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How to sustain the Chinese economic miracle? The risk of unraveling the global rebalancing

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Working Paper No. 617

**How to Sustain the Chinese Economic Miracle?
The Risk of Unraveling the Global Rebalancing**

by

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ABSTRACT

This paper investigates China's role in creating global imbalances, and the related call for a massive renminbi revaluation as a (supposed) panacea to forestall their reemergence as the world economy recovers from severe crisis. We reject the prominence widely attributed to China as a cause of global imbalances and the exclusive focus on the renminbi-dollar exchange rate as misguided. And we emphasize that China's response to the global crisis has been exemplary. Apart from acting as a growth leader in the global recovery by boosting domestic demand to offset the slump in exports, China has in the process successfully completed the first stage in rebalancing its economy, which is in stark contrast to other leading trading nations that have simply resumed previous policy patterns. The second stage in China's rebalancing will consist of further strengthening private consumption. We argue that this will be best supported by continued reliance on renminbi stability and capital account management, so as to assure that macroeconomic policies can be framed in line with domestic development requirements.

Keywords: Global Imbalances; Rebalancing; Renminbi Revaluation; Stimulus Package; Export-led Growth

JEL Classifications: E63, E65, F01, F42

1. INTRODUCTION

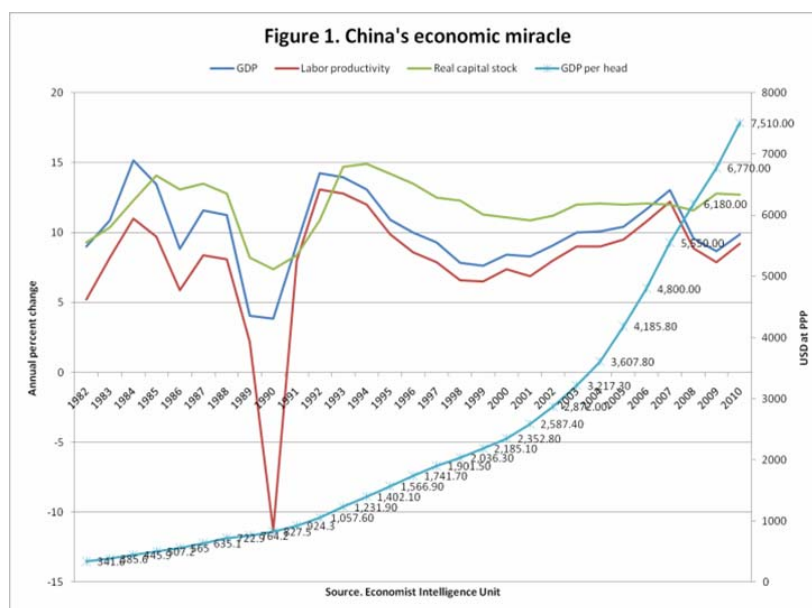
This paper investigates the idea of China as a paramount cause of global imbalances, a view that is closely related to calls for a massive renminbi revaluation as the chief policy change to forestall their reemergence as the world economy recovers from severe crisis. We find that the prominence widely attributed to China as a cause of global imbalances and exclusive focus on the renminbi-dollar exchange rate is misguided. China's response to the global crisis has been exemplary. Apart from acting as a growth leader in the global recovery by boosting domestic demand to offset the slump in exports, China has successfully completed the first stage in rebalancing its economy in the process, contrasting with other leading trading nations that have simply resumed previous policy patterns. The second stage in the rebalancing will consist of further strengthening of private consumption—supported by the continued reliance on renminbi stability and capital account management, so as to assure that macroeconomic policies can be framed in line with domestic development requirements.

The analysis begins in section 2 with a brief account of China's economic miracle and chief contributing policies. Section 3 addresses the issue of global imbalances and the extent of global rebalancing achieved since the global crisis. Section 4 then takes a closer look at China's crisis response policies and the ongoing rebalancing of the Chinese economy, while comparing China's performance with that of Germany is the subject of section 5. Section 6 addresses China's remaining challenges in rebalancing aggregate demand and offers some recommendations on how they might best be met, preferably without undermining China's economic miracle, as this would also be a sure recipe for unraveling the nascent global recovery. Section 7 concludes.

2. CHINA'S ECONOMIC MIRACLE AND ITS FOUNDATION

Starting from a low level of income and high incidence of poverty in the early 1980s, China's catching-up process has ensued at a breakneck pace. While the 1980s and early 1990s were somewhat volatile, including a slump (1989–90) and episodes of high inflation (1988–89, 1993–95), GDP growth was both high and stable from the mid-1990s until the global crisis hit China in 2008 (see figure 1). GDP growth had slowed around the time of the Asian crises in the late

1990s, but picked up speed again in the 2000s, peaking at 13 percent in 2007. Annual growth of the real capital stock has been even higher and exceptionally steady, indicating a focus on capital accumulation in China's development plans. Confirming that China's growth process has been capital rather than labor intensive, annual growth in labor productivity has only been little below GDP growth (on average, about one percentage point since the 1990s).



During this period the GDP share of the agricultural sector has shrunk from 40 percent to below 10 percent, while the services share increased by six percentage points to 36 percent and the share of industry by 20 percentage points to 55 percent, with the agriculture share in total employment declining from over two-thirds to around one-third and the urban population share rising from 20 to 45 percent. Meanwhile, annual population growth has slowed down from 1.5 percent in the 1980s to 1 percent in the 1990 and 0.5 percent in the 2000s; labor force growth slowed from 3 percent in the 1980s to just over 1 percent in the 1990s and just below 1 percent in the 2000s. With a population of 1.33bn and labor force of 800 million (in 2008), China is far advanced in its demographic transition and the demographic profile of its working age population is near its peak (partly owing to the one-child policy of the 1980s).¹ Remarkably, in purchasing power parity terms, real per capita income increased twenty-fold since the early

¹ See Brandt, Hsieh, and Zhu(2008), Ma and Yi (2010), Sheng (2009), and Economist Intelligence Unit (www.eiu.com/PublicDefault.aspx).

1980s; based on a poverty line of \$1.25 a day in 2005 prices, Chen and Ravallion (2008) calculate that China's poverty rate declined by 68 percentage points over 1981–2005, leaving 635 million fewer people in poverty.

As to the foundation of the Chinese economic miracle, three factors may be singled out here: industrial policies, controlled integration into the global economy, and heterodox macroeconomic management. Through a fine balance between government planning and market forces these three factors have acted as interdependent engines of fast-track development.

As Rodrik (2009: 2–3) observes, all growth superstars have in common that they “based their growth strategies on developing industrial capabilities, rather than specializing according to their prevailing comparative advantages.” He identifies the production of tradables as the main mechanism through which high productivity growth can be harnessed for fast-track development through industrialization. In China's case, too, industrial policies based on successful government planning have played a vital role. In this regard, the focus on tradables involved a controlled opening up to trade of the Chinese economy, with merchandise exports targeting markets in advanced economies and imports of foreign direct investment (FDI) from advanced countries supporting the production of industrial goods in China. After spending several decades following WWII as an almost closed economy aspiring to self-reliance, figure 2 shows that the Chinese economy has become remarkably open in the process—with foreign trade constituting 50 percent of GDP or more since the time of WTO entry in 2001. Figure 2 also reveals the sudden surge in exports and China's trade surplus as GDP shares in the mid-2000s, providing a first indication of the marked impact of the global crisis on the structure of aggregate demand.



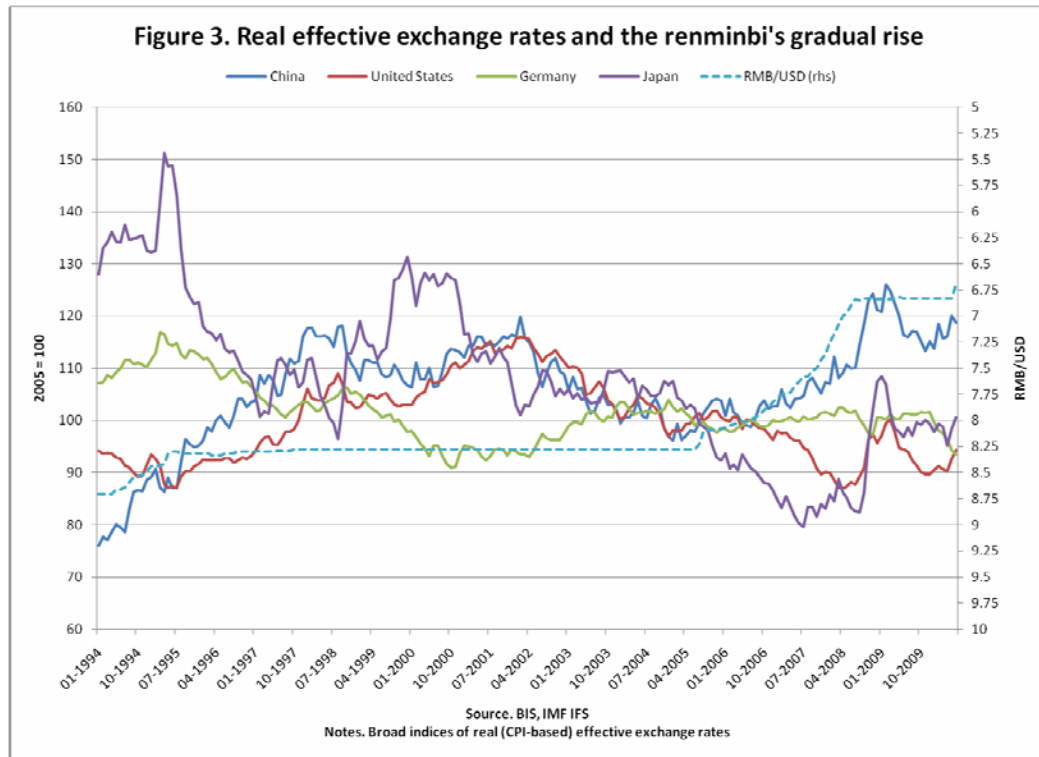
As an integral part of China’s industrial policies and controlled integration into the global economy the authorities have actively—albeit selectively—encouraged foreign companies to invest in China, mainly in the form of Greenfield FDI. China has been the number one destination among developing countries for FDI inflows for many years, reaching \$108bn and \$95bn in 2008 and 2009, respectively. Since 2003 China has also become an important source of outward FDI, soaring to roughly half the size of inward flows in 2008 and 2009 (up from next to nothing in the early 1990s), with developing countries as the foremost destination of Chinese outward direct investments.² Foreign-owned enterprises feature particularly prominently in China’s exports, more than half of which are processing exports.³ The significance of China’s export-processing trade reflects the country’s role as the foremost assembly hub in regional supply chains that have Europe and the United States as key destinations for final exports (with Europe overtaking the United States as China’s most important export market in the mid-2000s). Suffice to add that while they are believed to be an important channel of foreign know-how and state-of-the-art technology, overall, FDI inflows have played only a junior role in China’s fast

² See UNCTAD, WIR (2010). Zhang (2009: 84–85) also reports a selective support policy “to encourage outward direct investment in projects of natural resource exploration, exporting activities, overseas R&D centers, and M&A that can obtain foreign valuable assets such as brand names and technologies.”

³ Dullien (2005) reports that in 2001 almost three-quarters of total FDI had gone into manufacturing, with foreign-owned firms having a share of 50 percent in Chinese exports in 2003. See also Liang (2008) and Zhang (2007).

rate of gross fixed capital formation, with its share declining from an average of 10 percent for the period 1995–2005 to 4 percent in 2009 (UNCTAD, WIR 2010). Nor have massive trade-related FDI inflows contributed much to job creation, but, as Liang (2007) argues, may have provided an important conduit for establishing labor practices that follow the neo-liberal “flexibility” ideal and tend to marginalize workers’ power.

Be that as it may, defying the wisdom of the Washington Consensus that has ruled in much of the developing world since the 1980s, China’s development has been promoted by thoroughly heterodox macroeconomic policies. The renminbi’s dollar peg established in 1994 has provided the key external anchor in China’s development strategy. Starting in July of 2005 a gradual appreciation occurred vis-à-vis the U.S. dollar as the renminbi was officially referenced to an undisclosed basket of currencies. The de facto crawling peg episode then ended in mid-2008 as stress in global financial markets worsened, by which time the renminbi had appreciated by some 21 percent vis-à-vis the U.S. dollar over a period of three years. Externally, the Chinese economy has been shielded by a system of capital controls (see People’s Bank of China 2008), supporting both the exchange rate peg and control over domestic financial conditions in line with domestic policy objectives. All along, price stability has been secured by productivity-linked wage formation (especially in state-owned enterprises), freeing monetary policy to focus on financing growth in a low-interest rate environment (see Flassbeck 2005). China’s financial system remains tightly regulated until today, granting the Chinese authorities scope for targeted credit controls in support of the country’s development plans.



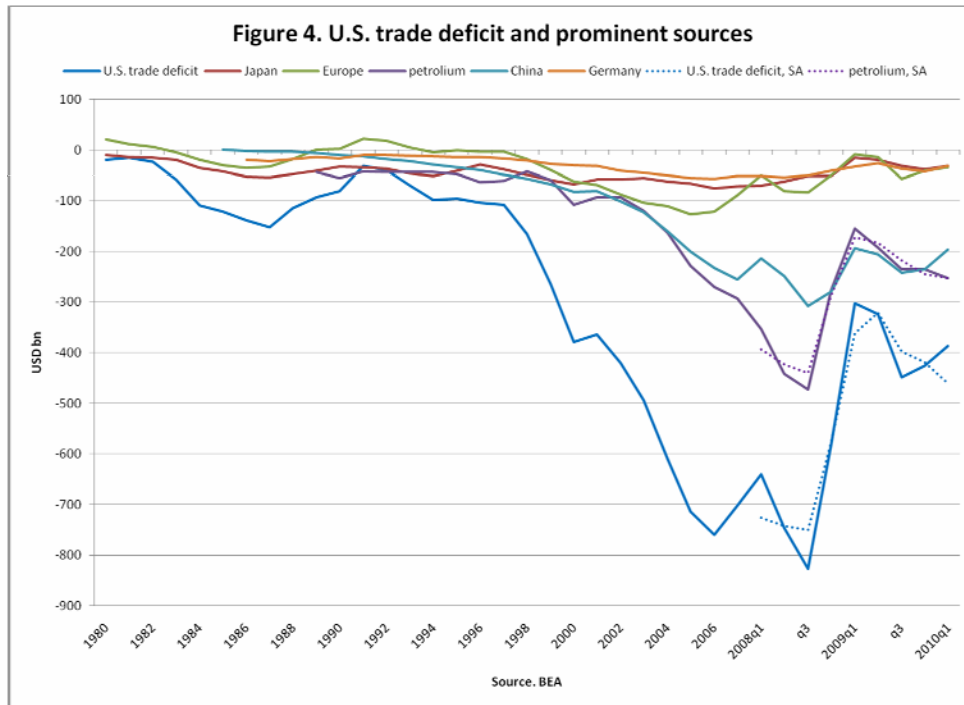
In conclusion, it seems fair to say that while providing the backbone to government policy in control of China's economic miracle, defying the Washington Consensus's unquestioning faith in unfettered market forces has done little harm to China's attractiveness to the international business community. Success breeds envy though, perhaps especially so when outcomes contradict conventional wisdom. In particular, China's export accomplishments and long-standing peg to the U.S. dollar made the country the chief target of criticism in policy debates on global imbalances prior to the global crisis, and again so today. Following two years of exchange stability between the renminbi and U.S. dollar, just ahead of the G-20 leaders' summit in Toronto in June 2010, the Chinese authorities announced that more exchange flexibility would be allowed henceforth (Batson 2010c; People's Bank of China 2010).⁴ International pressures calmed down at least temporarily as G-20 leaders labored hard to put a gloss over diverging policy visions regarding strategies to sustain global recovery. Apart from providing a convenient scapegoat, a crucial issue is whether renminbi appreciation might be

⁴ A month later, the PBoC's vice governor explained more specifics concerning the nature of the aspired managed floating regime featuring referencing of the renminbi to a basket of currencies: "In the future, consideration can be given to disclosure of the nominal effective exchange rate information on a regular basis and to gradually shift the public's attention on RMB/USD exchange rate to the effective exchange rate of RMB, which is the true reference for its movement" (Xiaolian 2010).

reasonably expected to contribute much to a benign global rebalancing anyway. Seen in longer-term perspective, China's real effective exchange rate has appreciated quite significantly since 1995 compared to other leading trading nations and especially vis-à-vis Japan. More recently, the euro's depreciation since the fall of 2009 has become an important force driving up China's real effective exchange rate (and Germany's down; see figure 3). The next section investigates China's role in global imbalances and global rebalancing.

3. GLOBAL IMBALANCES, GLOBAL REBALANCING?

Starting from a \$100bn level in the mid-1990s, U.S. trade deficits increased seven-fold over the next ten years. About half of the deficit consists of the U.S. oil bill, which ballooned in line with the oil price boom of the 2000s. The improvement since the 2006 peak too, is to a large extent, driven by oil. Going forward the oil price and U.S. oil dependency represent the two key variables affecting the U.S. trade balance. As to U.S.-Chinese trade, a sizeable imbalance built up in the 1990s, climbing from \$10bn to \$80bn over the course of the decade—similar in size by the late 1990s to corresponding U.S. trade deficits with Japan and Europe. While the trade deficits with Japan and Europe also continued to rise in the 2000s, their rise was outstripped by the surge in the U.S. trade deficit with China, peaking at \$262bn in 2008.



Even earlier, beginning in the late 1990s, the U.S.-Chinese bilateral trade imbalance became the center of attention in the United States. In 2001, the House Banking Committee of Congress still attributed the imbalance to a lack of U.S. national saving. But as concerns about the growing imbalance became ever more intense, this led senators Charles Schumer and Lindsey Graham to call for the introduction of an import tariff on Chinese goods in 2005. Today, another bill in waiting (and lingering threat), also owing to an initiative by Senator Schumer, accuses China of being a “currency manipulator,” with semiannual Treasury reports on the issue used to exert pressure on China to allow further renminbi appreciation. With chronic unemployment at elevated levels as a legacy of the global crisis, U.S. assertiveness on this matter is bound to rise.

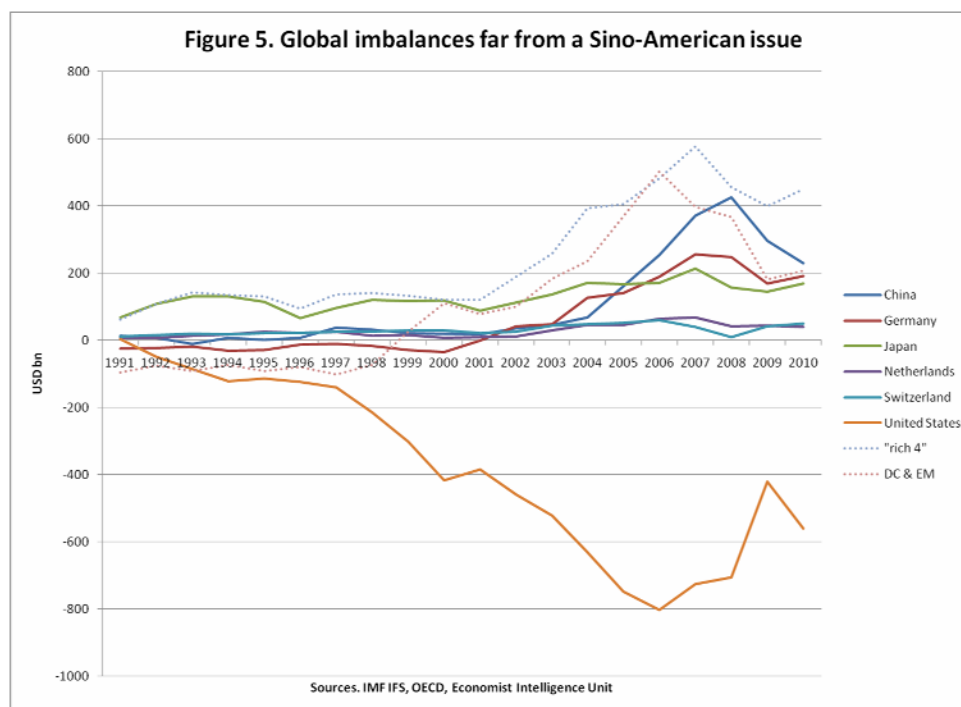
At first sight the truly large bilateral imbalance would even seem to justify such pressures. Yet, apart from the sizeable long-term appreciation of China’s real effective exchange rate seen in figure 3 (above), a number of important facts should better not be overlooked here. First, since 2000, U.S. exports to China have generally grown faster than U.S. imports from China, namely at a 20–30 percent annual rate. This is in contrast to the 1990s when import growth from China much exceeded U.S. export growth to China. Of course, export growth rates well in excess of import growth rates are indeed needed to narrow the bilateral trade imbalance,

given the much lower base level of exports. But working off what is really a legacy of the 1990s is a long-term issue that should not be confused with the immediate challenge of sustaining the current still-fragile U.S. recovery. In this regard, a second factor seems to be far more relevant from the U.S. perspective when hopes are pinned on exports to support recovery of the U.S. economy. The point is that as a destination of U.S. exports (goods only) China only had a market share of 6.6 percent in 2009, which compares with market shares for Europe and Canada of roughly 20 percent each. For goods and services taken together, Europe is the destination of over 25 percent of U.S. exports, five times China's market share of 5.5 percent (Bureau of Economic Analysis data). It is true that if China continued growing at a 10 percent rate, China will catch up in importance with Europe and Canada as a U.S. export destination in little more than a decade or so. In the short term, however, U.S. export performance remains far more dependent on the situation in Europe than on China's exchange rate. Arguably, for the next two or three years, the possibility of domestic demand stagnation in Europe, especially if it came along with euro depreciation vis-à-vis the U.S. dollar related to Europe's "sovereign debt crisis," poses the greatest threat to U.S. exports as a potentially contributing factor to sustained U.S. recovery. Obsession with the renminbi exchange rate risks losing sight of this key threat. This is especially the case as the U.S. deficit with Europe has essentially turned into a deficit with Germany, with Germany's real effective exchange rate falling and the German government today imposing austerity across Euroland (Bibow 2010a).

Ultimately, focusing on the bilateral U.S.-Chinese imbalance, or any other bilateral imbalance for that matter, is misguided anyway. If global imbalances are the issue, with the United States featuring prominently on the deficit side of the global equation, China's current account surplus position—rather than any bilateral trade position—should be addressed, and from a properly global perspective too.⁵ The point is that China's trade and current account surpluses only attained globally significant sizes in the mid-2000s. In the early 2000s, China still had a current account surplus that was similar in absolute size to that of Switzerland. Switzerland may be grouped together with Germany, the Netherlands, and Japan—other rich, non-oil-exporting countries with a history of large current account surplus positions. What distinguishes

⁵ As was pointed out correctly by Bernanke (2005), arguing that "a satisfying explanation of the recent upward climb of the U.S. current account deficit requires a global perspective that more fully takes into account events outside the United States." Surely a properly global perspective is also called for in assessing China's role in global imbalances.

these other surplus countries from China is not their much slower GDP growth as such, but their notorious reliance on exports to compensate for weak domestic demand growth. It seems curious to attribute an export-led growth strategy to China, especially when the two largest countries among this group of rich surplus countries, Germany and Japan, have exclusively relied on net exports for their meager GDP growth while suffering protracted domestic demand stagnation since the 1990s (see the next section below).



Much in line with U.S. trade deficits, U.S. current account deficits gradually built up during the 1990s and, until 2002, the IMF (2001 and 2002) attributed them mainly to stagnation in other industrialized countries.⁶ Several global developments stand out since the late 1990s. First, the U.S. current account deficit first surged in the context of the Asian crises, events that, as figure 5 shows, seem to have triggered an important turnaround in the aggregate current

⁶ In its *World Economic Outlook* of May 2001, the IMF observed that in the period 1995 to 2000 “rapid U.S. GDP growth and relatively weaker growth in other parts of the world, notably Europe and Japan, as well as a sharp increase in the real foreign exchange value of the dollar driven in large part by capital inflows, contributed to the rise in the deficit” (IMF 2001: 14). In its September 2002 *World Economic Outlook*, the Fund comments that “external imbalances across the main industrial country regions widened steadily during the 1990s [with these imbalances being] dominated by the euro area and Japan, respectively” (IMF 2002: 65–67).

account position of the developing world (Bibow 2008).⁷ Second, while this group's surplus position continued to grow, also reflecting the oil price boom of the 2000s, another group experienced a conspicuous surge in their surpluses in the 2000s, namely the "rich 4" (Germany, Japan, the Netherlands, and Switzerland). Third, China's current account surpluses appeared on the global scenery of imbalances at a rather late stage, soaring in the years 2005 until 2008; by then the U.S. current account deficit was already shrinking from its peak level in 2006. Finally, while global imbalances shrank sharply in the context of the global crisis, it is the "rich 4" group (apart from the oil factor) that appears to be powering the ongoing reemergence of global imbalances—not China.⁸

In conclusion, the exclusive focus on the U.S.-Chinese trade imbalance is thoroughly misguided and overlooks important facts. Seen in a global context, the exclusive focus on the renminbi and on China's current account surplus seems hardly justified. Other contributing factors and countries deserve attention too. The shrinking of the U.S. current account deficit in the wake of the global crisis has given rise to hopes that a global rebalancing may finally be under way. The next section investigates China's ongoing adjustment that was triggered by the global crisis. It turns out that it is China's ongoing adjustment in particular that would justify hopes for a global rebalancing, while developments in other surplus countries do not do so at all. This would further underscore our point that the Chinese renminbi is receiving excessive attention.

4. POLICY STIMULUS AND THE ONGOING REBALANCING IN CHINA

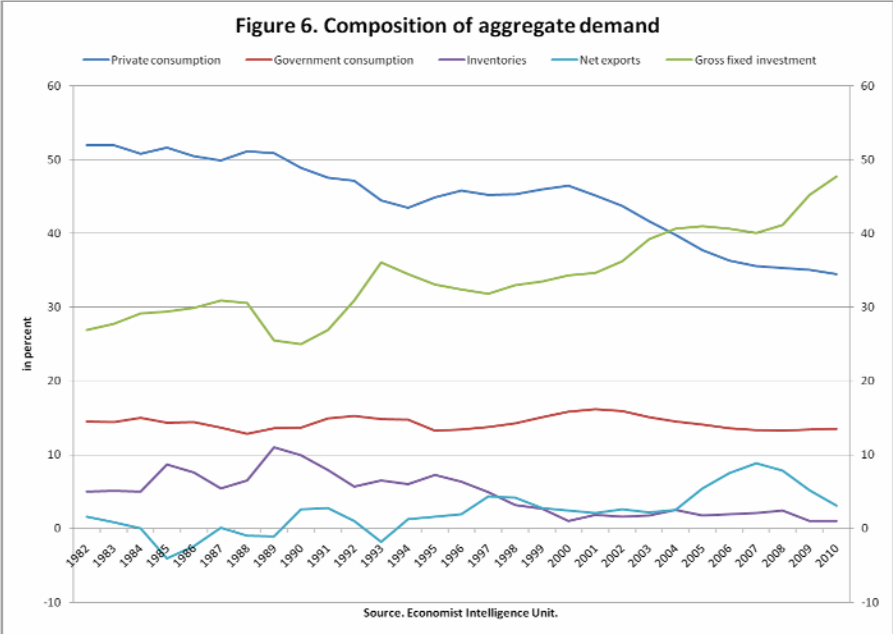
The Chinese economy slowed very sharply in the second half of 2008. Given the role that exports and surging trade surpluses had come to play in the years immediately preceding the global crisis it is no surprise that the collapse in global trade had a severe impact on China. Much in contrast to other leading export nations, the Chinese authorities responded quickly and decisively. In November 2008 a macroeconomic stimulus package of RMB 4tn (USD 586bn)

⁷ The aggregate "DC & EM" shown here is the sum of the IMF groups "developing countries" and "newly industrialized Asian countries," excluding China (which is shown separately).

⁸ It is curious that in contrast to most private forecasters, the IMF forecasts renewed rises in Chinese current account surpluses. Accordingly, the IMF sees the renminbi as substantially undervalued, a position that Davis and Back (2010) report as finding backing from rich industrialized countries (including Germany)—countries that also happen to dominate the IMF. See also Batson (2010d).

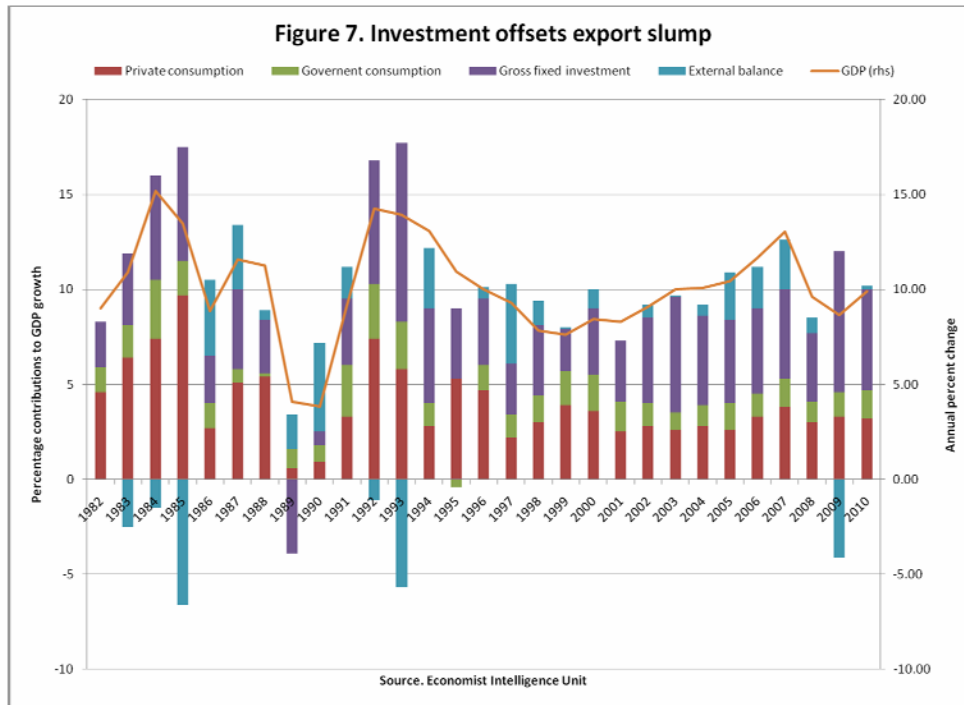
was announced to start immediately and last until the end of 2010, amounting to some 14 percent of 2008 GDP. The headline measure included increased central government spending of RMB 1,180bn (USD172bn) as well as increased local government spending (partly financed by newly allowed bond issuance backed by central government credit) and a vast lending program undertaken by state-owned banks. While featuring a very strong focus on infrastructure investment, the stimulus package also includes spending components targeted towards social objectives (Barboza 2008; Dyer 2008; Liu 2009; Naughton 2009; Yu 2009).

Importantly, while severely affected by the trade collapse, China did not suffer much damage through financial linkages. Tight financial regulation and capital account management had well-contained China’s vulnerability to the notorious excesses of unfettered global finance. Overhauled and recapitalized in the decade prior to the crisis, China’s banking system had little exposure to credit risks at the heart of the global financial crisis. Together with the protection provided by huge “self-insurance” reserve holdings (from which relatively minor outflows were recorded during some months at the peak of the crisis and again in May 2010 related to financial stresses in Europe), China enjoyed sufficient policy space to embark on its large stimulus program while keeping the renminbi stable to the U.S. dollar throughout the crisis. Exchange rate stability was a rare exception contrasting with strong depreciation against the dollar by most other currencies (Bibow 2010b).



Reflecting both the impact of the crisis as well as the policy response to it, the significant change in the composition of aggregate demand since the crisis can be seen in figure 6. Essentially, as net exports declined from their 2007 peak level of a 9 percent share to 3 percent forecast for 2010, the investment share rose from 40 to 48 percent. In previous decades the investment rate had increased from below 30 percent in the early 1980s to 40 percent in the mid-2000s as the growth rate of the real capital stock persistently exceeded GDP growth (see figure 1). The stimulus program in response to the global crisis then saw to the most recent surge to almost half of GDP. Over time the share of private consumption declined from just over 50 percent to 35 percent by 2010. Most of this decline occurred during the first half of the 1990s and the first half of the 2000s.

Figure 7 highlights the remarkable success of China's stimulus program. GDP growth slowed markedly from 13 percent in 2007 toward 6 percent in the second half of 2008, but quickly resumed a near 10 percent pace in the course of the following year. As China's GDP growth started to rebound already in the second quarter of 2009, investment—including investment stimulated by the government stimulus program—*fully offset* the large negative growth contribution of net exports. In the process, China assumed the role as global leader in the policy-driven global recovery from crisis, its industrialization and urbanization-driven hunger for commodities and capital goods and rising import demand in general spreading throughout much of the world.



Meanwhile, the impact of China’s large stimulus program on public finances appears to have been rather modest. The government’s budget balance only deteriorated from a surplus of 0.6 percent in 2007 to a deficit of 3.1 percent of GDP forecast for 2010, with the official public debt ratio remaining below 20 percent. Such an outcome would certainly vindicate the view that properly preemptive countercyclical fiscal stimulus partly pays for itself,⁹ but it also has to be borne in mind here that a good part of the stimulus package has taken the form of spending financed by bank loan expansion, which is not showing up as public debt in the national accounts.¹⁰

In fact, the magnitude of credit expansion undertaken as part of the stimulus package has given rise to much concern about the sustainability of the Chinese recovery. Some observers emphasize the short-term risk of asset market bubbles owing to excessive liquidity and low interest rates. In this regard, the authorities have implemented measures directed at asset market developments and Chinese equity markets have been under pressure in 2010 (Cookson 2010).

⁹ UNCTAD TDR (2009) estimated the magnitude of discretionary fiscal stimulus (excluding the automatic stabilizers) as amounting to 6.2 percent of GDP.

¹⁰ Local government loans for infrastructure projects are often arranged through “urban development and investment companies” as financing platforms, with local governments (and ultimately the central government) potentially liable for what are nominally corporate debts (McMahon 2010). Nor may bank loan statistics tell the whole story since off-balance-sheet (securitized) bank lending through lightly regulated Chinese trust companies has seen a sudden surge of late (Anderlini 2010b).

Other observers are more worried about suspected longer-term risks arising from boosts to China's export capacities derived from increased investment spending, allegedly heralding even bigger global imbalances in future. Yet others are concerned that infrastructure investment might run too far ahead of productive investment and lead to deteriorating public finances and/or push up banks' nonperforming loan ratios in due course (albeit from historically low levels) as loans for infrastructure investment funding might turn sour on a non-negligible scale (Anderlini 2010a; Yu 2009).

Given remaining stresses in global finance and protracted domestic demand weakness in advanced economies, low interest rates set at the center by leading central banks are here to stay for quite some time. For developing countries, such as China, this only underlines the continued need for capital account management to contain capital inflows and maintain sufficient policy space paired with extra vigilance in financial regulation and supervision. The authorities appear to be well aware of the risk of fragilities arising in the financial system and some observers even argue that government measures to cool property markets, including increased downpayments and restrictions on purchases of multiple homes, may have gone too far (see Batson 2010a). By contrast, risks of "excessive" and "wasteful" investment undertaken in response to the crisis appear less relevant as China's infrastructure capital stock, broadly defined to include environmental investment and investment in health and education, for instance, is way below "satiation point." If public debt rises in the process, either today or in due course, this has to be set against the benefits of rising incomes and sustained employment growth.

Crucially, apart from acting as a global leader in the recovery from the global crisis, China has rebalanced its economy in a way that also greatly contributes to a benign rebalancing of the global economy. I emphasized above that China only experienced large current account surpluses late in the game. Given the size the Chinese economy has meanwhile attained, surpluses surely will have to shrink as a share of GDP. This is happening fast, with renminbi appreciation and expenditure switching playing the junior role in the adjustment. Far more important is the policy-induced boost to growth in domestic demand and Chinese imports—triggered by the global crisis. The next section compares the rebalancing of the Chinese economy with the situation in Germany, another leading trading nation pursuing "export-led growth," albeit of a very different variety.

5. CHINA'S "EXPORT-LED GROWTH" IN PERSPECTIVE: THE CASE OF GERMANY

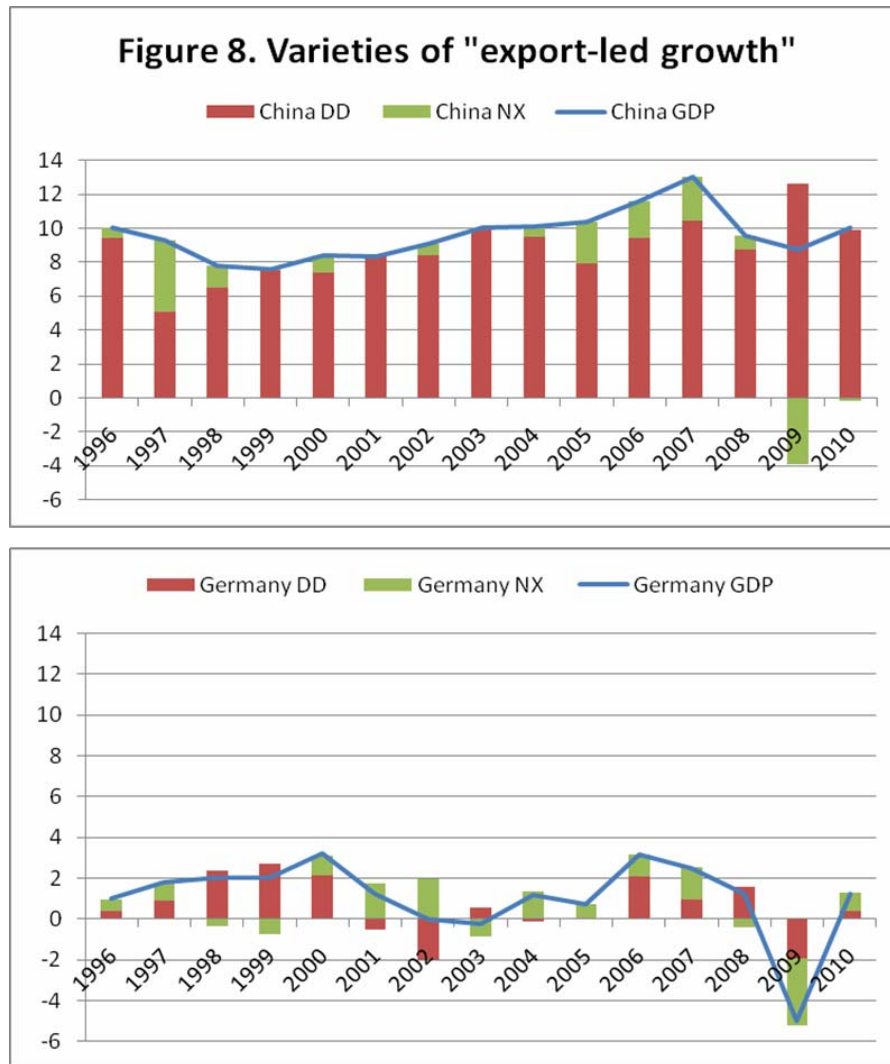
China is often said to pursue an export-led or "mercantilist" development strategy. Section 2 argued that the Chinese economic miracle was based, among other things, on the controlled integration into the global economy. Turning China into a remarkably open economy within a few decades, industrial policies and selective attraction of FDI have played key roles in this. Since 1990 China had trade surpluses in almost all years. While generally in the order of magnitude of 2–3 percent of GDP, China's trade surpluses temporarily reached 5 percent of GDP or more in the years 2005–09. Trade surpluses may be seen as an indication of currency undervaluation and in this regard China is often compared to Germany's post-WWII development model featuring persistent trade surpluses.

Focusing on the 2000s, when China's trade and current account surpluses attained a globally significant size after 2003, Germany experienced a comparable improvement in its external balances, a swing of some \$250bn (while China's improvement was about \$330bn). Trade surpluses sponsor employment and add to GDP in the (net) exporting country. Yet the notion of "export-led growth" attains an altogether different meaning in the German case. As figure 8 shows, net exports were the sole contributor to German GDP growth in the 2000s when soaring trade surpluses overcompensated for shrinking private consumption and overall domestic demand was flat. In China's case, the share of net exports as a GDP growth contributor was less than 10 percent on average, concentrated in the years 2005–07, with domestic demand providing more than 90 percent of overall GDP growth. Surely, then, if "export-led growth" is meant as a euphemism for "mercantilistic beggar-thy-neighbor policies" (or plain freeloading) that would justify calls for retaliatory import taxes or currency revaluation, and Germany, not China, should be the prime target. China's growth is predominantly domestic demand-led (Sun 2009). Developments since the global crisis are most revealing.

While both trading nations suffered large negative growth contributions from net exports when the global crisis struck, the crisis impact was more than offset by policy stimulus to domestic demand in China, while domestic demand amplified the GDP slump in Germany's case. Emerging from the crisis, China's GDP growth is exclusively sponsored by domestic demand, whereas Germany's is almost exclusively driven by net exports. In fact, the situation is

such that China is effectively sponsoring Germany's recovery, as recently observed by the managing director of Germany's engineering association who was quoted in *The Financial Times* as describing the demand for textile machines as "almost exclusively" Chinese: "Without China we would hardly have seen this recovery—it's a frightening trend" (Wiesmann, Schaefer, and Atkins 2010). Whether frightening or not, it is certainly ironic that German officials should join in the chorus calling for drastic renminbi appreciation (see footnote 8 above) when Germany's freeloading on China's stimulus program is amplified by the euro's depreciation—artificially boosting German competitiveness—anyhow. Europe's sovereign debt crisis driving the euro's slump is largely a consequence of Germany's wage underbidding strategy since the euro's launch (Bibow 2010c). As mindless "stability-oriented" austerity suffocates Germany's traditional export markets in Euroland's periphery, skyrocketing exports to China (running at over 50 percent growth rates in the first half of 2010) have come to Germany's rescue, largely offsetting the shortfall. Thanks to huge popularity among China's newly affluent, German car makers enjoy a surprise boon to their profitability.

Figure 8 highlights the contrasting varieties of "export-led growth" models of China and Germany. The key point is that while China is on track today in rebalancing its economy, Germany is not at all. Following a temporarily more prominent role of net exports as GDP growth contributor in the years 2005–07, China has successfully recalibrated its growth model, with GDP growth exclusively fired by domestic demand and trade surpluses on a downward trend as a share of GDP. By contrast, Germany is back to bad old habits of growing on net exports only and trade surpluses once again rising as a share of GDP—only that German exports are today powered by China instead of suffocated markets in Euroland. In other words, while China is playing a constructive part in rebalancing the global economy, Germany has merely switched its export sponsors, with German-imposed stagnation across Europe representing a paramount obstacle to any export-supported recovery in the United States as well.



This factor surely has to be borne in mind when multinationals increasingly moan about being treated unfairly in doing business in China.¹¹ With protracted stagnation in their respective home markets these foreign corporations are all the keener to expand their business and market shares in China. It is a reflection of a serious imbalance in global governance that foreign corporations can raise complaints against China on micro (WTO) grounds (see Batson and Dean 2010) when China has no such lever for raising complaints against rich industrialized countries on macro (stagnation cum fiscal austerity) grounds.¹² Instead, China is simultaneously also

¹¹ *The Financial Times* reports Chinese premier Wen Jiabao as having had to ask visiting Jürgen Hambrecht (chief executive of German chemicals group BASF) to “calm down” in his sharp complaints (see Dyer 2010).

¹² Recent G-20 meetings in Busan (ministerial) and Toronto (leaders) in June 2010 have made it clear that, following a promising episode during the height of the global crisis, international cooperation through the G-20 has hit the

facing macro pressures of the opposite kind, namely for renminbi revaluation, which would only further magnify the leakages from its own stimulus efforts towards countries that cherish austerity—so that they can freeload on exports. It is an irony that German corporations and German authorities (through a politicized IMF) should criticize China for containing import growth when Germany is notoriously starving its domestic economy (and today also its traditional export markets in Europe). Benign global rebalancing would require that Germany's competitiveness is adjusted to the point that prevents the country from freeloading on external stimuli. In actual fact, euro depreciation delivers the exact opposite of this requirement. The Chinese authorities have every reason to be concerned about these developments (see Batson 2010d and IMF 2010).

6. CHINA'S REAL CHALLENGES AND THE EXCHANGE RATE ISSUE IN PERSPECTIVE

An important upshot of the above analysis is that the popular push for drastic renminbi revaluation is much overdone. Triggered by the global crisis and global policy responses to it, China's external surplus is shrinking fast. Given the economic size and global weight China has meanwhile attained any reversal of this trend is not only an unrealistic longer-term option but also an unlikely short-term outcome in view of the Chinese authorities' revealed determination to sustain development and employment growth under more adverse global conditions. China's key export markets in Europe and the United States will see years of subdued growth. As China boosts domestic demand to sustain its fast-track development, China's real challenge may turn out to be that of containing external drags on its growth rather than further amplifying import growth through massive exchange appreciation.

While the rebalancing is well under way regarding external versus domestic demand orientation, going forward a rebalancing of domestic demand toward private consumption will be the key challenge. This is not to say that the focus on infrastructure investment in the stimulus program was a mistake. In fact, the remaining scope for China's catching up, involving both urbanization as well as upgrading poor rural areas as the economic structure shifts from

wall. Under German pressure, Europe has committed to continent-wide unconditional austerity; the negative spillover effects may get magnified even further by euro depreciation. See UNCTAD TDR (2010).

agriculture to services, will require continued expansion of public services and infrastructure. Great needs for infrastructure investment persist, especially also related to the environment and human capital, but the pace will slow compared to extraordinary circumstances created by the global crisis. To support efficiency of investment and technological advancement China should also reinforce its push for “indigenous innovation” initiated in 2006. In this regard, its large and fast growing domestic market is shifting the balance of power between China and multinational corporations, granting China leeway in fostering technology transfer and diffusion by FDI (see Liang 2008).

Regarding the challenge of rebalancing domestic demand toward private consumption it is important to note that the issue is not primarily a high household saving rate, but a declining household share in disposable income. While China’s household saving rate of around 25 percent exceeds corresponding rates in advanced countries, high national saving largely reflects lofty corporate and public saving. A strategy to boost private consumption should therefore focus on redistributing disposable income away from the public and corporate sectors toward the household sector, preferably calibrated so as to especially support low- and medium-income households in order to simultaneously redress sharply rising income and wealth inequalities. As to income redistribution between the public and the household sectors, this may be best achieved through income tax and social security reforms and expansion of social services. Apart from boosting household disposable incomes, such measures may also relieve precautionary saving motives. As to income redistribution from the corporate toward the household sector, changes in corporate dividend policies and faster wage growth (including minimum wages) would be desirable.

In fact, the highly welcome acceleration of wage inflation appears to be underway today as Chinese labor is also raising its assertiveness vis-à-vis foreign multinationals (see Batson 2010b; Batson and Shirouzu 2010; Mitchell and Hille 2010; and Mitchell and Kwong 2010)—a tendency that will receive support from demographic trends as well (see above). While inflationary forces (other than food prices) appear to be well-contained at present, suitable adjustment in policies that affect corporations’ incentives to invest¹³ would relieve pressures to

¹³ Such measures should be seen in the context of the redistributive policies just mentioned in the above since the rising corporate share in disposable income and surging corporate savings partly owe to reforms that reduced corporate provisions of healthcare, pensions, education, and housing to employees in state-owned enterprises—boosting employees’ precautionary saving needs accordingly. An expansion of the social security system designed

pass on rising wage costs and thereby contribute to shifting demand from investment toward consumption without creating inflationary strains. Increased competition in product markets provides another dynamic that can help containing cost-push inflation, and it is in this regard that gradual nominal renminbi appreciation could play *some* role. While real renminbi appreciation (measured in unit-labor costs) would likely be faster than nominal appreciation as China rebalances aggregate demand toward private consumption, a move away from the U.S. dollar focus towards a currency basket that better reflects competitiveness trends vis-à-vis China's main trading partners seems advisable.¹⁴

As China rebalances so as to sustain its fast-track development, current global trends would seem to leave only limited scope for recourse to reliance on expenditure switching via renminbi appreciation. Rather, with the still very high share of employment in agriculture concentrated in poor rural areas sending an important reminder of China's real challenges yet to fully master, exchange rate stability together with capital account management should continue to secure the policy space needed for growth-oriented macroeconomic policies and gradualism in adjustment.¹⁵ China may be the second largest economy in the world today, ahead of Japan and Germany (rich countries that have both become a heavy drag on China's GDP growth), but China is still a poor country. Yet, given the attained size of its economy the rest of the world would do itself a disservice in calling for policies that risk destabilizing China's miracle—an event that would also unravel any benign global rebalancing.

In conclusion, the main policy emphasis in rebalancing the Chinese economy, as currently underway, from exports to domestic demand and, going forward, from investment spending toward private consumption should not be on expenditure-switching policies (i.e., the nominal exchange rate). Rather, expenditure-expansion (i.e., growth-oriented macroeconomic policies) should be the driver of rebalancing and sustained development. In this regard, stability of the renminbi exchange rate (or cautious gradualism in its adjustment) together with capital

to relieve household precautionary saving should therefore focus on redistributing income from the corporate to the public sector.

¹⁴ In practice, export taxes provide another tool for adjusting incentives relevant to steering the composition of aggregate demand. See Hook (2010).

¹⁵ The argument for focusing on expenditure-switching policies was made forcefully by Roubini (2007). McKinnon (2007) made the case for renminbi stability based on monetarist reasoning from which the Keynesian argument presented here differs in stressing the continued need for securing policy space in pursuance of growth-oriented macroeconomic policies. On capital account management, see Bibow (2008–09) Ma and McCauley (2007), and People's Bank of China (2008), for instance.

account management should continue to act as macroeconomic anchors allowing China to maintain sufficient policy space in managing its development while containing its vulnerability to external forces.

7. CONCLUDING OBSERVATIONS

Our analysis denies the paramount role widely attributed to China as a cause of global imbalances in the precrisis era. As to crisis responses, China stands out as global leader in the recovery owing to successfully rebalancing aggregate demand by appropriate means. Going forward, double-digit-rate domestic demand growth in China paired with near-stagnation in its key export markets in advanced countries speaks for a continued decline in China's trade surplus as a share of GDP, leaving calls for a massive renminbi revaluation appearing in a dubious light since the world economy would surely be dealt a poor service by destabilizing its growth engine. China's key challenge will be to rebalance domestic demand toward private consumption, which we advise should be done through policies that boost household disposable incomes. Renminbi stability and capital account management should continue to play their crucial role in maintaining policy space for implementing heterodox macroeconomic policies with a proven track-record of supporting growth and development.

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