CHAPTER I

INTRODUCTION

A. Background

Seeing the history of China from its civilization until its rapid economic growth, it is undeniable that China is one of the greatest nation in the world. China, from the ancient era, is very popular with the term of socialist state, a state in which its economy is controlled and regulated by the central government. The economic of China has been much stronger since the introduction of economic reform in the era of Deng Xiaoping. After the introduction of economic reform, China, which is still considered as a country with the low per capita income, is trying to open its economy to the international trade. Thus, it creates China becomes one of the countries with largest economy in the world nowadays.

The success of China's economic growth cannot be separated from the economic reform which becomes the driving force that rapidly increase the China's economic growth. The economic reform happened when the centrally planned economy was not give any good improvement towards China's economic growth instead it creates the inefficiency towards the standard of living in China. Furthermore, the centrally planned economy failed to narrow the gap of the economic growth between China and other developing countries. The centrally planned economy itself was adopted since the establishment of China in the era of Mao Tze Tung. In the era of Deng Xiaoping, China's economic system has changed from centrally planned economy which is closed to the international trading into more market economy that plays a great role in global economy. Deng Xiaoping considered market-based method to revitalize the China's economic slowdown that happened in the era of Mao. On the other hand, he does not eliminate the fact that China as a socialist country. Therefore, Deng Xiaoping introduced socialist market economy to describe its economic system. This system of social market economy in China is characterized by state-owned enterprises which go along with the private sector. It also characterized by reduction of the control of the central government over the market.

Since China adopted market economic system, China began to involve in an international trading and investment. Since then, the economic growth of China shows good improvement even though there are still obstacles dealt by China's economy such as global economic slowdown in 2008 and others. China comes as one of countries with a strong economic power in the world. The GDP of China from 2006 to 2015 increased gradually. In the 2007 China's GDP reached 3552.18 billion US dollar. The next years later, China's GDP achieved 4598.21 billion US dollar. In the 2010, it achieved 6100.62 billion US dollar. In the 2012, it reached 8560.55 billion US dollar. In the 2014, it reached 10482.7 billion US dollar. Last, in the 2015 it achieved 11007.72 billion US dollar (Trading Economics, 2017). These numbers is simplified in the chart below. In addition of an incredible growth of its GDP, in recent year, China has emerged as a country with a high export and the country with the largest destination for investment. Yet, in the per capita income, China still remains low.

Figure 1.0.1 The increase of China's GDP from 2006 until 2015 (Trading Economics, 2017)

Basically, one of the purposes of the economic modernization in China is to attract the investment into China in order to help boosting the development of China, both in the domestic area and in the international area. Therefore, the China's government promotes and encourages the investors to come to China. As a result, the China's trade and investment led to a rapid increase, the investors are targeting China for the investment destination. As a result, the foreign direct investment in China gradually increases from 1985 until 2011. During that period, the annual FDI flow to China has experience steady increase from $2 billion until $108 billion. In 2009 it suffers from the impact of global financial crisis which fell 12.2% (Morrison, 2012). However, in the next year after the global financial crisis, China's annual FDI flow can lift up its growth. As a result, in 2011, FDI flow to China achieved $116 billion (Morrison, 2012). Such flows have been the source of productivity gains and rapid economic growth in China. This condition is different with the condition in pre-reform period. The foreign direct investment in pre-reform period was limited to the ally's countries. The increase of the annual FDI Flows in China makes China become the largest destination for the investment in 2011 after United State. During the period, the foreign direct investment in China achieved $1.2 trillion (Morrison, 2012). The Shanghai stock exchange market and Shenzhen stock exchange market are the biggest stock exchange market in China.

The China's government view the rapid increase on the economic sectors as the important aspect in order to maintain its social stability. However, after all of these, China still faces problems that challenge the future growth of China's economy. Those challenges include "distortive economic policies that have resulted in over-reliance on fixed investment and exports for economic growth, government support for state-owned firms, a weak banking system, widening income gaps, growing pollution, and the relative lack of the rule of law in China"

(Morrison, 2012, p. 2). These problems emerged as the reaction of its economic transition from socialist economy system into market economy system.

The year of 2015 becomes the dark year for the China’s stock market. China’s stock market dealt with the problem in which the China’s stock market index declined. China's stock market from the Shanghai Stock Exchange Composite Index declined 8.5 percent while index composite that consists of several large companies listed in Shanghai and Shenzhen declined by 8.6 percent (VOA Indonesia, 2015). China’s main stock markets are in crisis-mode. The stock index of the two big stock exchange in China keep declining until it reached 32 percent in Shanghai Composite Index while in the Shenzhen Composite Index fell more severe which is more than 40 percent over the period (Supriadi, 2015). The value index of Chinese stocks on the stock market which continues to decrease is triggered the shock on the foreign exchange market. The investors are hit by the panic due to the decline of the China’s stock market. It is feared that this decline will give the worst impact towards the economic growth of China. China which becoming a global economic power with the high export level is now called exporting global fears.

Based on the explanation above, the author is interested to discuss deeply about the reasons why the China’s stock market crisis happens in the mid of the China’s rise. It will be followed by the roles of the government in addressing its stock market crisis.

B. Research Question

China is a country with the greatest economy whose growth has the meaning to the global economic growth. The market economy in China has been able to encourage its economic growth and now China remains as one with the greatest economic power in the world. However, in the early of 2015, the stock market of China shows an unusual growth in which it shows the decrease of the China's stock indexes which is called as the stock market crisis. Based on these descriptions, the author would like to analyze more about: **Why did the China stock market crisis arise? What are the roles of the state in order to stabilize the financial crisis?**

C. Conceptual Framework

The conceptual framework is basically intended to help the authors to determine the direction and purpose of the study and to formulate the hypotheses. In order to explain about the reasons behind China's stock market crisis, the author uses the concept of Casino Capitalism by Susan Strange and the role of state by Keynesian perspective.

1. The Concept of Casino Capitalism

General understanding of the concept of casino capitalism is an economic system in which private business risks a large amount of money on investment and shares. The casino capitalism in a certain country is driven by the desire of the businessmen or investors to get money in a short time. This concept of casino capitalism refers to the unregulated dynamics of the global capital movement (Griffiths & O'Callaghan, 2002, p. 28). Griffiths & O’Callaghan (2002) also mention that in the casino capitalism, more than trillions dollars move freely in order to seek the profitable opportunities from the speculative investment around the world. The speculative investment is the investment with high degree of risk in which the focus is only to the price fluctuation (Market Business News, 2016). Speculative is somehow similar with the investment. The investment is sometimes interpreted as buying shares in a business. There are many ways to invest money which is by investing in the stocks, bonds and real estate. What distinguish both the investment and speculative is the period to get money. Based on the Market Business News (2016), the speculative can creates money in a short time meanwhile the investment will create money in the long time. The main actor in the casino capitalism is the big bankers and brokers who control the flow of money prices in the global financial system (Strange, 1997). However, with the existence if the advance technology, the actors of the casino capitalism becomes widen since all people can controls the price fluctuation through the electronic tools.

Casino capitalism is the title of the book written by Susan Strange (1997). In her book, Strange (1997) examines the origins and consequences of the global financial system. The origin of the casino capitalism was when the Bretton Woods system collapsed. “The year of 1973 becomes the turning point as the big changes coincide – an effective devaluation of dollars and the accompanying decision to leave the determination of exchange rate to the market" (Strange, 1997, p. 5). The fixed exchange rate was changed into floating exchange rate which is using dollar as the standard of currency exchange in the international monetary and financial system. The emergence of this floating exchange rate which then gave rise to the casino capitalism in which the speculators begin to meet the foreign exchange market. What meant by casino capitalism is a financial system that resembles a casino. As in a casino, they are just like gamblers that control the prices dynamics through the computer screens or such electronic tools that can connect across border (Strange, 1997).

After the system has been changed into floating exchange rate, the casino capitalism is closely related to the foreign exchange market. It is due to the foreign exchange market is the largest market in the world. Through the foreign exchange market, the country can engage in the trading and investment across the borders. In the trading activity across the border, the country's currency needs to convert into one currency. Thus, the foreign exchange market exists to convert the currencies (Griffiths & O'Callaghan, 2002). In the case of China, the financial system has rapidly expanded as it becomes integral to its economic policy. After the economy reform, China began to implement the financial system as the way to deploy the capital. Thus, banks are becoming more important for China's economy. China's official currency is known as Renminbi Yuan or called Yuan (CNY). The foreign exchange rate in China is depends on the exchange rate of Yuan to other currencies.

In China, the foreign exchange market is the important aspect for the national economy since there are many people who join the investment. In this context, it cannot be separated from the government's efforts which continue to promote and encourage the people to involve in the investment through its public policies. The Chinese government has always issued the policies to make it easier to invest in China. As a result, it receives positive responses from the investors and even an ordinary people. The purchase of shares in China increases rapidly as people start to invest their money. Thus, it becomes the productivity gains for the government itself. Based on the concept of casino capitalism explained above, the financial development in China is just like a casino. People are joining the gambling table through the speculative investment.

2. The Role of State

General understanding of state is an organization in a region that has a highest legal authority and is obeyed by its people. In this context, “the state is defined as the set of institutions within a society that exercise the monopoly and legitimate use of physical force within a given territory” (Wolfe, 1981, pp. 3-4). According to Montevideo Convention on the Rights and Duties of States, the state as a legal subject should be qualified as: (a) a permanent population, (b) a specific region, (c) the government, (d) the ability to relate to other countries. (Montevideo Convention on the Rights and Duties of States, 1969).

According to Karl Marx, the state is “an instrument of human power to oppress other human class” (Syafiie, 2014, p. 61). The state as a subject of international law has no real power but rather its real power is vested in the hand of dominant class. Therefore, the state becomes the instrument of the dominant class to achieve the interest of dominant class through oppressing the other human class (Budiman, 1996). According to Hegel, state "is not the tool of society, but the state is a tool of himself" (Budiman, 1996, p. 59). The state power is dedicated for the society by leading it to the better society in the future. Thus, the society needs to obey the rule of state. “The old thought that regard the state as a security guard and an arbitrary order or as a passive institution for resolving conflicts have been abandoned” (Surbakti, 2010, p. 270). The approach in the political economy gives different opinion regarding the role of the state in economic activity. However, the role of government in the economy is not only determined by economic issues, but also determined by economic and political system of the society itself.

The Keynesian perspective promotes a mixed economy, in which neither the state nor the private sector plays an important role. It found by John Maynard Keynes, he explains that the state intervention in market is necessary in order to help boost the economy. Keynesian perspective proposes the critic towards the hypothesis that said that the market can regulate itself (Caporaso & Levine, 2008). The essence of the argument that market can regulate itself is that the market can unite the consumers and producers. This refers to the price and demand. In market, the price of goods will experience ascent and decent depend on the demand. Such condition will meet the needs of market where goods that brought to the market will find the buyer or consumer. However, there is a possibility that the producers failed to sell their goods. Here, neoclassical argues that the failure is due to the wrong decision to allocate the capital so it produces the wrong goods. In contrast to these argument, the Keynesian perspective argues that this failure is not only about the miss-allocation of the capital but rather a systematic problem where the market fail to the unite demand and goods so that it fail to utilize the resources. Here, the Keynesian perspective is trying to consider the relations between economics and politics. Keynesian perspective argues if the market works without any interventions from the outside, what happen is the resources will not being fully utilized. This failure is a call for the government intervention. Government policies are needed to foster the economic growth. Therefore, the "Keynes's economic theories provided a theoretical justification for the state intervention which viewed not as an attack on the private accumulation of capital but as a necessary adjunct to it" (Wolfe, 1981, p. 88). Wolfe (1981) adds that during the Great Depression that occurred in the 1930s, the theory that exist at that time were not able to explain the cause of the worldwide economic collapse, which was refusing the government intervention instead letting the market to recover itself from the depression (Wolfe, 1981). According to the Keynesian perspective, the economic cannot be fully handed over to the market mechanism, the role of the government would be required. The Keynesian perspective argues that the government should intervene through public policies (Jahan, Mahmud, & Papageorgiou, 2014). Jahan, Mahmud, & Papageorgiou (2014) add that the government can intervene the market through public policies such as fiscal policy and monetary policy. The Keynesian perspective suggested the countercyclical fiscal. For example allocates the fund towards the infrastructure project to stimulate the employment (Jahan, Mahmud, & Papageorgiou, 2014). In addition, the monetary policy could also work in stimulating the economy such as reducing the interest rate. The Keynesian perspective argues that the central government needs to fix the problem in the short run.

The economic slowdown in China has been sparked panic in the stock market, particularly the investors. In fact, China's stock market crisis could affect the future growth of the investors' business. Therefore, the role of state in order to overcome the crisis is also needed. As proposed by Keynesian perspective, the market and the state play an important role. The solution towards the stock market crisis in China cannot be fully handed over to the market mechanism. The state as the regulator of the economic activity also has a crucial role to stabilize the financial crisis. The state as the regulator of the economic activity can be done through the public policies which is the monetary policy and the fiscal policy. Therefore, the government of China states that they will apply the fiscal policy as the response towards the financial crisis along with the monetary policy. In the context of China, the fiscal policy done by the government is through allocating more funds to encourage the government spending to some infrastructure projects. This is believed will encourage the productive investment to revitalize the financial slowdown in China. The central government disburses the fund to the market to stimulate economy. Besides the fiscal policy, the central government of China also issued the monetary policy states that they will lend more funds to the market, cuts the interest rate that will help to pump the liquidity to the system, and devaluating the Yuan.

D. Hypothesis

The China stock market crisis has arisen because of the un-controlled capital mobility. The role of the state as the regulator is through monetary policy and fiscal policy.

E. Research Purpose

Based on the research questions above, the author can set goals in this study. The purposes of this study are as follows: (a) Explaining China economic system, (b) Explaining China’s financial system and the China’s stock market, (c) Explaining the root of problem of the stock market crisis and the role of the state to overcome the crisis.

F. Research Benefits

Based on the purposes of this study, the research is expected to provide benefits theoretically and practically, as follows:

1. Theoretical Benefits

This research is expected to provide empirical evidence of the theory which examined the stock market crisis which occurred in China and as a reference for similar studies in the future.

2. Practical Benefits

This research can be a reference for students or other academicians to complete the research that will be conducted in the future, especially students from the International Relations and those who concern the economic problems in the world.

G. Research Method

This research is using explanatory method that aims to explain why the stock crisis in China happened and the role of the state itself in order to recover from the crisis itself. The explanatory method is a method that will be used to examine the theory and the hypotheses. The data collection techniques that will be used by the author is a literature review (library research) which is a data collection through reviewing the literature in the form of books, journals, documents, reports, news either printed or online, papers and articles related to the problem.

As for places expected to be a source of information and data in the study are as follows: (a) Central Library of Muhammadiyah University of Yogyakarta, (b) Library of Magister of International Relation Building Muhammadiyah

University of Yogyakarta, (c) Library of International Relations Muhammadiyah University of Yogyakarta, (d) Central Library of Gadjah Mada University, (e) Online news and journals.

The data used in this study are secondary data which are obtained through literature review related to the topic of this research. This study uses a qualitative approach that explains and analyzes data found by the author. Then the authors attempted to present the results of the study based on the style of its own. Qualitative research is conducted in the state of nature and nature discovery. In qualitative research, the researcher is a principal instrument.

H. Scope of Research

This research was conducted by looking at the time of the stock market crisis in China which was in the year of 2015. This research is limited to find out the reasons why the stock market crisis happened in China and the role of the state in addressing the crisis. In this research, the China becomes the subject of the research. In additional, the researcher also provides the explanation about China's economic transition from centrally planned economy into more market economy that becomes the foundation of China's economic modernization in twenty-first century. It happens in the era of Mao Tze Tung and Deng Xiaoping

I. System of Writing

In order to make the research easier to understand the flow of the writing of this study, the author divides the discussion into several parts: introduction, China's economy system, China's stock market crisis, the roles of the state and conclusion. The divisions in detail as follows:

Chapter 1: In this chapter, it contains the introduction which contains the background of the problem, research questions, research purpose, research benefits, theoretical framework, hypothesis, research method, scope of research, and system of writing. This chapter is the basis or framework to conduct the next step to write this undergraduate thesis.

Chapter 2: In this chapter, the researcher would like to explain the economic system of China in the era of Mao Tze Tung and in the era of Deng Xiaoping. Thus, it can illustrate the economy reform in China which believed as the driving forces of the economic modernization in China. Then, it will also describe the China's economy system under Chairman Xi Jin-ping as the current President of China.

Chapter 3: In this chapter, the researcher would like to explain the financial system of China after reform and then explain the un-controlled capital mobility in China which then led to the stock market crisis happened in 2015.

Chapter 4: In this chapter, the researcher would like to explain about non-market intervention done by China's government as the respond towards the stock market crisis.

Chapter 5: Conclusion