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CHINA

Olympics Shine a Light on China's Challenges. Brace for More Volatility.

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The Beijing Olympics logo.
Dreamstime

The Winter Olympics in Beijing offers a microcosm of challenges China is grappling with—from geopolitical tensions as its role in the global economy evolves to a diplomatic boycott of the games by the U.S. over China's human rights abuses toward the Uyghurs. Strict Covid restrictions are also putting a spotlight on the tightening grip of the state on society and economy.

China is on a course for more economic volatility and the world may need to brace for a more aggressive China, according to economist Eswar Prasad, former China head of the International Monetary Fund, and author of the *The Future of Money: How the Digital Revolution Is Transforming Currencies and Finance.*In a conversation that included discussions about digital money, here, *Barron's* talked with Prasad about why U.S. investors could be in for a difficult time in China. An edited version of our discussion follows.

Barron's: China had a difficult year, with crackdowns on its internet and property sectors and a sluggish economy. How is it managing these challenges?

Eswar Prasad: China is dealing with a set of interesting contradictions in its approach to policies that are going to inevitably lead to a variety of stumbles and accidents. For example, China recognizes it needs a dynamic private sector to continue generating productivity and employment growth and innovation.At the same time, it wants to restrict the power of the private sector—as seen with attempts to cut down big tech corporations that [it views as] having grown too economically and politically powerful. Xi Jinping has made it clear he views a state-dominated economy as the preferable outcome. How China can square the objective of greater state domination of the economy and financial system, with a more dynamic and vibrant private sector, is going to be a challenge.Another challenge is how it can rein in the property sector, a crucial driver of economic growth and very important component of household wealth, without setting off financial and economic problems, especially at a time growth is slowing.**How have the challenges evolved since you led the IMF China division 20 years ago?**

Many of the problems we had identified back then—the banking system not working very well, problems with non-performing loans, and corporate and local government debt—have expanded over the last couple of decades. But China, except for last year, has managed to sustain a decent pace of growth.China's approach [lately] shows it has reached some critical point where the problems can no longer be ignored, even if that comes at the price of losing some short-term growth. From a long-term perspective, I'm encouraged. But its seesaw approach is leading to more uncertainty, which is going to mean a cost to growth, a lot more volatility and stumbles in the short- to medium-term.**What does this mean for investors in China?**

China still remains a relatively fast-growing economy given its size—likely real growth of 4% to 5% over the next few years. Investors will have to be very selective about which sectors they invest in—and take a very specific firm-based approach. It's going to be a market difficult to resist, but also a little difficult to profit [from].

There's a bipartisan push for a stronger stance against China. How do you see this playing out?

We will continue to see the U.S. government trying to find ways to limit Chinese firms' access to U.S. markets and technology, and some attempts to limit U.S. financial firms' involvement in Chinese markets.

China wants a better homegrown financial system to rely less on foreign capital and on foreign sources of funding for its companies. But it also recognizes foreign financial firms can play a very important role in domestic financial market development. It has been able to play that game to some extent simply because US and other foreign financial firms continue salivating at the prospect of access to Chinese financial markets. It's still a fast-growing economy with huge latent demand for better financial services. U.S. firms are fully cognizant of the policy, financial and economic risks, but many feel the Chinese market is too difficult to stay out of.**What types of changes could be ahead if President Xi secures a third term later this year?**

In terms of domestic policies, Xi Jinping has clearly revealed his stripes: He views the state as having to maintain a very important role in both financial markets and the economy. On the global front, rather than trying to influence the rules of the game from the inside, it is going to be much more assertive in putting forward its view of how the world needs to be shaped. Especially in multilateral fora, China is going to make its soft power increasingly visible and start using its levers much more assertively.

Thanks, Eswar.

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