liberalisation to the areas that will promote real economic growth. They have also given rein to the entrepreneurial instincts of the Chinese.

However, times are troubling for the country and its policy-makers. Wages are rising, as are commodity prices, pushing up price inflation. The rich and dynamic regions have suffered unemployment and migration of workers back to their hometowns, although the continued revival of global demand post 2008 has reversed the trend. There has been a stock market bubble and more recently all the evidence of a real estate price bubble. Policy-makers have taken sensible measures to cool the economy but the pressure has yet to subside.

The real problem is that China's economy is unbalanced for its long-run stability. The real exchange rate is kept artificially low despite recent appreciation. The financial sector is still very limited in scope creating the stampede of wealth into whatever asset is perceived to be the one to deliver high (and self-fulfilling) profits. Wages are continuing to rise and the reliance on low value-added manufacturing industry is not the basis for sustainable growth.

To be sure China's policy-makers play a clever game. They are securing their long-run access to commodities through diplomacy and aid-giving in Africa (although recent events in the Northern part of the region may have caused them to re-assess the stability of some of the countries with which they do business). They recognise the importance of developing human as well as physical infrastructure in moving the economy to higher value-added industries. They are also aware of the inequalities that are being created as a result of the geographical concentration of growth.

Movement to higher value-added industries requires building human capital which takes time. As people's human capital becomes greater they typically want the freedom to think for themselves. The export of Chinese students to universities in developed countries is one way of achieving domestic human capital growth and the policy to create world-class universities in China is another (longer-term) mechanism. But increasingly we are living in a world where human capital is mobile and high quality people will choose carefully where to pursue their careers.

So are Chinese policy-makers willing and able to face the next stage of liberalisation of the economy and society for the country to move forward? Increasing the choices open to Chinese consumers through relaxing exchange rate restrictions, further opening of the financial sector, enhancing protection of intellectual property, giving free rein to innovative thinking and allowing more freedom of speech are some of the things required. We should all be considering the way in which Chinese policy-makers will react in the next few years since the success of the global economy is tied inextricably to the success of the China.

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