External Contradictions of the Chinese Development Model: Why China Must Abandon Export-led Growth or Risk a Global Economic Contraction

Thomas I. Palley

2004
External Contradictions of the Chinese Development Model: Why China Must Abandon Export-led Growth or Risk a Global Economic Contraction*

Abstract

China’s current development model faces an external constraint that promises to cause an economic hard landing. China has become a global manufacturing powerhouse, and its size now renders its export-led growth strategy no longer sustainable. China relies on the U.S. market, but the scale of its exports is contributing to the massive U.S. trade deficit, creating financial fragility and undermining the U.S. manufacturing sector. These developments threaten to stall the U.S. economy’s recovery, in turn triggering a global recession that will impact China. This is the external constraint.

China must shift from export-led growth to domestic demand-led growth, which requires growing the economy’s demand side as well as the supply-side. China must immediately and significantly revalue its currency to avoid stalling the U.S. recovery. Longer term, China must 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 Chinese political leadership. Solving China’s external economic contradiction therefore requires simultaneously solving this political roadblock.

Thomas I. Palley
Economist
Washington, DC 20010
e-mail: thomaspalley@yahoo.com

This version December 2004

* Paper presented at a conference on “China-U.S. Relations in the Asia-Pacific Context,” co-sponsored by the Graduate School of International Studies, Denver University and the School of International Studies, Peking University, held in Beijing, China, October 21-23, 2004.
I Limits to China’s current development strategy: competing hypotheses

Over the last twenty years China has experienced an economic development miracle. Its most recent success is captured in table 1 which details key economic statistics including the GDP growth rate, level of foreign direct investment (FDI), level of total exports, rate of growth of exports, exports to the U.S., trade surplus with the U.S., global trade surplus, and level of foreign exchange reserve holdings. Over the last five years, both real GDP and exports have grown rapidly, and especially impressive has been China’s continued growth during the most recent global downturn.

A debate has now opened regarding the sustainability of the Chinese model. Ironically, this debate has been triggered by the recent acceleration in Chinese growth, which exceeded 9 percent in 2003. The fear is that rapid growth is being driven by a private investment bubble and excessive misdirected state investment. As a result, China risks rising inflation, and when the bubble pops there could be a damaging hard landing.

This paper offers an alternative point of view on the Chinese development model. Like the conventional story described above, it too argues that the current model is unsustainable. However, it is not over-investment and excessive growth that are the reasons. Instead, it is China’s impact on the global economy, which threatens to trigger a world recession that will embrace China. In effect, there are two competing hypotheses about the Chinese development model. The conventional hypothesis is labeled the “internal contradictions” story. In Washington D.C. it is associated with the views of Alan Greenspan, Chairman of the Federal Reserve, and economists Morris Goldstein and Nicholas Lardy of the Institute for International Economics.¹ The alternative hypothesis is labeled the “external contradictions” story, and it is rooted in global Keynesianism.

Both hypotheses maintain that China risks a hard economic landing unless it changes policy direction, but they differ regarding the reasoning behind the hard landing.\(^2\)

The balance of the paper is as follows. Section II describes the current Chinese development model. Section III describes the internal contradictions hypothesis and its proposed policy remedies. Section IV describes the external contradictions hypothesis. Section V then describes the proposed policy remedies for the external contradiction problem. The core challenge is to build China’s domestic market, which means addressing China’s wage and income distribution problem. This leads into controversial territory since the economic institutions (e.g., free democratic trade unions) needed to solve this economic problem have political implications that are currently unacceptable to China’s political leadership. Section VI concludes the paper.

II The current Chinese development model

China’s recent economic record has been one of phenomenal success. Broadly speaking, the Chinese development model aims to gradually transition the economy from reliance on restrictive centralized planning to being centered on market-based private sector activity. The first step in this transition was taken with the historic 1979 reforms of the agricultural sector. Since then, private sector activity has been allowed to spread ever more widely in the economy by the removal of controls on economic activity, and it is also being spread by privatization. This spread has been accompanied by an explicit internal and external capital accumulation strategy. The external accumulation strategy rests on extensive FDI and export-led growth, while the internal strategy rests on use of

\(^2\)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.
state-controlled domestic bank credit creation to fund state owned enterprises and infrastructure investment. This development strategy is illustrated in Figure 1.

FDI has served to bring capital goods and high technology into the country, and it has been financed by foreign multinational companies (MNCs). The scale of FDI flows is reflected in the fact that China was the world’s largest recipient of FDI in 2002, and the total stock of FDI in China now exceeds $400 billion. China is currently the third largest cumulative recipient of FDI, and at current rates of inflow it will soon be the second largest. The construction and operation of foreign-owned plants has created employment. Particularly important is the fact that FDI has been a form of self-financing development that solves the historic resource shortage problem. Industrialization needs resources to fund investment in industry, and in the past it has been funded out of the agricultural sector’s surplus. This has often proven problematic for both economic and political reasons. On the economic side, there is need for effective financial markets that can accomplish the resource transfer, and agricultural owners of resources must also be willing to engage in such a transfer at an acceptable interest rate. On the political side, to the extent that these conditions have not been met and the state has stepped in to redistribute resources, this has led to conflict with agrarian interests. China’s current development model has short-circuited this transfer problem via FDI.

In addition to funding industrialization, FDI has also has provided a source of export earnings since a significant portion of MNC output in China has been exported. In 2003, MNCs provided 55 percent of total exports, and these exports earnings have provided foreign exchange and balance of payments cover that has ensured external

---

3 Classic examples of such conflicts are Stalin’s Russia in the 1930s and Peron’s Argentina in the 1950s.
This export production has been a core element of China’s export-led growth strategy. In the absence of a developed domestic consumer market, China has relied on foreign markets – especially the U.S. market – to provide demand for the goods produced by Chinese factories. At the official exchange rate exports constituted approximately 27.5% of China’s GDP in 2003. According to the World Bank, manufacturing represents approximately 44.5% of China’s GDP. Assuming all exports are manufactured and imported inputs represent one-third of the value of exports, this means exports represent 41% of China’s manufacturing output.

FDI has also provided advanced technology and capital to China, which combined with China’s low wage labor, has made China the low cost global manufacturing leader. With exports booming, foreign MNCs have been willing to continue building new plants in China. On the surface, this has given rise to the anomalous situation in which low income China has been a lender (in the form of its trade surplus) to the high income United States. Normally, it is expected that high-income households save and lend to low-income households. However, there is logic to this situation. Exports and a trade surplus (i.e. Chinese savings) are the price that China pays for getting foreign MNCs to invest in China. For the Chinese government this is a deal worth striking, since China gains productive capacity and high technology, and the foreign exchange from the trade surplus also provides protection against the vagaries of the international economy.5

---

4 MNC share of exports is from the Hong Kong Trade Development Council.
5 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, and demand is provided by export markets rather than domestic markets.
This external strategy has been complemented by an internal strategy predicated on state-directed domestic bank credit expansion, which has financed domestic expenditures in state owned enterprises (SOEs). The domestic banking system, which is state owned, has been used to fund large industrial and infrastructure investment projects as well as to maintain employment in loss-making SOEs. This has helped support domestic aggregate demand (AD) and also avoided a precipitous collapse of employment in the SOE sector, which is targeted for gradual extinction.

The fact that the state owns the banking system means that the state has been able to direct funds in these ways. Lack of alternative financial institutions and investments means that Chinese savers have effectively been forced to finance these state investment activities since savers have few alternatives in which to place their money. Finally, the interest cost of this internal strategy has been kept down via financial repression – that is keeping interest rates low by policy edict.

III The internal contradictions hypothesis

The above development model, with its internal and external strategy pillars, has worked remarkably well. However, recently doubts have been expressed about the long run viability of this strategy. In particular, there are fears that China’s growth rate has increased beyond what is sustainable, and is being driven by an asset price bubble and excessive state investment financed with domestic credit creation. In addition, China’s large current account (trade) and capital account (FDI) surpluses combined with its fixed exchange rate, have led to increased money supply growth (see table 1). This is because China’s central bank has had to provide liquidity in order to prevent the exchange rate from appreciating. As a result, monetary policy has been highly accommodative of the
investment boom. The danger is that this will generate even more investment, further
asset price increases and accelerating overall inflation, all of which will eventually come
to an end in an economic hard landing (Goldstein and Lardy, 2004).

This view of China’s situation can be labeled the internal contradictions hypothesis, and it sees China’s existing development strategy as running into trouble because of problems internal to the Chinese economy. This internal contradictions hypothesis can be understood with the help of Figure 2. The internal contradictions view focuses on problems in the banking system and corruption, and it also focuses on the domestic inflation consequences of an undervalued real exchange rate (Greenspan, 2003; Goldstein, 2004; Rajan and Subramanian, 2004).⁶

With regard to the banking system, the internal contradictions view focuses on problems associated with state direction of bank lending and reliance on non-market lending criteria. First, such lending is frequently associated with corruption, with lenders able to misappropriate funds as lending is not based on commercial criteria and there is limited obligation to repay. Second, the absence of commercial lending criteria results in misallocation of resources, with over-building in some sectors and under-building in others. When resources are allocated on market principles, they are directed to those sectors where there are shortages and returns are highest. When cronyism dominates the resource allocation process, there can be under-building in sectors with shortages and bottlenecks, and continued over-building in sectors with excess capacity. At the macroeconomic level, this means the Chinese economy may be simultaneously prone to

---

⁶ The article by Rajan and Subramanian (2004) is indicative of the International Monetary Fund’s (IMF) thinking on the China question. The IMF also 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.
both inflation and deflation – inflation in sectors with bottlenecks and deflation in sectors with excess capacity. Third, the non-commercial allocation of credit means that China’s banking system is full of non-performing loans (NPLs) and is insolvent. Many of the “so-called” investments financed by bank loans are unproductive, and in many cases loans have simply financed SOE operating expenditures that should have been covered by normal operating revenues.

The internal contradictions view also identifies inflation caused by an undervalued fixed exchange rate as a problem. This is classic open economy monetarism (Greenspan, 2003). Maintaining an undervalued exchange rate requires the monetary authority to sell local currency, which expands the domestic money supply leading to domestic inflation and economic distortions that go with higher inflation.\(^7\)

China’s policymakers have already accepted some of this argument, and have initiated policies aimed at slowing down the current expansion and reducing inflationary pressures. Thus, state and local governments have been instructed to cut back on infrastructure investments, banks have been ordered to curtail the expansion of lending, reserve requirements have been raised to drain liquidity from the banking system, and open market sterilization operations have also been used to reduce liquidity.\(^8\) In October 2004 the official interest rate was also raised a quarter point. Steps are also being taken to partially privatize the banking system by selling off minority stakes. This will raise

\(^7\) 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 in the agrarian sector. Inflation exacerbates these problems since the costs of inflation often hit the rural poor hardest. 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.

\(^8\) Open market sterilization operations have the central bank selling bonds, which drains deposits from the banking system. Such operations can offset expansions of the money supply resulting from defense of the undervalued exchange rate.
foreign exchange for the Chinese government, and it is hoped that the introduction of foreign owners will result in the adoption of new management practices that put banks on a commercial profit-oriented footing. However, no action has been taken regarding the under-valued exchange rate.

Proponents of the internal contradictions view maintain that these partial reforms are not enough to avoid a hard landing, and that more fundamental reforms are needed (Goldstein and Lardy, 2004). Administrative lending controls are unlikely to be adequate as companies turn to other unregulated sources of funding, and the central government also has difficulties controlling state government investment spending. Partial privatization of the banking system may also be insufficient to root out existing management and put an end to politically directed bank lending. Finally, failure to revalue the exchange rate means that there will be continued inflationary pressure from trade surplus and capital inflow induced increases in the money supply.

Fundamental contradictions or costly frictions?

There is considerable substance to the internal contradictions hypothesis. However, the key question is whether these problems constitute a “fundamental contradiction” within the Chinese development model or whether they are just “costly frictions.” Reflection upon these problems suggests that they are costly frictions rather than fundamental contradictions. That is they impose a large cost on the Chinese economy, and China would be better off if they were remedied. However, failure to do so will not force the economy into a hard landing.

The current misallocation of credit results in sub-optimal use of resources. However, as long as China maintains its existing capital controls, the system can
continue. This is because Chinese depositors have nowhere else to place their money, and this closed nature of the domestic financial system protects against bank runs. As long as the system remains closed, the NPL problem can be dealt with by periodic bank recapitalizations financed by the central bank – which is similar to the way the U.S. dealt with its saving and loan crisis through the Resolution Trust Corporation.

As currently configured, the financial system is stable even though it is inefficient. It only risks becoming unstable when capital controls are removed or when it is opened up to foreign competition. If capital controls are removed, Chinese depositors will be able to shift money outside the system. Given their existing limited international portfolio diversification, future political uncertainties regarding property rights in China, and the questionable status of China’s banking system, depositors would almost certainly rush for the exits and precipitate a financial crisis. Similarly, if foreign commercial banks are allowed to operate independently in China, there will likely be a move out of Chinese banks into foreign owned banks, and this would quickly expose the failings of domestic banks. These considerations suggest China should avoid opening its capital account, and they also suggest China will be reluctant to meet its WTO commitment to allow foreign financial competition.9

---

9 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 WTO illegal, 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.
Regarding the undervalued exchange rate and current account surplus, the internal contradictions view emphasizes the accelerating inflation danger of maintaining an undervalued fixed exchange rate. Such analysis represents a form of monetarist thinking. The argument is that China’s large international surpluses put upward pressure on the exchange rate that must be offset by central bank sales of domestic currency, which expands the money supply and causes inflation. This inflation channel does exist, but the link between money supply expansion and inflation is subject to long and uncertain lags. Moreover, inflation can be suppressed through such measures as increased reserve requirements on banks or sterilized open market operations in which the central bank sells bonds and drains excess money from the financial system. If inflation were the only problem associated with an under-valued exchange rate, it would be an irritation but not a fundamental systemic contradiction.  

**IV The external contradictions hypothesis: limits to export-led growth**

The previous section argued that the internal contradictions hypothesis does not stand up to scrutiny. While there are major internal inefficiencies in the current Chinese development model, these inefficiencies are costly frictions rather than contradictions. If nothing is done about them, Chinese economic welfare will be lower but they will not pull down the system. Indeed, if modestly faster inflation were the only cost to an undervalued exchange rate, then Chinese policymakers would be well advised to stick with an undervalued exchange rate because of the other benefits under-valuation yields.

---

10 Another argument put forward by internal contradictionists (Williamson, 2004) regarding why China should revalue and cease running massive trade surpluses is that these surpluses are invested in relatively low yielding U.S. treasury bills represents poor use of resources. The claim is that China would be better off by directing these resources toward internal consumption which would yield a higher welfare return given China’s low level of income.
This leads to the external contradictions story, which maintains that China’s current development model suffers from an external contradiction. In terms of Figure 2, the focus is the far right bottom box. The argument is that China’s existing strategy is fundamentally flawed owing to its reliance on export-led growth powered, principally, by the U.S. market.\textsuperscript{11} The reason for this contradiction is that China has become such a global manufacturing powerhouse that it is now driving the massive U.S. trade deficit as well as undermining the U.S. manufacturing sector. The trade deficit threatens to become a source of financial instability, while the problems of the manufacturing sector are preventing a robust investment-led recovery. Together they threaten to push the U.S. economy back into recession after a stultified recovery. If this happens it will have catastrophic consequences for the Chinese economy and the global economy since the U.S. economy has been the main engine of demand growth that has kept the world economy flying.\textsuperscript{12} Thus, the contradiction in the Chinese development model is that China’s success threatens to undermine the U.S. economy, which has provided the demand fuelling that success. China must therefore abandon its export-led growth strategy and adopt a new domestic demand-led growth strategy.

The underlying contradiction operates through the U.S. trade deficit. Fixing this deficit undoubtedly requires action by more countries than just China. But that said, China is the single largest contributor to the deficit, accounting for approximately 30 percent of the non-oil deficit. Moreover, its share is growing. In 2003 China ran a trade

\textsuperscript{11} Blecker (2000) and Palley (2003a) provide 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. \textsuperscript{12} Much is made of China as an engine of demand growth, particularly with regard to Japan’s economic recovery. However, China’s demand growth is derived from the prosperity generated in China by exporting to the U.S. economy. In this sense, the U.S. economy is the ultimate source of demand growth, and this demand growth is then multiplied in the global economy with China being an important contributor to the multiplier.
surplus with the U.S. of $124 billion, up from $104 billion in 2002. Furthermore, China’s trade surplus with the U.S. has continued to increase in 2004 when it is projected to reach $160 billion.\footnote{There is some controversy about China’s global trade surplus. The Chinese claim that in 2002 they ran a global trade surplus of $45.1 billion, and that this has changed to a deficit in 2004. However, there are good reasons to believe that this figure is understated. For instance, the Chinese report a trade surplus in 2003 with the U.S. of $60.3 billion, but U.S. customs data reports a goods trade deficit of $124.9 billion. The Fair Currency Alliance in Washington DC undertook a research exercise in which they totaled the bilateral trade balances reported by China’s forty three largest trade partners, and they came up with a cumulative Chinese trade surplus in 2002 of $189.9 billion. They also report a consistent pattern of under-reporting by China of its trade surplus over the last several years (see table 1). This data suggest that China is running a large global trade surplus, and it is running an especially large surplus with the United States.} In other words, China occupies a unique place in the conversation about the U.S. deficit, and the U.S. trade deficit cannot be fixed within without China’s cooperation.

Not only is China the single largest contributor to the U.S. trade deficit, other East Asian countries (Japan, South Korea and Taiwan) which are large contributors to the deficit are reluctant to take corrective action unless China does too. Their argument is that if they take action and China does not, they will lose competitive advantage and just transfer market share to Chinese exports with no benefit to the U.S. economy. For these reasons, it is legitimate to speak of the U.S. trade deficit problem as a “China problem” since it cannot be amicably fixed without China’s buy-in.

Given the above caveat about the need for coordinated action with other East Asian trade surplus countries, the logic of the external contradiction is as follows. China has become such a large exporter of manufactured goods to the U.S. that it is undermining the sustainability of the U.S. economic recovery. First, consumer spending on Chinese manufactured imports has drained aggregate demand from the domestic economy so that a significant part of monetary and fiscal stimulus and consumer borrowing has leaked out of the economy rather than creating domestic jobs. Second,
China’s exports have also undermined the profitability of U.S. domestic manufacturing, which has lowered domestic capital goods spending (Blecker, 2002). In addition, U.S. business has redirected enormous amounts of investment spending to China and this has further undermined U.S. domestic investment spending.\footnote{The arguments about consumer demand leakage and investment profitability apply to other East Asian countries running trade surpluses with the United States.}

These adverse features are reflected in the U.S. jobless economic recovery. Job creation after the mild recession of 2001 has been the weakest on record since World War II, and three years (October 2004) into recovery the economy is still short of over 500,000 jobs relative to the most recent employment peak. In the private sector the shortfall is worse, and the jobs deficit relative to the previous peak is over one million.

As of the moment, these problems have not derailed the U.S. economy owing to continued debt financed spending by U.S. households. China has therefore been able to continue to grow despite the weak U.S. recovery from recession. However, the U.S. trade deficit, the erosion of the U.S. manufacturing base, the increase in U.S. household indebtedness, and the weak jobs recovery are collectively undermining the structural strength of the U.S. economy. This situation is tantamount to a case of economic termites. Though the economy looks strong, there is reason to believe that it is increasingly fragile – akin to a “Wiley Coyote” economy running on thinner and thinner air. The recovery has been financed by asset price appreciation, especially in real estate, which has supported increased borrowing that has funded consumer spending. Owing to the trade deficit, this spending has not generated a robust jobs recovery and the income to pay back these borrowings, yet indebtedness has increased. There is now a danger that the U.S. economy could stall, and the over-hang of consumer debt could then drive the economy into
recession. With private sector balance sheets strained by debt taken on at today’s low interest rates and not open to refinancing, the U.S. would not have recourse to another recovery driven by consumer borrowing. Instead, debt burdens will deepen a slump. If asset prices fall, the downturn could be amplified by household wealth erosion and the creation of negative homeowner equity that causes the housing market to seize up.

This is a difficult scenario for Chinese policymakers to grasp since the damage to China is indirect, operating via recession in the United States. China’s trade surplus has been viewed as a sign of success and as critical to the Chinese development model. Now, Chinese policymakers must change their thinking and recognize that the trade surplus has become a fatal flaw in the Chinese model. If the U.S. has a consumer-driven recession (as against a capital goods driven recession), China risks catching economic pneumonia. Moreover, with much of the global economy also relying on the U.S. market, a U.S. recession will injure the global economy which will further hurt China by lowering global demand for Chinese exports.

Finally, China’s export-led growth model is not just a problem for the United States. It is also a problem for other developing countries that compete with China in world markets. Moreover, this is likely to worsen with the ending of the multi-fiber agreement (MFA) governing textile trade.\textsuperscript{15} With the end of the MFA, China stands to increase its share of global exports at the expense of other developing countries, creating balance of payments problems for these countries.

China also poses an increasing problem for the European economy. First, Europe has a large textile industry that stands to be adversely impacted by the end of the MFA. Second, Europe is being adversely impacted by the appreciation of the euro against the

\textsuperscript{15} The MFA is scheduled to end on 1 January 2005.
dollar since the renminbi is pegged to the dollar, which implies an appreciation of the euro against the renminbi. Vis-a-vis China, Europe gained when the euro was weak: it loses when the euro is strong.

The bottom line is that China has become a global manufacturing powerhouse on the back of its FDI export-led growth development model, and its manufacturing size is now exerting huge strains on the entire global economy. China has been free-riding on the global aggregate demand. The strategy worked when China was small: it cannot work now that China is so large. In effect, China’s free-riding has now become an international public bad, and if global demand growth slows the consequences could be ominous. China’s policymakers must recognize the necessity of adjusting their development model. However, it is difficult to persuade policymakers that adjustment is needed since China’s model works as long as the U.S. plays the role of buyer of last resort and accepts body blows to its manufacturing base. The piper will only have to be paid when this role is exhausted.

IV Beyond export-led growth: developing the demand side of the Chinese economy

The solution to the contradictions posed by China’s emergence as a global export powerhouse is to build a robust internal Chinese market that supports domestic demand-led growth. This requires developing structures, institutions, and economic relations that generate sustained stable internal demand growth. This is an enormous task and one that

---

16 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 U.S.). However, the government does not yet appear to have considered the economic dangers resulting from limits to export-led growth.

17 This raises the question of whether China and other trade surplus countries can keep funding the U.S. consumer indefinitely. The answer is no. This is because the funding is delivered via U.S. banks, and U.S. banks will only make loans to U.S. 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.
is completely unrecognized in conventional development economics, which focuses exclusively on the supply-side of the economy. Developing the demand side of an economy is key to moving from developing to developed country status, yet it is a task that has received negligible attention.\(^\text{18}\)

Moving from the current model to the new model requires a short- and long-term strategy. The short-term strategy must address the fact that China is exerting destabilizing deflationary pressures on the global economy, that if not corrected will plunge the global economy into recession. The long-term strategy must wean China from export-led growth to domestic demand-led growth. This two-part adjustment strategy is shown in figure 3.

*Short term strategy: coordinated East Asian currency revaluation*

In the immediate short-term China must significantly revalue its exchange rate against the U.S. dollar by between 15 and 40 percent.\(^\text{19}\) This appreciation should be conducted as part of a broader coordinated move that has the exchange rates of other trade surplus East Asian economies (Japan, South Korea, Taiwan, Singapore, and Malaysia) also adjusting upward. Coordination is essential since all are contributing to the problem, and adjustment by just one country alone will cause it to lose competitiveness and suffer economic injury without fully correcting the problem. This is because its exports would tend to migrate to those countries that retained under-valued exchange rates so that the U.S. trade deficit would be only modestly improved.

Coordination is therefore essential for a rapid effective correction of the U.S. trade deficit.

---

\(^{18}\) Palley (2002) 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.”

\(^{19}\) The 15 – 40 percent range is based on the broadly held consensus that the renminbi is undervalued against the dollar by some amount in this range (Fair Currency Alliance, brief No. 2, June 2004).
deficit, which is the immediate threat to the U.S. and global economy. That said, China should lead this coordinated adjustment as it has by far the largest trade surplus with the U.S., and that surplus is growing rapidly. Once China has signaled its acceptance of currency adjustment, others will do so voluntarily or can be easily persuaded to do so.

Exchange rate revaluation will impose costs on China, which will experience a decline in U.S. demand for its exports. This decline will reduce demand for Chinese production and could slow growth. Why then should China make such an adjustment? The reason is that failure to do so risks a deep U.S. economic contraction that will seriously harm China, and it is better to take less costly pre-emptive action. Moreover, this is a propitious time to make such an adjustment, and it will also yield several benefits for China. With regard to timing, China has a large balance of payments surplus with the U.S. and the global economy. This means that it can accommodate a revaluation that appreciates the real exchange rate without being plunged into a balance of payments crisis. Second, revaluation can help China address the current threat of exchange rate induced accelerating inflation which poses both economic and political threats. Third, revaluation will improve China’s terms of trade, making imports cheaper. This will benefit the average Chinese consumer. It will also lower the cost of imported inputs, partially offsetting the adverse competitive impact that revaluation has on Chinese export and import-competing industries.

In addition to revaluing East Asia’s currencies, there is need for a new managed global exchange rate system analogous to Bretton Woods. Simply revaluing currencies will not bring about the changes in business behavior needed to put the U.S. economy

---

20 Inflation is a political threat because it risks creating discontent among groups, especially the peasant class, that are disproportionately adversely impacted by inflation.
back on a robust path of sustained growth. If business is to retain plants in the U.S. and again invest in U.S. manufacturing, businessmen need to have confidence that the new exchange rates will hold for a significant period of time. If they feel that the revaluation will reverse in the near future they will not alter their business plans. Investment and production will therefore not return the U.S., and the recovery will remain fragile. On this score, U.S. policymakers deserve criticism for failing to recognize this problem. In a knee-jerk reaction to earlier problems with fixed exchange rates in the 1990s, they are now pushing floating rates for all. This is inappropriate policy for a world integrated by trade and financial capital flow, and in which production and investment are highly mobile.²¹

**Long term strategy: domestic demand-led growth**

With regard to long-term strategy, there is need for a dramatic recalibration of China’s development policy. Economic theory and policy has traditionally focused on expansion of the supply-side. This is the focus of the export-led growth paradigm that has countries focus on becoming internationally competitive producers. In the new paradigm, export markets, which are outside the control of developing country policymakers, provide demand and absorb increases in production. China has followed this paradigm for the last fifteen years, growing its supply-side through FDI and relying on export markets to provide demand. Now, China must start to develop its demand side capacity. This is a difficult challenge, and one that economics has traditionally said little about. Yet, successfully developing the demand side is the distinguishing hallmark between developed and developing countries.

²¹ There are many proposals for how a new Bretton Woods coordinated exchange rate system could work. These include Bergsten et al. (1999), Blecker (1999), Grieve-Smith (1999), Williamson (1999), Weller and Singleton (2002), and Palley (2003b).
The main body of development economics essentially ignores the demand-side owing to its domination by classical general equilibrium economics that emphasizes Say’s law – the claim that supply creates its own demand. The implication is that policymakers need only focus on the supply-side, and demand will automatically be forthcoming. As a result, little attention has been devoted to the challenge of developing the demand side.

Keynesian economics emphasizes demand considerations, but it operates in the context of mature market economies in which the process of demand generation is established. For Keynesians, shortages of demand can be remedied by government policies (lower interest rates and taxes) that stimulate private sector demand or by direct government spending. However, these policies only ameliorate temporary failures in the demand generation process. In developing countries the challenge is to build the demand generation process. Application of Keynesian policies to stimulate private sector demand in developing countries tends to contribute to excessive government deficits and promote an excessively large government sector. Increased government spending adds to demand but it increases deficits, and it tends not to contribute much to the generation of “market” incomes that are the basis of a sustainable demand growth generation process.

China’s challenge is to develop sustainable sources of growing non-inflationary domestic purchasing power. This means attending to both the investment allocation process and the income allocation process. The former is critical to ensure that resources are efficiently allocated, earn an adequate rate of return and add to needed productive capacity. The latter is critical to ensure that domestic demand is forthcoming to absorb increased output. Income must be placed in the hands of Chinese consumers if robust
consumer markets are to develop. The challenge is to deliver this income in an efficient equitable manner that maintains economic incentives and is also consistent with aggregate production so as to avoid inflation.

Reforming the investment allocation process

Chinese investment spending relies significantly on FDI and public investment funded through the government owned banking system. This reliance on public direction of the banking system has proven inefficient, and it is ultimately unsustainable. With capital widely allocated on the basis of non-market criteria, investments are frequently unable to generate adequate market returns so that China’s banks are beset by massive non-performing loans. From a macroeconomic standpoint, the failure to use market signals means that investment fails to remedy bottlenecks and can aggravate problems of surplus capacity. This is because politically favored sectors continue to receive investment funds even if they have surplus capacity, while out of favor sectors are denied funds even if they have bottlenecks. This misallocation means that inflation and deflation can coexist, with bottleneck sectors experiencing inflation while those with over-investment experience deflation.

Reform of the banking system is critical to improving China’s capital allocation process, and it is also necessary to create efficient consumer credit and mortgage markets that can support demand generation in the household sector. If successful, banking sector reform will raise productivity and output growth by improving the investment allocation process. At the same time, by strengthening consumption and housing demand, it will stimulate new investment spending to provide for those increased demand.
Privatization of China’s banking system is key to reform, and some privatization is already underway. The Chinese model is one of partial privatization – selling off minority ownership stakes. The hope is to inject private sector management techniques into the banking system, thereby transforming it so that loans are made on the basis of borrower credit-worthiness. Selling off of state-owned banks will also raise considerable sums for the Chinese state, while retaining a majority stake means that the Chinese government will also benefit from improvements in bank profitability.

However, there are also risks with this strategy. First, foreign investors may be blocked from making needed reforms to lending and organizational practice because they are minority shareholders. Second, reform of the banking system will necessitate reform of government finances. This is because the banking system is currently used to dole out subsidies to failing SEOs and to direct capital to politically favored clients. If the banking system is made to operate according to commercial lending practices, such subsidies will no longer be available. Government can still use the banking system, but only as a payments system for making disbursements and collecting taxes. If China is unable to reform its public finances, this will likely sabotage banking sector reform. This points to a significant time consistency dangers problem in the current reform process. Having sold minority stakes in the banking system, Chinese policymakers may be unwilling to follow through and adopt real reform of banking practices.

Lastly, as China modernizes its banking and financial system it must simultaneously develop a framework for conducting effective financial policy. If financial markets are to contribute fully to the demand generation process they must be stable, free of corruption, and deserving of investors’ confidence. They should also
facilitate government counter-cyclical economic stabilization policy. China must therefore develop (i) deep bond markets that allow for open market monetary operations that control short-term interest rates, (ii) transparent and fair central bank discount window policy, (iii) transparent and effective accounting requirements and prudential regulation, and (iv) policy instruments of quantitative control – such as margin requirements, reserve requirements on capital inflows, and asset based reserved requirements – that can help mitigate pro-cyclical tendencies in financial markets.\textsuperscript{22}

*Income distribution: free trade unions and minimum wages*

Banking and financial market reform is a needed component of a domestic demand-led growth strategy. However, a greater challenge is developing an appropriate system of household income distribution that can support domestic consumer markets. Investment spending is an important source of demand, but the output generated by investments must find buyers or investment will cease. Likewise, public sector investment can be an important source of demand, but private sector output and income must grow overtime or else the government sector will come to dominate with likely negative consequences.

With a population of 1.3 billion people China has an enormous potential domestic market. The challenge is to distribute income in a decentralized equitable fashion that leaves work and production incentives intact. The conventional view is that markets automatically take care of the problem by paying workers what they are worth and that all income is spent thereby generating the demand for output produced. In effect, the

\textsuperscript{22} The case for asset based reserve requirements is outlined in Palley (2004). Such a system can be contrasted with the current system which is liability based.
problem is assumed away. Indeed, to intervene and raise wages to increase demand would be to cause unemployment by making labor too expensive.

This conventional logic contrasts with Keynesian economics, which identifies the economic problem as one of ensuring a level of aggregate demand consistent with full capacity utilization. Moreover, the level of aggregate demand is affected by the distribution of income, with worsened income distribution lowering aggregate demand because of the higher propensity to save among higher income households. From a Keynesian perspective, market forces do not automatically generate an appropriate level of AD. Demand can be too low because of lack of confidence among economic agents that lowers investment and consumption spending. It can also be too low because the distribution of income is skewed excessively toward upper income groups.23

The importance of income distribution for aggregate demand and full employment means that labor markets are of critical significance. Labor markets determine wages, and wages impact income distribution and AD. From a Keynesian perspective, the problem is that bargaining power can be highly skewed leading to wages that are too low. This problem is particularly acute in developing countries. Trade unions are a vital economic mechanism for rectifying imbalances of bargaining power and they can therefore help achieve an appropriate distribution of income. Far from being a market distortion as described in neo-classical economics, trade unions may correct market failure associated with imbalanced bargaining power.

Viewed in this light, trade unions are the market friendly approach to correcting labor market failure. This is because unions set wages in a decentralized fashion. Though

23 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.
wages are set by collective bargaining, wages can differ across firms with unions in stronger more efficient firms bargaining higher wages than those at weaker less efficient firms. This contrasts with a government fiat approach to wage setting.

A key priority for China should therefore be to develop a system of democratic trade unions that bargain wages. Just as China is reforming its corporate governance and financial system, so too it must embrace labor market reform centered on democratic trade unions because this is the market centered way of establishing an income distribution that can support a consumer society. Outside of Western Europe, only the U.S., Canada, Japan, South Korea, Australia and New Zealand have successfully made the transformation to fully developed market economy status. In all cases this transformation coincided with the development of effective domestic trade unions.

The encouragement of free trade unions should also be supported by effectively enforced minimum wage legislation. Just as trade unions have helped developed countries make the move to demand-led growth, so too have minimum wages. China is a continental economy in which regions differ dramatically by level of development. This suggests the need for a more refined system of minimum wages in which minimum wages are set on a regional basis and take account regional differences in living costs. Overtime, as development spreads and backward regions catch up, these settings can be periodically adjusted with the ultimate goal being a uniform national minimum wage.

Can China afford higher wage costs?

Finally, there is the issue of costs. As long as China follows an export-led growth strategy, production costs will be paramount. The dynamic of export-led growth, with its focus on international markets, forces countries to try and ever lower costs to gain
international competitive advantage. This makes for systemic downward pressure on wages, and these pressures are needed to keep export-led growth viable.

A domestic demand-led growth paradigm removes this pressure. Now, higher wages become a source of demand and therefore strengthen the viability of employment. Capital must still earn an adequate return to pay for itself and entice new investment, but moderately higher wages now strengthen the system rather than undercutting it.

V Summation

China’s current development model faces an external constraint that promises to cause a hard landing in China and the global economy. China has become a manufacturer of global scale, rendering its export-led growth strategy no longer sustainable. China relies on the U.S. market, but the scale of its exports is undermining U.S. manufacturing and risks tipping the U.S. economy back into recession, which would then trigger a Chinese and global recession. This is the external constraint.

China must shift from export-led growth to domestic demand-led growth. This requires a focus on growing the demand side of the economy, not just the supply-side. In the immediate short-term it must significantly revalue its currency to avoid stalling the U.S. economic recovery. Longer term, China must move to raise wages and improve income distribution. In an export-led growth system, higher wages undermine growth. In a domestic demand-led growth system, they support it. The challenge is to raise wages in an efficient decentralized manner, which calls for developing independent democratic trade. However, independent unions are unacceptable to the current Chinese political leadership. Solving China’s external economic contradiction therefore requires solving this political roadblock.
References


---------------, “Export-led Growth: Is There Any Evidence of Crowding-Out?,’ in Arestis


Figure 1. Overview of the Chinese development strategy.
China’s Economic Development Strategy

Internal weaknesses

Banking system – politicized lending.

Corruption

External weaknesses

Exchange rate based inflation

Export-led growth & global deflation

Figure 2. Weaknesses in the existing Chinese economic development model.
Figure 3. Domestic demand-led growth strategy.
<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Real GDP growth (%)</strong></td>
<td>7.1</td>
<td>8.0</td>
<td>7.5</td>
<td>8.0</td>
<td>9.1</td>
</tr>
<tr>
<td><strong>FDI – utilized ($ billions)</strong></td>
<td>40.3</td>
<td>40.7</td>
<td>46.9</td>
<td>52.7</td>
<td>53.5</td>
</tr>
<tr>
<td><strong>China’s exports ($ billions) – Chinese data</strong></td>
<td>194.9</td>
<td>249.2</td>
<td>266.2</td>
<td>325.6</td>
<td>438.4</td>
</tr>
<tr>
<td><strong>% change in China’s exports</strong></td>
<td>6.1</td>
<td>27.8</td>
<td>6.8</td>
<td>22.3</td>
<td>34.6</td>
</tr>
<tr>
<td><strong>China’s trade surplus with the U.S.:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- <strong>Chinese data ($ billions)</strong></td>
<td>23.5</td>
<td>30.9</td>
<td>29.4</td>
<td>44.1</td>
<td>60.3</td>
</tr>
<tr>
<td>- <strong>U.S. data ($ billions)</strong></td>
<td>68.9</td>
<td>84.2</td>
<td>84.1</td>
<td>104.2</td>
<td>124.9</td>
</tr>
<tr>
<td><strong>China’s global trade surplus:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- <strong>Chinese data ($ billions)</strong></td>
<td>37.7</td>
<td>35.4</td>
<td>35.3</td>
<td>45.1</td>
<td></td>
</tr>
<tr>
<td>- <strong>43 partner data ($ billions)</strong></td>
<td>140.4</td>
<td>171.6</td>
<td>170.3</td>
<td>189.9</td>
<td></td>
</tr>
<tr>
<td><strong>FX Reserves ($ billions)</strong></td>
<td>154.7</td>
<td>165.6</td>
<td>212.2</td>
<td>286.4</td>
<td>403.3</td>
</tr>
<tr>
<td><strong>% Money supply (M2) growth</strong></td>
<td>14.7</td>
<td>12.3</td>
<td>14.4</td>
<td>16.8</td>
<td>19.6</td>
</tr>
</tbody>
</table>