The Cost of China's Export-driven Growth Strategy

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Introduction

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Introduction

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Introduction

- China’ s export-led growth/reserve accumulation strategy has been framed by the mainstream as an economic development success story and an example for development for emerging market nations.

- This paper shows otherwise, revealing how China’s export-led growth, while supporting China’s export-related industries, has done so at the expense of the macro economy and the overall standard of living.

- Furthermore, this is the general case for export-led growth, which implicitly requires repression of domestic demand and consumption, as the fruits of domestic labor are exported rather than consumed or used for domestic investment for future domestic consumption.

- The resurgence of mercantilist practices mimicked in China’s current economic strategies, starkly echoes the historical episodes of gold accumulation under the mercantilist doctrines discredited by Adam Smith. The essence of mercantilism—accumulating wealth at the cost of domestic consumption—parallels China’s emphasis on export over domestic market development.

Overview of China’s economy

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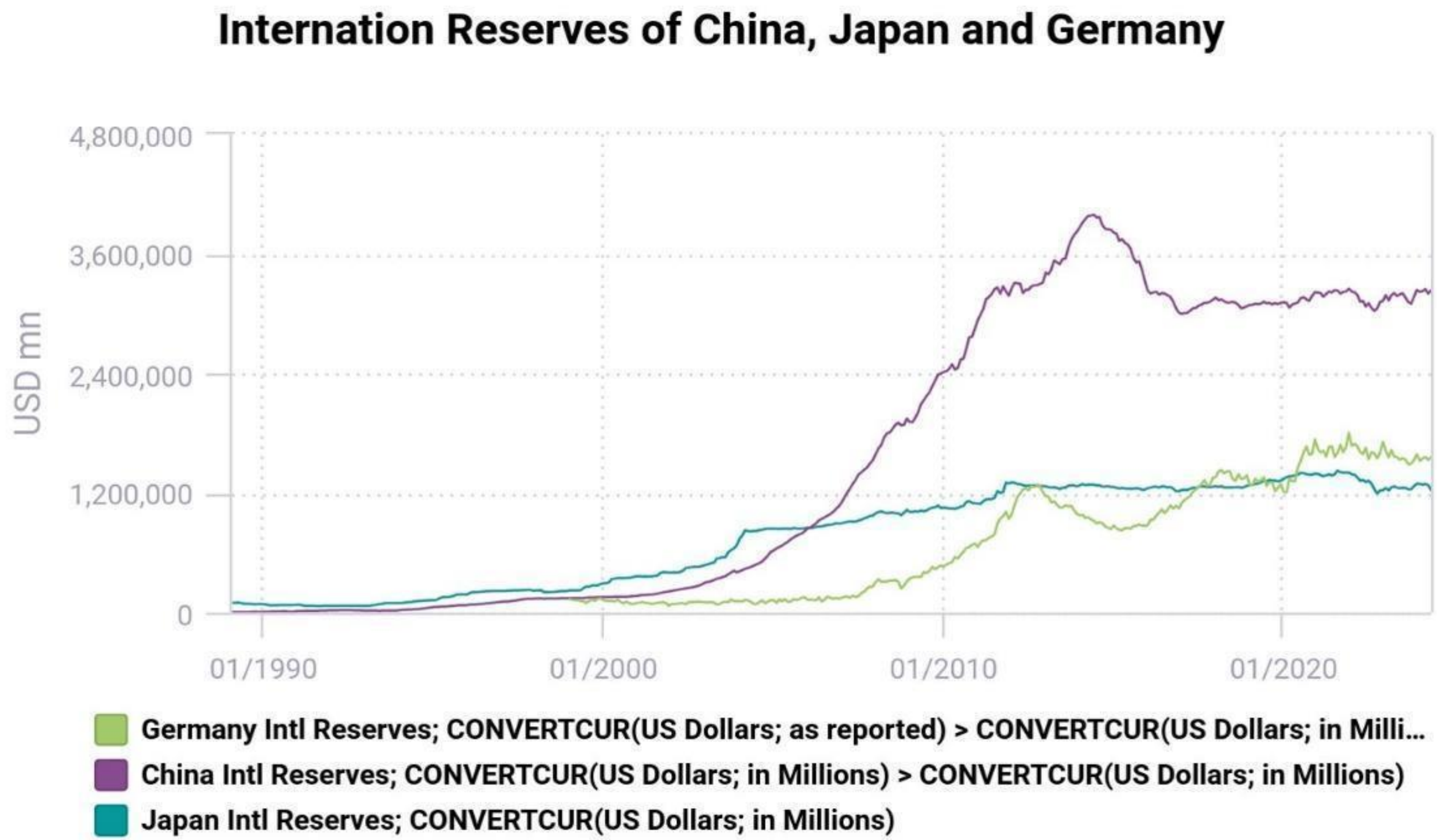
Overview of China’s economy

- China has been a highly successful net exporter, as evidence it currently possesses **the world’s largest holdings of international reserves**, recorded at 3,200.8 billion USD through April 2024.
- China’s trade surplus stood at $99.05 billion in June, **the highest in records going back to 1981**.



China’s export-driven growth strategy

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China’s export-driven growth strategy

- China’s substantial accumulation of reserves is related to China’s export-driven growth imperative.

- The Chinese government has prioritized net exports per se as a central element of its economic policy.

- To support export competitiveness, China has purposely kept the RMB exchange rate undervalued, coupled with state policy support of low domestic labor and commodity prices. This has been sustained as needed to ensure Chinese manufactured output is priced competitively in international markets.

- Applying this strategy, China has been exporting significant domestic resources-particularly labor content-through its trade surpluses since 2000. As part of this strategy, China has effectively directed real wealth from workers, through corporations and government, to the foreign sector.

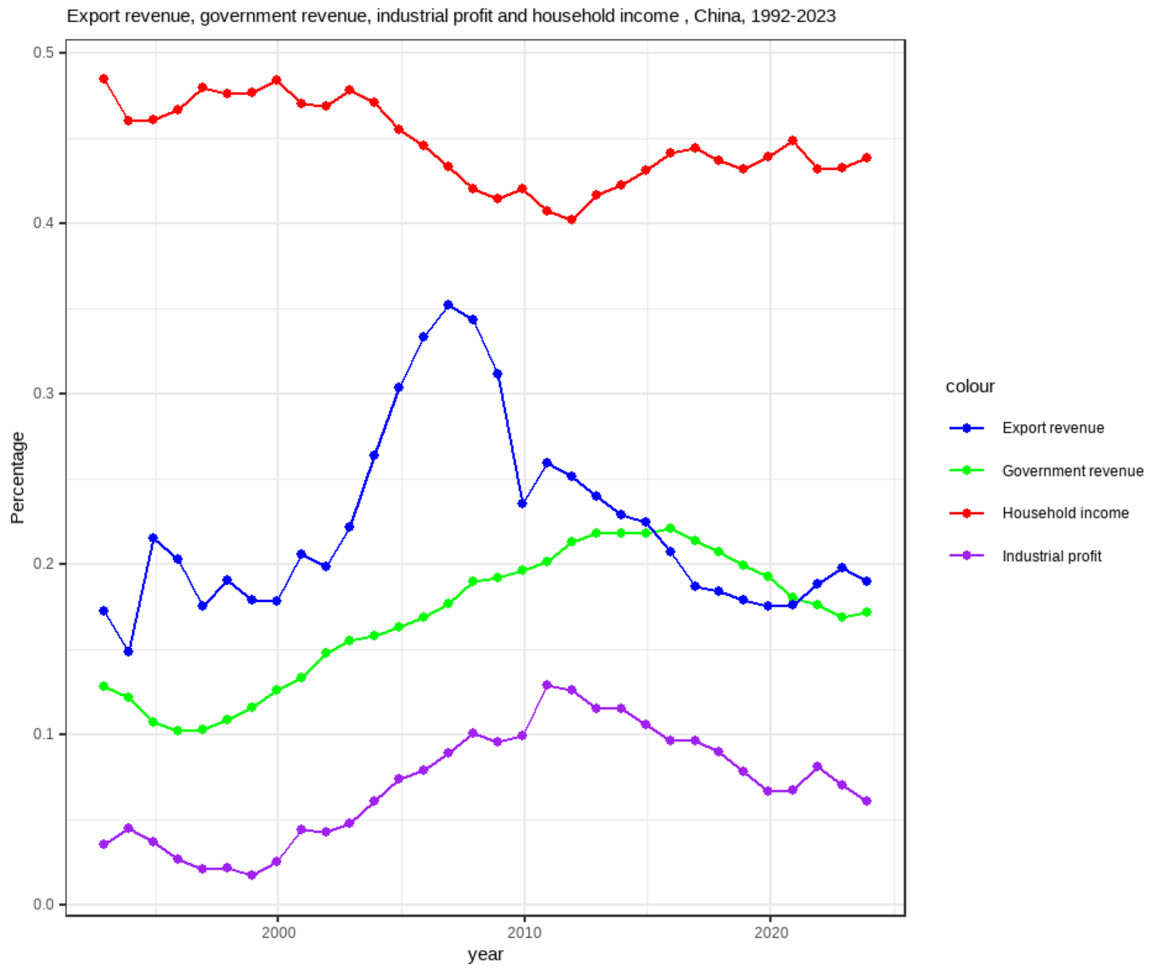
China’s export-driven growth strategy

- Since 1992, **the income share of household sectors** is showing a downward trend, while **the shares of government** and **corporate sectors** are rising.

- A notable feature in the graph is that from 2000 to 2008, the rapid growth **in the income share of the export sector** coincided with a decline **in the income share of the household sector**.

- The disparity in income share suggests that while corporations and the government have benefited significantly from economic growth, households have not seen proportional increases in their incomes.

- While multiple factors contribute to the disparity in income share in China, it nonetheless contributes to China’s export-driven strategy.



China’s Policies to Contain Real Wages and Aggregate Demand

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China’s Policies to Contain Real Wages and Aggregate Demand

- Suppression of wages is part of a general policy of favoring enterprises with policies that lower business costs, making the distribution of wealth more favorable to capital, for the further purpose of ensuring more competitive prices in world markets.

- Furthermore, keeping wage increases below productivity increases sustains low labor costs for exporters, skewing income distribution away from labor.

China's Policies to Contain Real Wages and Aggregate Demand

1. Local governments promote cost-saving infrastructure
2. High rates of savings in non-state-owned enterprises
3. The control of unspent incomes from SOEs
4. The degree of production factor marketization in China
5. The rapid rise in housing prices
6. China's tax structure

China’s Policies to Contain Real Wages and Aggregate Demand

- First, with China’s fiscal decentralization local governments compete to attract businesses that promote local economic growth. To attract this business investment, local governments promote cost-saving infrastructure. Secondary industries, such as manufacturing and construction, are the largest beneficiaries of this support. Secondary industry is encouraged to be more capital-intensive, which decreases labor content and minimizes upward pressure on wages and contains domestic consumption as the export economy grows.

- Second, China’s financial system includes both state-owned banks and non-state-owned banks. The share of loans of state-owned banks exceeds 60% of total financing. State-owned banks provide low cost funds to state-owned enterprises, while non-state-owned banks have extremely limited access to credit, and so rely more heavily on their accumulation of capital. This leads to high rates of savings in non-state-owned enterprises.

China’s Policies to Contain Real Wages and Aggregate Demand

- Third, one of the strategies to limit aggregate demand is the control of unspent incomes from SOEs (State Owned Enterprises). SOEs in China are often required to retain a significant portion of their earnings rather than distributing them as dividends or reinvesting them domestically. For example, in 2023, China’s centrally-administered SOEs reported a total profit of 2.6 trillion yuan, much of which was retained rather than spent. By limiting the amount of income that SOEs can spend domestically, the government effectively controls aggregate demand and dampens inflationary pressures.

- Fourth, the degree of production factor marketization in China works to suppress wages. China manages the long-term segmentation of the labor market between urban and rural areas, creating a discriminatory labor market that restricts the free flow of labor factors between urban and rural areas. By keeping the rural areas at subsistence level, and releasing labor to urban areas on an as-needed basis, low labor costs for exporters are sustained.

China’s Policies to Contain Real Wages and Aggregate Demand

- Fifth, the rapid rise in housing prices has been a large factor for Chinese household savings, and has taken the pressure off of aggregate demand outside of the housing sector. In China, high house prices significantly affect the future consumption expectations of urban residents. When a large portion of household income is devoted to housing expenses, disposable income available for other types of consumption decreases. This can have a dampening effect on overall consumer spending, which is a crucial component of aggregate demand.

- Sixth, China’s tax structure works to limit domestic consumption. For example, China’s workers pay full value-added tax (VAT) taxes, while one of the most common forms of subsidies for export industries is the VAT rebate, with Chinese exporters receiving rebates on VAT paid on inputs used in the production of export goods. These rebates have been adjusted multiple times. In 2018, for example, VAT rebates on a range of products were increased to support exporters amid trade tensions with the United States. China has a policy of production subsidies that promote exports. The distribution of production subsidies among manufacturing enterprises favors exporting firms. For example, more than 40 percent of state-owned exporting firms receive production subsidies.

Central Bank Monetary Operations

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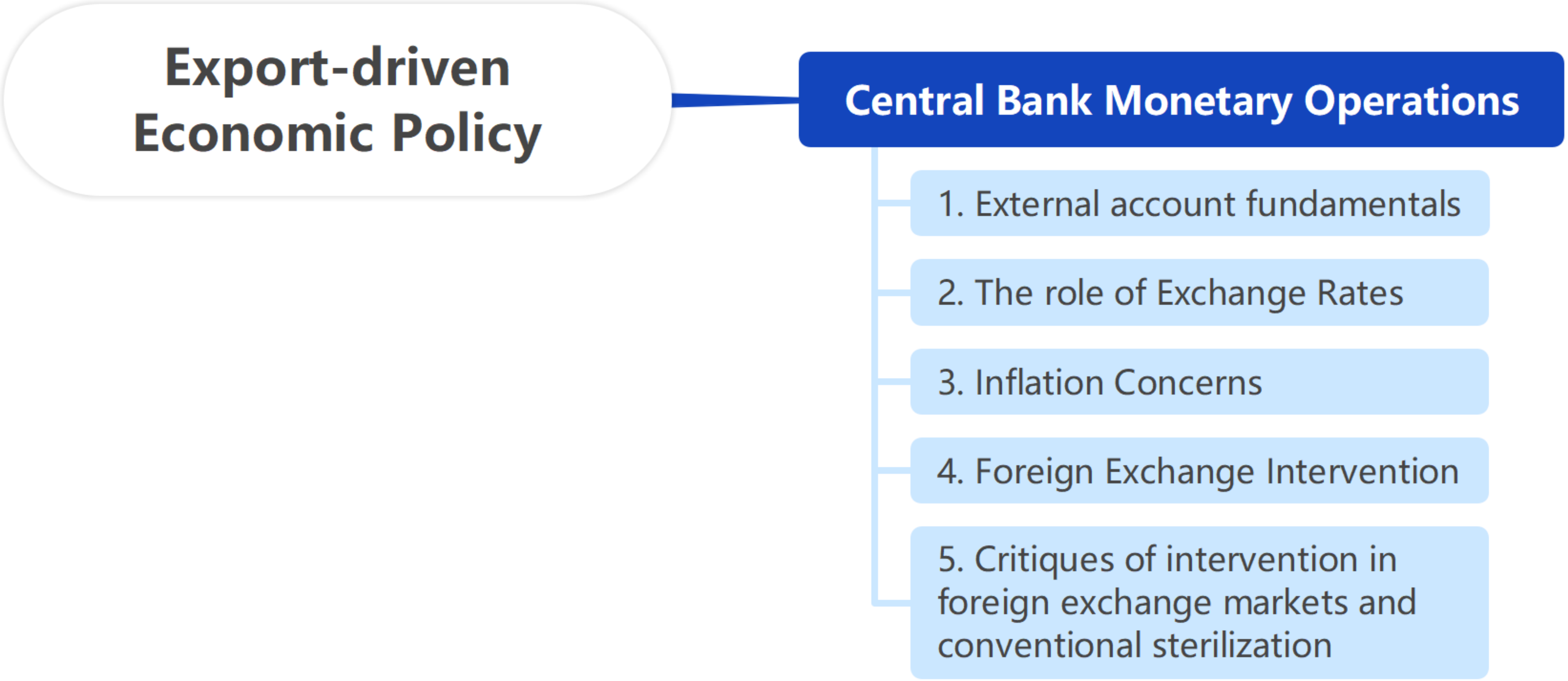
Central Bank Monetary Operations



Central Bank Monetary Operations

1. External Account Fundamentals

A trade surplus implies a financial account deficit, with the surplus country, at the macro level, saving its unspent foreign exchange income rather than spending it on imports. This means that a trade surplus represents a reduction of a country's real terms of trade (real wealth).

2. The role of Exchange Rates

Intervening to prevent currency appreciation, as is the case in China, is sustainable if the policies that are creating the strong currency are sustained. However, also as in China, those strong currency policies, when used to support net exports and continuous foreign exchange accumulation, exact a real wealth toll on the macro economy, beginning with the need to sustain the sufficiently low real wages needed to facilitate net exports, through the various mechanisms previously described.

Floating exchange rate policy, on the other hand, opens the door for both domestic full employment fiscal policy and the optimization of real terms of trade to further enhance China's real wealth.

Central Bank Monetary Operations

3. Inflation Concerns

China currently controls domestic demand through internal policies, which allows for purchases of foreign exchange that would otherwise be inflationary, to instead fill the ‘spending gap’ currently being created by domestic policies (including retained earnings of state owned enterprises).

4. Foreign Exchange Intervention

FX intervention is best understood as ‘off balance sheet deficit spending’ because it injects money into the economy, stimulating demand and influencing resource allocation without the appearance of direct government spending.

In China, this practice supports the export-led growth model by maintaining an undervalued currency to keep wages competitive, as it provides a form of fiscal stimulus that works to fill a demand deficiency created by their other restrictive fiscal policies.

The purchase of $US to keep the currency ‘competitive’ is itself, functionally, a fiscal, deficit spending operation that could otherwise directly or indirectly pay for imports of real goods and services, rather than ‘imports’ of $US.

5. Critiques of Intervention in FX Markets/Conventional Sterilization

Conventional foreign exchange interventions are examples of government utilizing its fiscal capacity to build FX reserves at the expense of the real macro economy. Accordingly, China has elected to increase its nominal wealth denominated in $US rather than increase its real wealth.

Thus, China is pursuing a classic export-led growth policy that for decades has been building FX reserves at the expense of its real wealth, and consequently remains a low-wage, low-consumption economy. FX interventions utilize fiscal space created by taxation and unspent income policies to accumulate foreign exchange reserves. The spending for foreign exchange reserves could otherwise be directed towards public investment, social programs, or infrastructure development, which directly benefit the domestic economy.

In summary, China’s use of sterilized interventions to build FX reserves at the expense of the real macro economy highlights a fundamental policy trade-off. While this strategy supports export-led growth and accumulate nominal wealth denominated in $US, it undermines real wealth and social equity.

Cost of China's Sterilization

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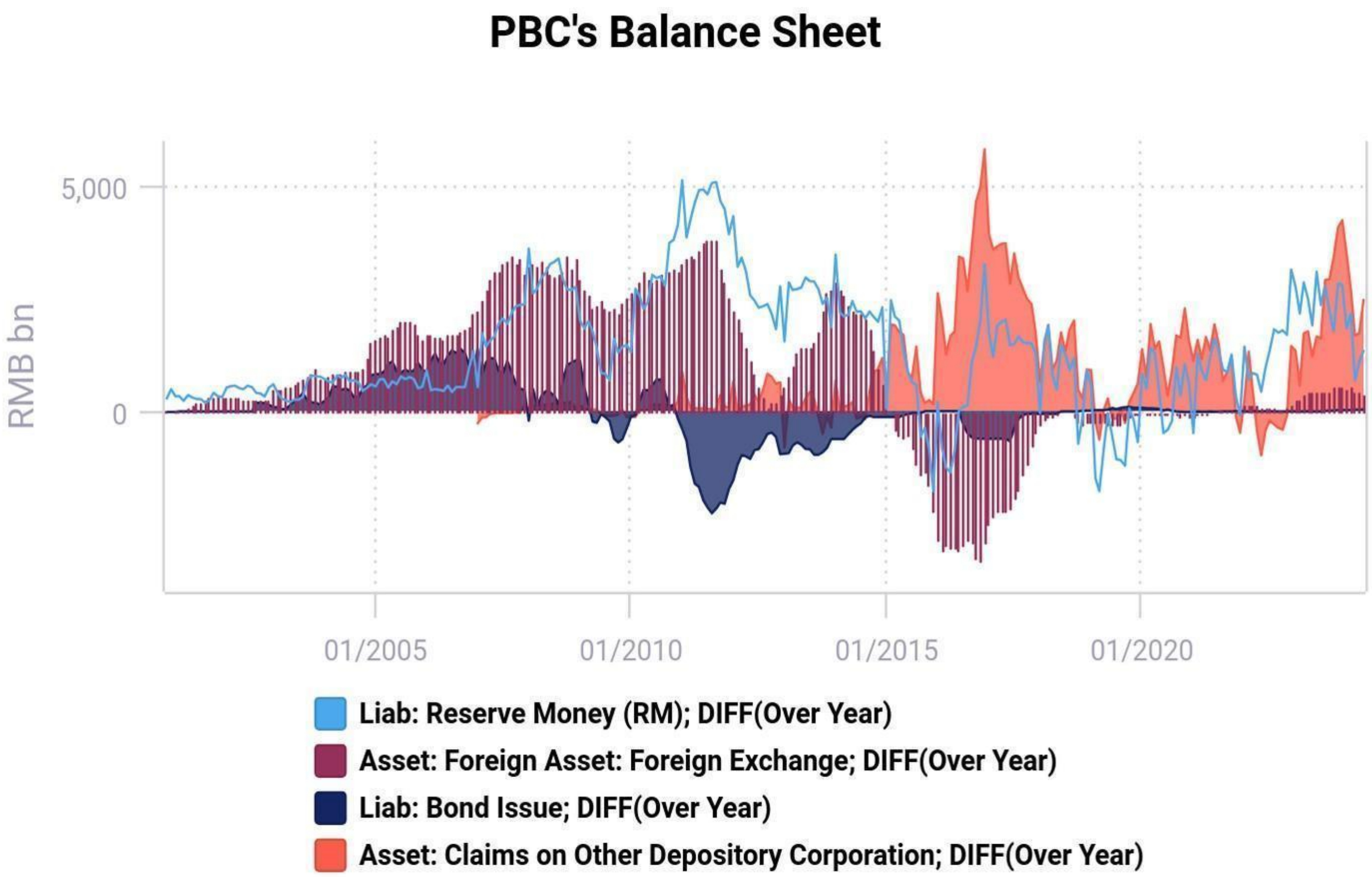
Cost of China’s Sterilization

- When a central bank aims to fix both the exchange rate and the interest rate, an automatic compensation mechanism comes into play. This mechanism, as practiced in China, is entirely self-contained and it neither affects the money supply in a lasting way nor disrupts the financial activities and asset holdings of the private sector.

- Thus, China, a country with current account and balance of payments surpluses, can peg interest rates while measures of the money supply are passively balanced with private demand.



Cost of China’s Sterilization

- We also find that while there are differences, the effectiveness of the sterilization mechanism does not depend on the specific instruments used, which includes government bonds or central bank bills in the case of China, nor the sector that ultimately holds these assets.

- For a country with a surplus, a fixed exchange rate, and an export-led growth policy, its central bank typically accumulates substantial foreign reserve assets to contain currency appreciation that would otherwise increase real wages and reduce competitiveness.

- When the compensation mechanism involves **government bonds**, the increase in yuan deposits from the CB’s purchase of foreign exchange reserves is offset by an increase in the economy’s holdings of domestic government bonds. However, this outcome is not driven by discretionary monetary policy. The central bank is merely striving to maintain stable interest rates as it sterilizes (offsets) reserves added by its purchases of foreign exchange.

- When the sterilization mechanism involves the sale of **central bank bills** instead of government bonds, it exhibits significant differences in government accounting and reporting, shifting interest expense from the treasury to the PBC, all however, of no consequence for government finance or the real economy

A Cost-sharing Strategy of China's Sterilization

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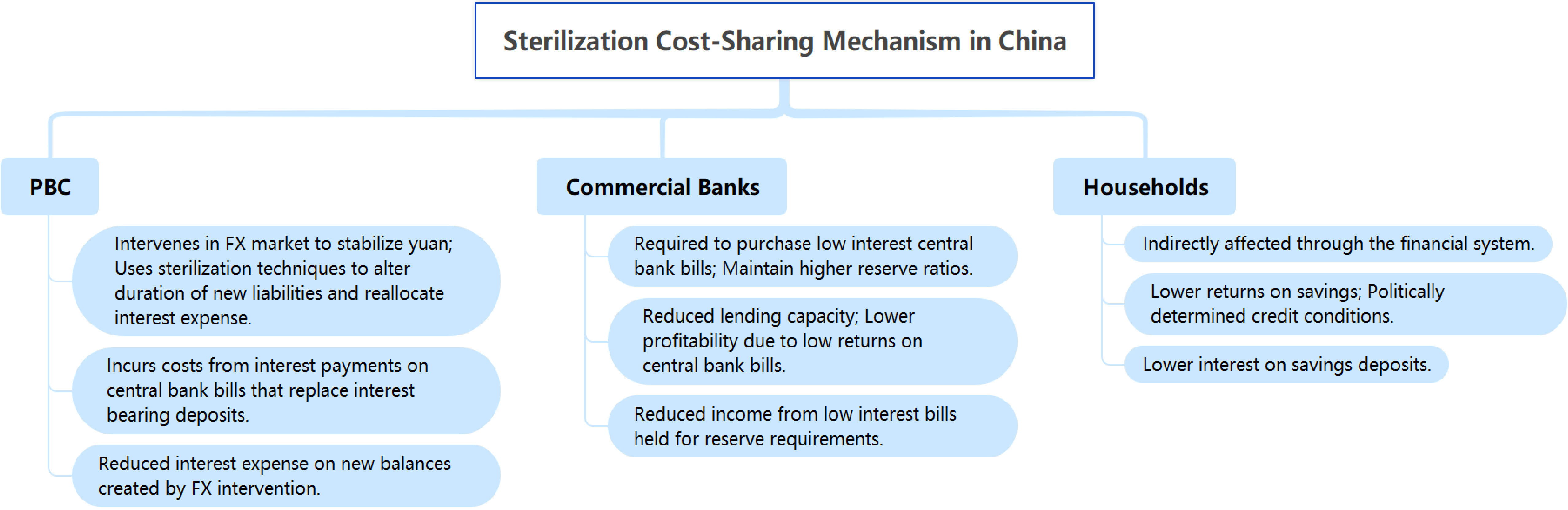
A cost-sharing strategy of China’s sterilization

To allocate interest expense from the ‘deficit spending’ for foreign exchange purchase and subsequent sterilization away from the PBC, Banks are required to absorb some of the expense by purchasing low-yield central bank bills that maintain high required reserves and Chinese households bear a portion of the burden through both a VAT tax on the nominal rate along with negative real interest rates on their deposits.



Sterilization Cost-Sharing Mechanism in China

Households

PBC interest rate policy includes capping the deposit interest rate to shift the costs associated with intervention and sterilization.

- From 2000 to 2008, China's financial system was characterized by interest rate regulation and financial repression, **with deposit rates kept artificially low**. In February 2002 the PBC fixed the maximum interest rate banks could pay on demand deposits at 0.72 percent. But inflation ticked up from –0.8 percent in 2002 to 4.8 percent in 2007 and then to 8 percent in the first quarter of 2008.
- China's recent removal of the last ceiling restriction on deposit rates in October 2015.
- China's financial repression strategy involves shifting the costs of managing foreign exchange and maintaining currency value from the central bank to commercial banks and households. **This approach helps support the country's export-driven growth model but affects the profitability of banks and the real income of households, ultimately suppressing domestic demand and consumption.**
- Financial repression can lead to the growth of **underground finance**, which operates outside the official banking system.

Conclusion

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Conclusion

- The Chinese Government has historically used the regulation of deposit and loan interest rates to redirect income from households to the corporate and government sectors, all in support of its export growth strategy.

- The reason to trade at all remains the ability to import. A trade surplus means China obtains all the imports it needs with far fewer exports than its total exports, with the additional exports instead exchanged for unspent foreign currency reserves consisting of data of uncertain value accumulating in accounts in foreign central banks, under the direct operational control of those banks.

- Maximizing unit volume of imports relative to exports is how a population maximizes its real terms of trade. And excess exports for the purpose of a trade surplus diminishes a nation's real terms of trade.

- A surplus country like China can easily achieve external balance and optimize real terms of trade and real wealth without economic disruption, and immediately elevate the real standard of living of its population. This can be done, for example, by simply increasing deficit spending on domestic investment, approximately equal to the PBC's foreign exchange expenditures that would otherwise be done to purchase foreign exchange reserves.

Thank You!

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