How the Chinese Economy Works (For Now)

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The Chinese economy is a source of wonder and fascination in the West, as well it might be. According to the World Bank, the People's Republic clocked a cool 9.1% growth in 2011, while the United States languished at 1.7%. While the Chinese central bank is sitting on $3.24tn of reserves, the United States federal government is the most heavily-indebted entity in the history of humanity, with nearly $16tn in liabilities.[1] While the absolute figures are smaller, the debt problem in Europe is so acute that it may yet rip the Eurozone apart, and it will almost definitely be a drag on growth for a decade or more.[2] Increasingly, bewildered politicians in Europe are lashing out at each other, with few seeming to appreciate the magnitude of the debt problem and even fewer willing to level with the public about what it means.

China, by contrast, seems like a land of opportunity. Since China joined the World Trade Organization in 2001, the country's coastal provinces have been transformed in a short period of time into the world's workshop. Cities such as Shenzhen, Guangzhou and Chongqing may not yet be global household names in the same way London, Paris and New York City are, but their impact on the world economy in recent years has been profound.

Although there is an extensive academic literature questioning this view, the Chinese economic miracle has widely been interpreted in the West, especially in the middle-brow press, as heralding the emergence of a new international order in which the United States will be much diminished and China increasingly dominant.[3] One hugely popular book on the subject is entitled *When China Rules the World*.[4] It is hardly surprising that anxiety on this score has increased dramatically since the onset of the 2008 financial crisis. Much Western commentary on the subject takes China's future success as a given and focuses on the qualities that apparently make China "different" – thus, there is much talk of its "ancient civilization", its remarkable unity and homogeneity despite its stupendous size, and its strong sense of national pride.[5]

All of these things are worthy of comment – but they do not tell us the entire story about modern China, nor will they allow us to accurately predict its future. China has made great achievements not only in headline figures of economic growth but also in enriching the lives of its citizens. For instance, the proportion of people in the country living in extreme poverty fell from 60% in 1990 to 13% in 2008.[6] But there is too much of a tendency in Western commentary to view the country as a monolith, and pretend that there are only winners and no losers in modern China. This is not the case.[7]

At the time of this writing, a violent environmental protest has just come to an end in Qidong, a town close to Shanghai in China's economic heartland. The protest centred on plans to pump pollutants from a foreign-owned factory into the nearby sea, which residents feared would harm local fisheries. Remarkable pictures taken by *Reuters* show policemen being assaulted and a local government building being ransacked – all despite protesters being warned by the city's vice-mayor that they faced severe punishment.[8] Nor are such incidents now particularly rare – according to a Chinese professor, there were 180,000 large-scale protests in 2010.[9] Even official estimates are in the tens of thousands.[10]

Protests against corrupt local officials or abusive business practices only tell part of the story about the winners and losers in modern China. An even more fundamental part of the story is to analyse how the Chinese economy works, and who it benefits. China's economic miracle has been achieved not only through the blood, sweat and tears of its over-burdened workers, but also through a very deliberate economic policy which benefits some groups within China while disadvantaging others. It is important to understand this, not necessarily as a basis for criticizing the morality of China's political economy, but also to delve below the mystique of its economic miracle to see how it really works, and what problems it might encounter in the future.

China's wealth creation in recent years has come primarily from two, inter-related sources: domestic investment and an export-oriented manufacturing sector. This is in contrast to most advanced industrial countries, where household consumption (frequently, in recent years, debt-driven) is the main driver of the economy. There is a tendency in the West to view China's newfound dominance of global manufacturing as marking a profound and permanent shift in the global economy, as if the Chinese Communist Party has discovered the key to perpetual prosperity. Rarely is the policy by which this growth has been achieved dissected.[11]

At the heart of the Chinese economy are a set of financial and economic policies that encourage resources to flow into the manufacturing and construction sectors at the expense of the services sector and, even more crucially, households. Firstly, household savers are forced to accept negative real interest rates – meaning money they put in the bank loses value over time – while banks have a guaranteed profit margin due to a state-mandated difference between the interest rate paid to account-holders and the interest rate paid on loans made by the banks to businesses.

Money taken from household savers hence effectively subsidizes banks and businesses, and especially the manufacturing sector. Because the banks are kept on a tight leash by the state, political favourites inevitably benefit from loans. The result of this wealth transfer has been that as China's per capita GDP has increased, the amount of money households spend on personal consumption has actually declined as a percentage of GDP. Meanwhile, households have increasingly shied away from accepting negative real interest rates in banks and instead speculated on the property market, fuelling a real estate bubble which will inevitably burst.

Secondly, the Chinese state maintains the country's currency, the renminbi, at an artificially low level. It does so through enormous interventions in the currency market, the aim of which is to make it cheaper for foreigners to buy the Chinese currency, and hence Chinese goods. This again punishes households and discourages consumption, as it is much more expensive for Chinese consumers to purchase goods from abroad. The debate over the extent to which the renminbi is undervalued waxes and wanes, but the fact remains that until Beijing fully embraces market pricing of the currency, the possibility for future manipulation remains.[12] The currency interventions also require the central bank to keep a tight lid on the financial system, preventing the fair setting of interest rates.

Thirdly, the state subsidizes a range of goods which favour the manufacturing sector, such as energy, as well as using profits generated by successful state-owned companies to subsidize the less successful. This is in contrast to the usual practice of profits from state-owned enterprises accruing to the central government, where they might be used for projects of wider public benefit or to finance social security.

Thus it is not just the low wages and impressive work ethic of Chinese workers – many, who are migrants, not benefitting from social services, as these can only be delivered in the district of one's birth – which has driven the country's economic miracle, but a very deliberate economic policy which directs resources from households to companies, from consumers to producers, and from those provinces which don't contain export-oriented manufacturers to those that do.

To make this point is not to be churlish; rarely has economic growth anywhere in the world, especially in its early stages, been entirely equitable or resources entirely fairly divided. China has undergone a pace of industrialization and urbanization that has been dazzling to behold, and this speed was bound to exacerbate inequality and uneven development. The magnitude of change in China can often leave one numb – consider, for instance, that in late 2008, some 20 million migrant workers were estimated by Beijing to have lost their jobs as the global credit crisis unfolded.[13] This would be equivalent to some two-thirds of the entire British labour force in 2012 losing their jobs, yet China absorbed the blow. China's society and economy are clearly highly resilient.

Yet a more serious point can be made about the sustainability of the current model. Far from being a one-way ticket to eternal prosperity as it is sometimes viewed in the West, the current Chinese model risks collapsing under the weight of its own distortions. The highly state-directed nature of China's financial system is not compatible with long-term economic efficiency or with preparing Chinese companies for a time when they can no longer take shelter behind a devalued remnimbi.[14] To believe otherwise is largely to abandon everything we know about the market's efficiency, and the state's inefficiency, at allocating capital.

Funnelling resources into the export-oriented manufacturing sector and the property sector has generated millions of jobs and brought the country spectacular growth, but without a greater role for the market in allocating capital within the Chinese economy, there is a risk of massive distortions arising. Politically-favoured sectors such as manufacturing may have prospered in recent years thanks to conditions in the global economy, but they locked the country into a situation where it is too heavily dependent on overseas demand and is failing to distribute the benefits of its growth to its citizens, whose aspirations are rising all the time. The proportion of profits made in the Chinese manufacturing sector accruing to corporations, often foreign ones, are high, raising not only questions of economic justice but also fuelling the lack of domestic consumption by workers in the sector.[15]

The key to China's future, then, is a more balanced approach to growth, and a greater role for consumers in the economy. There is only so far a country can go as a producer of low-end manufactured products for foreign markets. There are signs that factions within the Communist Party recognize this – the recent downfall of Bo Xilai was, in part, one battle in the war between reformers and traditionalists.[16] Who will win this battle and whether sensible policies will be adopted for the future is far from certain.

Increasing personal consumption and the general level of education and wellbeing among Chinese citizens, as well as preventing policy from being captured and distorted by powerful interest groups such as the manufacturing lobby and local government officials who are heavily invested in the property bubble, will be an incredibly difficult task for a one-party state which also seeks to maintain its own monopoly on power. There is no guarantee that the Communist Party's ossified and opaque decision-making process will manage to maintain the support of all key constituencies, especially as economic pain begins to be more widely felt and the question inevitably arises of how it ought to be distributed. However hard the party tries to keep its disagreements behind closed doors, with time and growing economic dislocation the image of unity and single-mindedness that the party has managed to project will emerge as the myth it has always been.

This is especially true in an era in which social protest is rising and the transmission of information via social media makes Chinese citizens even more aware that their own specific local problems are part of a wider national picture – and perhaps, eventually, a national or regional protest movement.

China's leaders do not like *terra incognito*; that has been one lesson of the Bo Xilai affair. Yet this is exactly what they are entering as they seek to reform their growth model and deal with the frustrations visited upon their citizens by the global financial crisis. Lacking the feedback mechanisms that only a democratic politics can provide, they must still travel through a long period of creative destruction to reform their economy while maintaining their own legitimacy. Far from being on a sure path to global dominance, the Chinese Communist Party's struggle is only just beginning.

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[1] For the Chinese figures, see "China's Foreign Exchange Reserves Fall to USD 3.24 Tn at the End of June", *ChinaScope Financial*, 13 July, 2012, http://http://www.chinascopefinancial.com/news/post/14020.html. Accessed 28 July, 2012. For

U.S. debt, see "U.S. National Debt Clock: Real Time", http://www.usdebtclock.org/. Accessed 28 July, 2012.

[2] On the difficulty of the political response to the eurozone crisis, see Andrew J. Gawthorpe, 'The Merkel Gambit', *e-International Relations*, 12 Decemer, 2011, http://www.e-ir.info/2011/12/12/the-merkel-gambit/. Accessed 28 July, 2012.

[3] An excellent overview of the arguments against supposing that China is on course to "rule the world" can be found in Luke M. Herrington, 'Why the Rise of China Will Not Lead to Global Hegemony', *e-International Relations*, 15 July 2011, http://www.e-ir.info/2011/07/15/why-the-precarious-rise-of-china-will-not-lead-to-global-hegemony/. Accessed 8 August 2012. An interesting analysis can also be found in John Gulick, '*The Long Twentieth Century* and Barriers to China's Hegemonic Accession', *Journal of World-Systems Research* 17 (2011), pp. 4 – 38. Gulick argues that this thesis is flawed because it fails to take into account the fact that the conditions will shortly no longer exist for any state to achieve global hegemony in a capitalist world-system. Other works in this vein include Gordon G. Chang, *The Coming Collapse of China* (London: Arrow, 2003); Michael Beckley, 'China's Century? Why America's Edge Will Endure', *International Security* 36, 3 (2011/12), pp. 41 – 78; Joseph Nye, *The Future of Power* (New York: Perseus, 2011), chap. 6.

[4] Martin Jacques, *When China Rules the World: The End of the Western World and the Birth of a New Global Order*. 2nd ed. (London: Penguin, 2012).

[5] See, for instance, Jacques, *When China Rules the World*.

[6] United Nations, *The Millennium Development Goals Report,* 2012, p. 7. The report is available online at http://www.un.org/millenniumgoals/pdf/MDG%20Report%202012.pdf. As John Gulick notes: "Despite its sporting of an infamously high Gini coefficient, China's GDP per person figure is 12 times higher today than 30 years ago, helping to cement the stability of CCP rule". See Gulick, "Barriers to China's Hegemonic Accession", p. 17.

[7] An excellent study on some of the losers in modern China is Ian Buruma, *Bad Elements: Chinese Rebels from Los Angeles to Beijing* (London: Atlantic, 2001).

[8] "China Cancels Waste Project after Protests Turn Violent", *Reuters*, 28 July 2012, http://www.reuters.com/article/2012/07/28/us-china-environment-protest-idUSBRE86R02Y20120728. Accessed 28 July, 2012. For the vice-mayor's warning, see "Paper Mill Pipeline Project is Suspended", *China.org.cn*, http://www.china.org.cn/environment/2012-07/28/content_26043220.htm. Accessed 28 July 2012.

[9] Tom Orlik, "Unrest Grows as Economy Booms", *The Wall Street Journal*, 26 September 2011, http://online.wsj.com/article/SB10001424053111903703604576587070600504108.html. Accessed on 28 July 2012.

[10] Ian Johnson, "Do China's Village Protests Help the Regime?", *The New York Review of Books Blog*, 22 December 2011, http://www.nybooks.com/blogs/nyrblog/2011/dec/22/do-chinas-village-protests-help-regime/. Accessed 28 July 2012. This is a very perceptive piece.

[11] I owe much of the economic analysis below to Nicholas R. Lardy, *Sustaining China's Growth after the Global Financial Crisis* (Washington, D.C.: Peterson Institute for International Economics, 2011). A more accessible source is David Barboza, "As Its Economy Sprints Ahead, China's People Are Left Behind", *The New York Times*, 9 October 2011, http://www.nytimes.com /2011/10/10/business/global/households-pay-a-price-for-chinas-growth.html?pagewanted=all. Accessed 29 July, 2012.

[12] We appear currently to be at a point where the currency is less undervalued than it has been in the past – but this is inseparable from the generally depressed state of the global economy. For the latest assessment, see Simon Rabinovitch, "IMF Says Renminbi 'Moderately Undervalued'", *Financial Times*, 25 July 2012, http://www.ft.com/cms/s/0/370ef804-d62c-11e1-b547-00144feabdc0.html#axzz222LilOEE. Accessed 29 July, 2012.

[13] Sharon LaFraniere, "20 Million Migrant Workers in China Can't Find Jobs", *The New York Times*, 2 February 2009, http://www.nytimes.com/2009/02/02/business/worldbusiness/02iht-china.4.19876521.html. Accessed on 29 July, 2012.

[14] See Zhang Jun, "The Internal Roots of Economic Downturn in China", *e-International Relations*, 27 July 2012, http://www.e-ir.info/2012/07/27/the-internal-roots-of-economic-downturn-in-china/. Accessed 29 July 2012.

[15] For an author who has argued that China's entry into the world trading system has benefitted political and economic elites in the United States and China more than average workers, see James Mann, *The China Fantasy: Why Capitalism Will Not Bring Democracy to China* (London: Penguin, 2008).

[16] Bob Davis, "In Chinese Politics, a Fall – and a Rise", *The Wall Street Journal*, 28 July 2012, http://online.wsj.com/article/SB10001424052702303933704577531623651645112.html. Accessed 29 July, 2012.

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