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External Contradictions of the Chinese Development Model: export-led growth and the dangers of global economic contraction

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Abstract

China's development model faces an external constraint that could cause an economic hard landing. China has become a global manufacturing powerhouse, and its size now renders its export-led growth strategy unsustainable. China relies on the US market, but the scale of its exports is contributing to the massive US trade deficit, creating financial fragility and undermining the US manufacturing sector. These developments could stall the US economy's expansion, in turn triggering a global recession that will embrace China. This is the external constraint. These considerations suggest that China should transition from export-led growth to domestic demand-led growth. This requires growing the economy's demand side as well as its supply-side. To avoid stalling the US economic expansion, which is critical to China's growth, China should significantly revalue its currency as part of a generalized East Asian upward currency revaluation.

Longer term, China should raise wages and improve income distribution. Under export-led growth, higher wages undermine employment. Under domestic demand-led growth, they support it. The challenge is to raise wages in an efficient decentralized manner. History shows that this requires independent democratic trade unions. However, such unions are currently unacceptable to the Chinese political leadership. Creating a domestic demand-led growth regime therefore requires solving this political roadblock.

Notes

35. T. I. Palley, 'Labor standards, democracy and wages: some cross-country evidence', *Journal of International Development* 17, (2005), pp. 1-16.

34. For neo-classicals, labor markets set wages such that there is full-employment, and income distribution is a by-product that has no consequence for full-employment. For Keynesians, full-employment requires an appropriate level of AD, and the distribution of income is a key parameter impacting AD.

33. The case for asset based reserve requirements is outlined in Palley. Such a system can be contrasted with the current system which is liability based. See T. I. Palley, 'Asset based reserve requirements: reasserting domestic monetary control in an era of financial innovation and instability', *Review of Political Economy* 16, (January 2004), pp. 43-58.

32. Economics ignores demand-side considerations owing to its domination by classical general equilibrium economics that emphasizes Say's law, the claim that supply creates its own demand.

31. There are many proposals for how a new Bretton Woods coordinated exchange rate system could work. These include: C. F. Bergsten, O. Davanne and P. Jacquet, *The Case for Joint Management of Exchange Rate Flexibility*, Policy Brief 99-9 (Washington, DC: Institute for International Economics, 1999), available at www.iie.com/publications/papers/wp/1999/99-9.htm; R. A. Blecker, *Taming Global Finance: A Better Architecture for Growth and Equity* (Washington, DC: Economic Policy Institute, 1999); J. Grieve Smith, 'A new Bretton Woods: reforming the global financial system', in Jonathan Michie and J. Grieve Smith, eds, *Global Instability: The Political*

Economy of World Economic Governance (London: Routledge, 1999) ; J. Williamson, *Crawling Bands or Monitoring Bands: How to Manage Exchange Rates in a World of Capital Mobility*, Policy Brief 99-3 (Washington, DC: Institute for International Economics, 1999), available at www.iie.com/publications/pb/pb99-3.htm; C. Weller and L. Singleton, *Reining in Exchange Rates: A Better Way to Stabilize the Global Economy*, Briefing Paper #131 (Washington, DC: Economic Policy Institute, September 2002); T. I. Palley, *Beyond the Over-valued Dollar: A New Agenda to Avoid Future Dollar Misalignments*, unpublished policy discussion paper (Washington, DC: December 2003).

30. Inflation is a political threat because it risks creating discontent among groups, especially the peasant class, that are disproportionately adversely impacted by inflation.

29. The 15–40% range is based on the broadly held consensus that the renminbi is undervalued against the dollar by some amount in this range. See Fair Currency Alliance, *Experts Agree: China's Currency is Undervalued*, Brief No. 2 (Washington, DC: 28 June 2004).

28. Palley provides an exploratory analysis of the types of policies needed to develop the demand side. Unlike conventional Keynesian economics, the focus is not on increasing individual components of AD. Instead, it is on establishing an income generation and production process that ensures income gets into the hands of those who will spend it, and encouraging production of needed goods that have high domestic employment and expenditure multipliers. This can be termed 'structural Keynesianism' and contrasts with conventional 'demand side Keynesianism'. See T. I. Palley, 'A new development paradigm: domestic demand-led growth', *Foreign Policy in Focus*, (September 2002), available at <http://www.fpif.org/>. Also published in T. I. Palley, 'After neo-liberalism: economic policies that work for the poor', in D. Jacobs, J. Weaver and J. Baker, eds, *New Rules for Global Finance* (Washington, DC: 2002).

27. This raises the question of whether China and other trade surplus countries can keep funding the US consumer indefinitely. The answer is no. This is because the funding is delivered via US banks, and US banks will only make loans to US consumers as long as they believe they will be repaid. The constraint on the system is therefore not the willingness of surplus countries to lend, but rather the availability of good borrowers to lend to.

26. Private conversations with Chinese policy advisers indicate that the Chinese government understands the national security dangers of export-led growth that relies excessively on a single market (the US). However, the government does not yet appear to have considered the economic dangers resulting from limits to export-led growth.

25. The MFA ended on 1 January 2005.

24. The US trade deficit debate evokes competing theoretical explanations that cannot be tackled in the current paper. Essentially, there are two positions. One position is that the deficit is due to inadequate US saving. A second position is that it is due to severe relative international price misalignments in conjunction with export-led growth. The former view calls for the US to reduce spending and increase saving. The latter view calls for major international relative price realignments and a shift away from export-led growth. This will cause expenditure switching in the US but total spending will remain unchanged. This paper implicitly adopts the second position.

23. Much is made of China as an engine of demand growth, particularly with regard to Japan's economic recovery. However, China's internal demand growth is significantly derived from the prosperity generated by exporting to the US economy. In this sense, the US economy is the ultimate source of demand growth, and this demand growth is then multiplied in the global economy with China being an important participant in the multiplier process.

22. The arguments about consumer demand leakage and investment profitability apply to other East Asian countries running trade surpluses with the United States.

21. US real fixed non-residential investment peaked at \$1,232.1 billion in 2000 and in 2004 was \$1,228.6 billion. The fact that investment remains below its previous peak level is significantly due to the problems of manufacturing, and these problems can be linked to China.

20. R. A. Blecker, *The Economic Consequences of Dollar Appreciation for US Manufacturing Profits and Investment: A Time Series Analysis*, paper presented at the Post Keynesian Conference, University of Missouri, Kansas City, 26–29 June 2004; and R. A. Blacker, *Exchange Rates in North America: Effects of the Over-valued Dollar on Domestic US Manufacturing and Implications for Canada and Mexico*, paper presented at the conference 'Can Canada and Its NAFTA Partners Conduct Independent

19. K. Bronfenbrenner and S. Luce, *The Changing Nature of Corporate Global Restructuring: The Impact of Production Shifts on Jobs in the US, China, and Around the Globe*, report prepared for the US-China Economic and Security Review Commission, Washington, DC, October 2004.
18. A more complete discussion of the employment implications of the China trade deficit is contained in T. I. Palley, *Trade, Employment and Outsourcing: Some Observations on US-China Economic Relations*, paper presented at France/ILO Dialogue, 'The Internationalization of Employment: A Challenge for a Fair Globalization?', Annecy, France, 11-12 April 2005 and forthcoming.
17. R. Scott, *US-China Trade, 1989-2003: Impact on Jobs and Industries, Nationally and State-by-State*, report prepared for the US-China Economic and Security Review Commission, Washington, DC, January 2005.
16. Detailed theoretical and empirical critiques of the export-led growth paradigm, focusing on why it will not work if simultaneously adopted by all developing countries, are provided by R. A. Blecker, *The Diminishing Returns to Export-Led Growth*, paper prepared for the Council of Foreign Relations Working Group on Development, New York, 2000; and T. I. Palley, 'Export-led growth: is there any evidence of crowding-out?', in P. Arestis et al., eds, *Globalization, Regionalism, and Economic Activity* (Cheltenham: Edward Elgar, 2003).
15. China's partial privatization of the banking system represents a form of managing entry of foreign financial competition. Rather than setting up new foreign banks, which would drain deposits out of existing banks and precipitate a banking crisis, China aims to reform the banking system by selling part ownership in existing banks to foreign firms. The hope is that this will introduce new management and rectify the credit misallocation problem. China will also benefit from the proceeds raised by selling shares, and these proceeds are large because of the franchise value of the Chinese market. All of this is done within existing institutions so that depositors will have no incentive to exit. Two dangers to this strategy are: (i) that preventing foreign firms from opening up will shortly become illegal under the WTO; and (ii) partial privatization may be insufficient to induce real managerial change within China's banks. However, if China doesn't allow real change of managerial control, it is foreigners who will get

fleeced since they will have paid a high price for part ownership of banks that turn out to be worthless.

14. Another argument put forward by internal contradictionists regarding why China should revalue and cease running massive trade surpluses is that these surpluses are invested in relatively low-yielding US treasury bills and represent poor use of resources. The claim is that China would be better off directing these resources toward internal consumption which would yield a higher welfare return given China's low level of income. See J. Williamson, The Choice of Exchange Rate Regime: The Relevance of International Experience to China's Decision, outline of a lecture at the Central University of Finance and Economics, Beijing, China, 7 September 2004, available at www.iie.com/publications/papers/williamson1103.htm.

13. Goldstein and Lardy, 'Don't hail China's soft landing too soon'.

12. Open market sterilization operations have the central bank selling bonds, thereby draining deposits from the banking system. Such operations can offset expansions of the money supply resulting from defense of the undervalued exchange rate.

11. Western economists emphasize the economic distortions associated with inflation. Chinese policymakers are probably more concerned with the political consequences. China already faces political difficulties associated with downsizing employment in the SOE sector and absorbing surplus labor from the agrarian sector. Inflation exacerbates these problems since its costs hit the rural poor hard. The last major political troubles in China—Tiananmen Square, 1989—occurred at a time of rising inflation. Chinese policymakers are likely aware of this, and may fear inflation more for political than economic reasons.

10. Greenspan, Remarks before the World Affairs Council of Greater Dallas.

9. Greenspan, Remarks before the World Affairs Council of Greater Dallas; Goldstein, Adjusting China's Exchange Rate Policies; R. Rajan and A. Subramanian, 'Exchange rate flexibility is in Asia's interest', Financial Times, (Monday 27 September 2004). The article by Rajan and Subramanian is indicative of the International Monetary Fund's (IMF) thinking on the China question. The IMF accepts the internal contradictions hypothesis, and has sought to push China to adopt exchange rate flexibility on the grounds that it would facilitate management of the Chinese economy and avoid internal distortions of the economy.

8. Goldstein and Lardy, 'Don't hail China's soft landing too soon'.

7. In 2004 total Chinese fixed asset accumulation was 5,862 billion RMB. Total utilized FDI was \$60.6 billion, which translates to 503 billion RMB using an exchange rate of 8.30 RMB per dollar. That implies that FDI was 8.6% of the total, fixed asset accumulation. Data are from the Hong Kong Trade & Development Council, available at www.tdctrade.com/main/china.htm.

6. The idea that developing countries should run trade deficits for extended periods of time while they develop belongs to the earlier import-substitution development paradigm. The new FDI-export-led growth paradigm has developing countries run surpluses along the development path. Producing cheap exports is the way to attract FDI, which builds the supply-side; demand is provided by export markets rather than domestic markets.

5. Hong Kong Trade Development Council, available at www.tdctrade.com/main/china.htm.

4. UNCTAD, 'Country fact sheet: China', World Investment Report, (2004).

3. Since delivering this paper (October 2004) the external contradictions story has begun to surface on Wall Street. Stephen Roach writes in the Financial Times, (Friday 22 April 2005), p. 15: 'In China the name of the game is exports. China's biggest export market is the US, absorbing fully one-third of its overseas shipments in 2004'.

2. The external contradictions hypothesis does not deny the significance of the problems identified by the internal contradictions hypothesis. China's economy would be greatly strengthened by remedying these internal problems. However, these internal problems are not core contradictions. Fixing them will improve Chinese economic performance, but failure to do so will not cause the model to collapse. That will only happen if China fails to address the external contradictions inherent in the current development model.

1. Alan Greenspan, Remarks before the World Affairs Council of Greater Dallas, Dallas, TX, 11 December 2003; M. Goldstein, Adjusting China's Exchange Rate Policies (Washington, DC: Institute for International Economics, 2004); M. Goldstein and N. Lardy, 'Don't hail China's soft landing too soon', Financial Times, (Wednesday 6 October 2004).

Additional information

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