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China, the Global Economy, and the Contradictions of Export-led Growth

Abstract

China has become a global manufacturing powerhouse, and its size means that its export-led manufacturing growth strategy is exerting pressures could trigger a global recession that will embrace China. At this stage, China should transition from export-led growth to domestic demand-led growth. This will require raising wages and improving 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 unacceptable to China's current political leadership. Creating a domestic demand-led growth regime therefore requires solving this political roadblock.

Keywords: Export-led growth, domestic demand-led growth

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Thomas I. Palley
Principal
Economics for Democratic and Open Societies
Washington, DC 20010
www.thomaspalley.com

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I The debate over China's development strategy

Over the last twenty years China has undergone an economic development miracle. However, a debate has now opened regarding the sustainability of the Chinese model. Ironically, this debate has been triggered by recent acceleration in China's growth, which exceeded 9 percent in 2003 and 2004. The fear is that this acceleration is being driven by a private investment bubble and by misdirected state investment, which risks rising inflation and a hard landing when the bubble pops.

This paper offers an alternative interpretation of China's development model that also argues that China's model is unsustainable. However, it is not over-investment and excessive growth that are the reasons. Instead, it is China's "external" impact on the global economy, which threatens to contribute to triggering a world recession that will rebound and embrace China. This alternative view is rooted in global Keynesianism and emphasizes the deflationary consequences of China's export-led development model.

II A brief review of China's development model

Broadly speaking, China's development model aims to reduce the size of the centrally planned economy and increase the size of 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 more widely by removal of controls on economic activity, and it is also being spread (in limited fashion) by partial privatization of state owned enterprises (SOEs).

This spread of market-centered activity has been accompanied by an external and internal capital accumulation strategy. The external strategy rests on foreign direct

investment (FDI) and export-led growth. The internal strategy uses state-controlled bank credit creation to fund SOEs and infrastructure investment.

FDI has served a number of functions. First, it has brought capital goods and high technology into the country, and the inflow has been financed by foreign multinational companies (MNCs). The scale of FDI is reflected in the fact that China was the world's largest recipient of FDI in 2002. China is currently the third largest cumulative recipient of FDI, and at current rates of inflow it will soon be the second largest.

A second benefit is that 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 foreign exchange shortage problem. Industrialization calls for importing capital goods from developed economies. Historically, this has imposed a balance of payments constraint on growth. It has also led to the accumulation of foreign currency denominated debts that have exposed countries to financial fragility as the real value of debts can change rapidly due to exchange rate fluctuations. China's FDI-based development model short-circuits this foreign financing problem.

Third, FDI has provided a source of export earnings since a significant portion of MNC output in China is exported. In 2004, MNCs provided 57 percent of total exports, and these exports earnings have provided foreign exchange and balance of payments cover that has ensured external investor confidence.[1] 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.

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[1] Hong Kong Trade Development Council, www.tdctrade.com/main/china.htm.

Combining China's low wage labor with FDI-provided advanced technology and capital, 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, high technology, and jobs. It also gains foreign exchange from the trade surplus, which provides protection against the vagaries of the international economy.[2]

The bottom line is that though FDI is small relative to total Chinese fixed asset accumulation, it occupies a special position in the Chinese development model.[3] Much Chinese capital accumulation is public infrastructure capital that yields social returns. FDI yields market returns, transfers technological know-how, and generates export earnings. Moreover, this is done without recourse to foreign borrowing.

The above external accumulation strategy has been complemented by an internal strategy predicated on state-directed bank credit expansion, which finances domestic

[2] 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.

[3] 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 FDI was 8.6% of total, fixed asset accumulation. Data are from the Hong Kong Trade & Development Council, www.tdctrade.com/main/china.htm.

expenditures in SOEs. The state owned banking system 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 aggregate demand (AD) and also avoided a precipitous collapse of employment in the SOE sector.

The fact that the state owns the banking system means that the state has been able to direct funds in these ways. Chinese savers have effectively been forced to finance these state investments owing to lack of alternative places to invest their money. Finally, the interest cost of this internal accumulation strategy has been kept down via financial repression – that is keeping interest rates low by policy edict.

III External contradictions: limits to export-led growth

Though highly successful to date, China's development strategy is ultimately fundamentally flawed owing to its reliance on export-led manufacturing growth, powered principally by the U.S. market.[4] 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 and undermining the U.S. manufacturing sector. This threatens the economic health of its major customer. In addition, China is also putting pressure on the European Union's manufacturing sector, slowing economic growth in that region.

China's trade surpluses threaten to become a source of financial instability. The U.S. trade deficit has undermined manufacturing and hampered the emergence of a robust investment-led U.S. recovery by. This is because the deficit has drained spending out of

[4] 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 Blecker, R.A., *The diminishing Returns to Export-Led Growth*, paper prepared for the Council of Foreign Relations Working Group on Development, New York, 2000 and Palley, T.I., Export-led Growth: Is There Any Evidence of Crowding-Out?, in Arestis et al. (eds.), *Globalization, Regionalism, and Economic Activity*, Cheltenham: Edward Elgar, 2003.

the U.S. economy. Additionally, China's under-valued currency has made production in China cheaper, encouraging firms to both shift existing facilities and build new facilities in China.

These impacts risk a premature end to what has already been a weak U.S. expansion. If this happens, there will be significant adverse consequences for the Chinese economy and the global economy since the U.S. economy is the main engine of demand growth that has been keeping the world economy flying.[5]

The contradiction in the Chinese model is that China's success threatens to undermine the U.S. economy, which has provided the demand fuelling that success. It is for this reason that China needs to replace its export-led growth strategy with a domestic demand-led growth strategy.

It is also the case that fixing the U.S. trade deficit will require action by other countries.[6] That said, China is the single largest contributor to the deficit, accounting for approximately 30 percent of the non-oil (non-OPEC) deficit. Moreover, its share is growing. The implication is that the U.S. trade deficit cannot be fixed without China's cooperation.

The key to remedying the deficit is a depreciation of the dollar against the Chinese renminbi and the currencies of Japan, South Korea and Taiwan. However, there

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[5] 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 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 participant in the multiplier process.

[6] The U.S. trade deficit debate evokes competing theoretical explanations that cannot be tackled in the current essay. Essentially, there are two positions. One position is that the deficit is due to inadequate U.S. 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 U.S. 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 U.S. but total spending will remain unchanged. This essay implicitly adopts the second position.

is a first mover problem. If these other countries revalue their currencies upward but China does not, they will lose competitive advantage and just transfer market share to Chinese exports with no benefit to the U.S. economy. To a lesser degree, if China revalues and they do not there could be a similar market share transfer effect. This points to the need for a coordinated East Asian currency adjustment. However, as the largest contributor to the U.S. deficit and the regional low cost producer, China must play the lead role in this adjustment.

For the moment, China's adverse impact has not derailed the U.S. economy owing to continued debt-financed spending by U.S. households. China has therefore continued to grow despite the weak U.S. recovery from recession. But there are reasons to believe the U.S. economy 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 real estate, which has collateralized the borrowing that has funded consumer spending. This means the U.S. economy is increasingly burdened by debt which could soon drive the economy into recession. Once in recession, with private sector balance sheets clogged with debt taken on at current low interest rates and not open to refinancing, the U.S. would not have recourse to another recovery based on consumer borrowing and housing price inflation.

This is a difficult scenario for Chinese policymakers to grasp since the damage to China is indirect, operating via recession in the United States. Having become a global manufacturing powerhouse, China's export-led manufacturing growth model is exerting huge strains on the global economy owing to the size of its manufacturing sector. Until now China has been able to free-ride on global aggregate demand. The strategy worked

when Chinese manufacturing was small, but it cannot continue working now that it is so large. The difficulty is to persuade China's policymakers of the need for change before a crash and while the model still seems to work.

IV Developing the demand side of the Chinese economy

In place of export-led growth, China must adopt a model of domestic demand-led growth. Such a model requires developing structures, institutions, and economic relations that generate sustained stable internal demand growth. This is an enormous task and one that is 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 becoming a developed country status, yet it is a task that has received negligible attention.[7]

Economic theory and policy has traditionally focused on expansion of the supply-side. This is the focus of the export-led growth paradigm, which emphasizes becoming internationally competitive and relying on export markets to provide demand and absorb increases in production. The demand-side is generally ignored in the main body of development economics because economists assume that supply generates its own demand – a proposition that is known as "Say's law." Consequently, little attention has been devoted to the challenge of developing the demand side. Yet, that is precisely the distinguishing hallmark between developed and developing countries.

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[7] Elsewhere I have explored 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." Palley, T.I., A New Development Paradigm: Domestic Demand-Led Growth, *Foreign Policy in Focus*, September 2002, http://www.fpif.org/. Also published in *After Neo-liberalism: Economic Policies That Work for the Poor*, in Jacobs, Weaver and Baker (eds.), New Rules for Global Finance, Washington, DC, 2002.

Keynesian economics does emphasize demand considerations, but it operates in the context of mature market economies in which the process of demand generation is established. For Keynesians, demand shortages can be remedied by policies that stimulate private sector demand (e.g. lower interest rates and taxes) or by direct government spending. However, these policies ameliorate temporary failures in an established demand generation process. In developing countries the problem is different: they need to build the demand generation process.

Application of Keynesian policies in developing countries tends to create excessive government deficits and promote an excessively large government sector. Increased government spending adds to demand but it increases deficits, and it also does little to generate "market" incomes that are the basis of a sustainable demand growth generation process.

Turning to China, the challenge is to develop sustainable growing sources of 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. But this income must be delivered in an efficient equitable manner that maintains economic incentives, while being consistent with aggregate income so as to avoid inflation.

With regard to investment, China relies on a combination of FDI and public investment funded through the government owned banking system. This reliance on

public direction of the banking system has proven inefficient. Capital is widely allocated on the basis of non-market criteria, so that investments frequently fail to generate adequate returns. Hence, China's massive non-performing bank loans. The failure to use market signals means that investment fails to remedy bottlenecks and can aggravate problems of surplus capacity. 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 sectors with over-investment experience deflation.

Banking reform is critical to improving China's capital allocation process. It is also necessary to create efficient credit and mortgage markets that can support consumer demand. Successful banking reform will raise productivity and output growth by improving the investment allocation process, and it will strengthen consumption and housing demand.

Privatization of China's banks is key to reform. This can inject private sector management techniques into the banking system, thereby transforming it so that loans are made on the basis of borrower credit-worthiness. Privatization is probably the only way to end political abuse of the banking system that results in doling out of subsidies to failing SEOs and making loans to politically favored clients.

However, the greater challenge is developing an appropriate system of household income distribution that supports 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 income must grow overtime or else the government sector will come to dominate with 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 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 (AD) 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.[8]

The importance of income distribution for demand means that labor markets are of critical significance. Labor markets determine wages, and wages impact income distribution. 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

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[8] For neo-classical economists, 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.

unions are a vital mechanism for rectifying imbalances of bargaining power and achieving an appropriate distribution of income. In another paper, I have presented evidence showing that improved freedom of association in labor markets is associated with improved income distribution and higher wages.[9]

Rather than being a market distortion as described in conventional 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 because unions set wages in a decentralized fashion. Though wages are set by collective bargaining, wages can differ across firms with unions in more efficient firms bargaining higher wages than those at less efficient firms. This contrasts with a government edict approach to wage setting.

This suggests that a key priority for China is to develop democratic trade unions that freely bargain wages. Just as China is reforming its corporate governance and financial system, so too it must embrace labor market reform and allow free democratic trade unions. 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 mature developed market economies. In all cases this transformation coincided with the development of effective domestic trade unions.

Free trade unions should also be supported by effectively enforced minimum wage legislation that can also help demand-led growth. China is a continental economy in which regions differ dramatically by level of development. This suggests the need for a

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[9] See Palley, T.I., Labor Standards, Democracy and Wages: Some Cross-country Evidence," *Journal of International Development*, 17 (2005), p.1 – 16.

system in which minimum wages are set on a regional basis and take account of regional differences in living costs. Overtime, as development spreads and backward regions catch up, these settings can be adjusted with the ultimate goal being a uniform national minimum wage.

Lastly, these wage-targeted labor market reforms should be paired with the development of a social safety net that provides insurance to households. This will increase households' sense of confidence and security, thereby diminishing the need for precautionary saving and enabling households to spend more on consumption.

V Can China afford higher wages?

The above reforms raise the issue of wage costs. As long as China follows an export-led growth strategy, production costs will be paramount. This is because export-led growth forces countries to try and ever lower costs to gain international competitive advantage, thereby creating systemic downward pressure on wages.

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

Independent democratic trade unions are key to a demand-led growth model, as they are the efficient decentralized way of raising wages. However, independent unions are unacceptable to the current Chinese political leadership. That means China must also solve this political problem as part of moving to domestic demand-led growth regime.