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The Twilight of "Chimerica"?: China and the collapse of the American model[1]

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Abstract

"Chimerica" illustrates the interactions between a Chinese model of high savings, overinvestment and export-led growth and the American model of leverage investment, credit consumption and finance-led growth. The collapse of the U.S model, linked with the unregulated derivatives market, drives China to redirect its growth toward domestic consumption, despite the strengthening of regionalisation in East Asia. The new stimulus plan, based on investment, is limited by both income disparities and the under-development of social protection. Land reform, or the collective redistribution of the remaining state assets, could stimulate domestic consumption. But the first solution deprives the local state of financial resources, and the second solution collides with the interests of the state-party system. However, stronger social movements could lead to a better income distribution. Like two faces of the same coin, credit consumption or high savings rate reflect the crisis of a global accumulation regime, tailored for a financial oligarchy in the U.S, or for a party-state oligarchy in China.

Keywords
World Financial crisis, World Economic crisis, China, Usa

JEL Codes
F02, F43, F59, R58

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The rise of China and its impact on the world economy, especially its relationship with the US, has played a major role in the present global crisis. The early years of the 21st century have seen the development of a close interdependence between the American model of finance-led growth and the Chinese model of export-led growth.

1. Finance-led growth

The progressive deregulation and globalisation of financial markets since the 1980s created an unusual situation where global savings were financing the credit consumption of one of the richest countries in the world, the USA, because of the supremacy of the US dollar. As the winner of the Cold war, the USA set the tune with its low inflation and easy money policy, which allowed financial operators in their quest for profit maximisation to create asset bubbles, i.e. the internet bubble of the 1998-2001, the housing bubble between 2001 and 2007, and the primary commodity bubble in 2007-2008, which created another surge of global inflationary trends. The collapse of this neo-capitalist model in September 2008 also signals the transformation of what Moritz Schularick at Berlin's Free University and Niall Ferguson at Harvard University have called "Chimerica", to illustrate the symbiotic relationship between the two giants which were responsible for more than half of the world's economic growth in the years 2002 to 2008. "One half did the saving and the other half did the spending", as China's accumulated international reserves (estimated at $2 trillion) served to finance the U.S current account deficit as well as keeping Chinese exports affordable. There are two faces of the same coin: from the end of 2001, which marked the access of China to the WTO to 2008, Americans' personal accumulated debts have exceeded the sum of their debts in the previous 40 years, US savings having declined from more than 5 percent to less than zero of gross national income, while Chinese savings rose from less than 30 percent to more than 45 percent.

This relationship was of course not limited to these two countries as the rest of Asia was also export-driven, trade deficits and household indebtedness had also increased in Europe, and energy exporters were also recycling their petrodollars in other western countries, but as Niall Ferguson rightly puts it "Chimerica was the real engine of the world economy".[2] Thus, as the roots of the present crisis are inseparable from its consequences and the mutations it may generate, it is useful to analyze them from a "Chimerica" perspective.

First of all, we may underline that the market booms of 1998 to 2008 were based on rational expectations. The digital revolution,

[2] www.Niallferguson.org «Geopolitical consequences of the credit Crunch», 30/09/08.

comparable in its impact, to the invention of printing, explains the Internet boom. Oil prices have risen more than five-fold between 2000 and 2007, as strong demand from China and India, accompanied by the depreciation of the US dollar pushed commodity exporters to raise their prices. But as Thomas Palley has shown, "there is a documented change in the character of oil trading, with speculators (i.e financial institutions and hedge funds) now accounting for 70 per cent of trades, up from 37 per cent seven years ago"[3]. Thus, the accumulation of pro-cyclical risks, based on the easily obtainable banking credit[4], led to irrational expectations. In this respect, the collective culpability of central bankers and fiscal authorities, especially in the USA and Europe, is overwhelming, since they voluntarily let develop the highest range of financial globalisation with minimum national (not to mention international) regulation. Focusing on the prices of goods and services, they neglected the follow-ups of asset inflation (real-estate and stocks), and of financial innovations, which were supposed to reduce risk, but which were also "designed to circumvent regulation or taxation" [5], and finally spread risk to unprecedented levels.

The market for derivatives or credit risk transfers (CRTs), which has grown more than a thousand times since the beginning of the 1980s, to insure operators against commodity prices, interest rates or currency exchange fluctuations, was extended to credit default swaps (CDSs). A credit default swap is a contract under which the seller, for a fee, agrees to make a payment to the protection buyer if the referenced security, usually some kind of bond, experiences various "credit events", such as bond issuer bankruptcy, default or reorganisation. In 2000, President Clinton signed the Commodities Futures Modernisation Act exempting certain derivative transactions on commodities and swap agreements, including CDSs, from regulation. As CDSs were not subject to state laws or control, the way was cleared for the growth of a market where deals were privately made between two parties, without standards for the solvency of the parties. "The buyer does not know how much risk the seller is taking on. And there are no requirements for the seller to hold reserves of capital against the risks it is taking on selling swaps."[6] CDSs were massively used to insure against mortgage default risks and

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3 «Speculators at the Pumps», www.project-syndicate.org , 2008.

4 Robert Boyer, Mario Dehove et Dominique Plihon, *Les crises financières, Rapport au Conseil d'Analyse Economique*, La Documentation Française, 2004, p. 112.

5 Hannes Androsch, Former Finance Minister and Vice-Chancellor of Austria, «Europe's Financial Vulnerability», www.project-syndicate.org ; The fact that regulators are always running behind private sector innovation, does not explain the neglect of asset inflation, which had been underlined by economists such as Patrick Artus: *Les incendiaires: Les banques centrales dépassées par la globalisation*, Paris, Perrin, 2007.

6 Superintendant Eric Dinallo, New York State Insurance Department, Testimony to the US House of Representatives Hearing to Review the Role of Credit Derivatives in the U.S Economy, Washington, November 20, 2008.

created the illusion of a low-risk environment _accepted by the regulators of the Federal Reserve.[7]
This unregulated market, whose notional value stood at $54.6 trillion at midyear 2008, was a principal cause of the near collapse of the U.S financial system, as CDSs played a major role in AIG's, Bear Stearns' and Lehman's financial problems. Lehman Bros. was one of the largest over the counter (OTC) derivative dealers. AIG Financial Products, a subsidiary of AIG, active in the derivative market, did not routinely hold reserves of capital, or collateral for the risks it was taking. It issued transactions covering more than $440 billion in bonds with obligations that it could not cover. The head of AIG Financial Products, M. Joseph Cassano, apparently made $280 million in the eight years up to 2008, and after leaving the company, in February 2008, got a consultancy contract with AIG for $1 million a month.[8] The Bank of International Settlements, noted as early as 2002, that this market had given rise to a concentration of risk in financial operators less capitalised and less governed by regulation[9], such as the hedge funds, two-thirds of which are located in offshore locations, with a predilection for the Cayman Islands, but which are mostly funded (86 per cent) in the US [10].
Hedge funds, with their progressive institutionalisation after 2000, have played a key role in financial innovation and risk-transfer techniques, especially securitisation, which is at the origin of the sub-prime crisis. They were responsible for 58 per cent of the US credit derivatives market by volume and 45 per cent of its emerging markets bonds in 2005. They represented 40 per cent and 50 per cent respectively of the New York stock exchange and London stock exchange transactions on the eve of the 2008 crisis. Apart from hedge funds, the new surge of private equity funds, "ranging from start-up venture finance to leverage buyouts to vulture or distressed asset funds", according to the IMF, increased the use of risk-taking and leverage to unprecedented levels, with concrete implications for the operation of restructured or acquired firms. Cross-border mergers and acquisitions by private-equity firms and hedge funds reached more than $100 billion per annum after 2003, and represented more than a quarter, on average, of global foreign direct investment flows, between 2003 and 2007 [11]. The Carlyle

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7 See Martin Neil Baily, Robert E. Litan and Matthew Johnson, *The Origins of the Financial Crisis*, Paper 3, November 2008, The Brookings Institution, Washington, 47 p. In May 2006, Alan Greenspan called the CDS «the most important instrument in finance», adding «What CDS did is lay off all the risks of highly leverage institutions…on stable American and international institutions.» Contrary to Greenspan's comments, the «biggest source of recent growth of the CDS market was not among stable institutions, but rather among highly leveraged institutions like hedge funds and investment banks»(p.33).
8 Idem, Testimony of Henry T.C Hu, University of Texas School of Law, October 13, 2008.
9 Bank of International Settlements, *Annual Report* 2002, Bâle.
10 IMF, *Global Financial Stability Report,* April 2007.
11 IMF, *Global Financial Stability Report*, April 2007, p. 54-57, for the weight of hedge funds in the U.S. For their weight in stock-markets transactions, see Michel Agglietta in Patrick Artus *et al.*, *La crise des subprimes,*

Capital Corporation, a subsidiary of the US based Carlyle Group, particularly active in the Defence industry contracts in Iraq, was leveraged up to 32 times, or 1 dollar of capital for 32 dollars of liabilities before adverse market developments led to its liquidation in march 2008, with a $16 billion debt.[12]

Far from effective supervision, the growing impact of offshore financial centres in all continents, which represented half of the activity of international banks and a third of the total of outward foreign direct investments, have also strong fiscal implications, since they cost $350 billion, 10 per cent of the fiscal receipts in the US, and would represent from 1.7 to 3 per cent of GDP in France, or the equivalent of the annual fiscal deficit[13]. As wealthy individuals in the developing world evade more than $100 billion worth of taxes in their home countries each year[14], these fiscal issues are a perfect reflection of the current political order.

The crisis which extended to the whole world with the fall of the Lehman Brothers investment bank, in September 2008, prompted exceptional bail-out plans in the US and Europe. Rising deficits mobilised governments in the US and Europe to support banks and insurance companies. This assistance which may represent 12 per cent of GDP in the US and 8 per cent in United Kingdom for 2009, raises again the question of this fiscal evasion which has become systemic, creating a kind of "illegal legality", and exacerbating the speculative tendencies responsible for the local and regional financial crises since the end of the Cold war [15]. As Jeffrey Sachs underlined, "the boom in housing and stock market prices increased U.S households net wealth by around $18 trillion during 1996-2006. The rise in consumption based on this wealth", which fed global growth, notably in China, "in turn raised house prices further, convincing households and lenders to ratchet up the bubble another notch".[16]

Jacques Sapir has clearly shown that the gains of growth due to the "wealth effect" of the mortgage credit (under the form of the *Home Equity Extraction*) explains the growth performance of the US economy between 2002 and 2007. Without the *Home Equity Extraction* contribution, US growth would have been comparable to the Eurozone and even less important.[17]

Report of the CAE, La Documentation Française, 2008, and Hubert Reynier, Director of International Affairs Regulation, at the French « Autorité des Marchés Financiers », in *Le Monde Economie*, II, 3/10/2006. For the statistics on M&A, *World Investment Report*, 2008, UNCTAD, p.6. In 2006, hedge funds drove nearly 60 % of CDS trading volume (see Martin Neil Baily and others, paper cited, p.33)

12 Hannes Androsch, idem note 2.

13 U.S General Accountability Office; $350 billion represents not only 10 % of the fiscal receipts but 80 % of the US fiscal deficit in 2008, estimated at $438 billion; Christian Chavagneux, « Le boom de la finance offshore », *Alternatives économiques,* n° 75, p.44-45.

14 Dani Rodrick, « Let Developing Nations Rule », Project Syndicate, December 2008.

15 Guilhem Fabre, *Criminal Prosperity : Drug trafficking, Money Laundering and Financial Crises after the Cold War*, RoutledgeCurzon, 2003.

16 Jeffrey Sachs, «Boom, Bust and Recovery in the World Economy», www. project-syndicate.org

17 Jacques Sapir, (EHESS, Paris), «Les sources internationales de la crise actuelle», 2008. Since the 1980s, Home equity loans were advertised by banks as a way for homeowners to «extract wealth» from their home in order to finance credit consumption. Greenspan and Kennedy (Discussion Paper n°2007-20,

In short, the American model of finance-led growth had succeeded in resolving by way of deregulation and mathematical formulations one of the issues which dominated the last ten years after the Asian crisis of 1997-1998: how to give to the one percent richest people, particularly active in the financial sphere, rent-seeking incomes comparable to the beginning of the 20th century, while lending to the poor and letting them realise their dream of security by buying their homes. Finance-led growth, built on an easy availability of credit, led to a high concentration of wealth and income gains in the hands of a few: 40 per cent of American corporate profits in 2006 went to the financial sector, while the share of income going to the top 1 per cent of the population doubled[18]. Behind all the magic of this financial alchemy, the "shadow banking system" created according to Nouriel Roubini "a housing bubble, a mortgage bubble, an equity bubble, a bond bubble, a credit bubble, a commodity bubble, a private equity bubble, and a hedge fund bubble, which are all now bursting simultaneously."[19]

Whatever the political consequences of this systemic crisis, which will certainly come with the socialisation of losses by the public authorities, it is clear that it will redesign the post Cold war geo-economic balance, perhaps in favour of Europe, but certainly in favour of East Asia, mainly China. Despite the likelihood of a lasting recession in Britain, Ireland and Spain, due to the size of their housing recessions, the State's redistributive tradition in Europe, which was being more and more discredited in Brussels as it is on the other side of the Atlantic, as the main symptom of euro-sclerosis, is better suited to face the current economic crisis. Moreover, the existence of the euro, in a zone whose intra-regional trade represents 31 per cent of global trade, and whose interregional trade, mainly directed toward Asia and North America, represents another 20 per cent of global trade, will certainly raise its global status as a reserve currency, despite the lack of political integration in Europe. Official reserves held in Euro are 27 per cent of 2008 world total, up from 18 per cent a decade ago, while the US dollar share has fallen to 63 per cent from 71 per cent in the same period.[20]

Board of Governors of the Federal Reserve System) estimate that homeowners extracted $747 billion in net equity from their homes at the peak of the housing boom in 2005, up from $229.6 billion in 2000 and $74.2 billion in 1991 (cited in Martin Neil Baily and others, *The Origins of the Financial Crisis*, p.17)

18 Lawrence Summers, *Financial Times*, 26/10/2008. In 2006 alone, the value-added of the US parent Companies in the Finance (except depository institutions) and insurance sectors increased by 43.8 percent. (Raymond J. Mataloni Jr, « US Multinational Companies, Operations in 2006 », *Survey of Current Business*, November 2008, p.31).

19 Nouriel Roubini « From Financial Meltdown to Global Depression ? », www.project-syndicate.org

20 Adam Chen, *South China Morning Post*, Jan 05,2009.

2. Versus export-led growth

But the rise of the economic power of East Asia, and especially China, will be the main consequence of this global crisis for a few reasons. First of all, China, with 6 per cent of the global GDP, and Japan, with 10 per cent, are two of the four large economies having huge export surpluses, along with Germany and Saudi Arabia. China and Japan are in a position to lend to other countries, to demand a bigger share of decision-making in international organisations such as the IMF, or to create their own Asian Monetary Fund, with an 80 billion US dollars reserve, as the idea, first launched during the Asian crisis of 1997-1998, has been revived during the fall of 2008. They are also in a position to diversify their portfolio with the fall of commodity and asset prices, which is offering new business opportunities in strategic sectors corresponding to their long-term priorities such as energy, minerals, transport, environment and health.

China has bypassed Japan for the first time to become the largest holder of US Treasury securities, with $652 billion in October 2008, compared with Japan's $573bn dollars. China's State Administration of Foreign Exchange (SAFE) and commercial banks held $370bn in debt issued by then struggling US mortgage giants Fannie Mae and Freddie Mac[21]. With the decrease of interest rates, it will be less profitable or even loss making for China, to invest in US treasury bonds, given the gap between their low-yield and the 20 percent appreciation of the Renminbi to the US dollar since 2005. But it will be more lucrative to buy back the Chinese enterprises' shares held by the US, and to diversify its business portfolio. China Investment Corp, the sovereign wealth fund, has incurred large unrealized losses, of the order of several billion US dollars, on its stakes in US private equity firms Blackstone Group and Wall Street Bank, Morgan Stanley. It does not intend to take the steps of Japanese banks and securities firms, which are acquiring stakes in beleaguered US financial institutions. But firms such as KBC, AIG and HSBC Holdings are competing with 30 other financial institutions for a share of China's $263 billion asset management industry. More and more countries such as Canada, which owns important oil reserves, welcome Chinese investments[22]. However, the securing of adequate returns on the $ 2 trillion of foreign currency reserves has become a daunting task for China as the USA has become its main banker, and there are plans for the Yuan to join other international currencies to be used for foreign exchange reserves. The Chinese government has decided to allow in the next two years the Renminbi to be used for settlements with Hongkong and Macao, and has signed settlement agreements with Russia, Mongolia, and other ASEAN countries, to use the

[21] *South China Morning Post website,* Hongkong, 20/11/08.

[22] Shanghaï, Reuters, 5/11/2008 ; *Le Figaro*, 21/11/08.

Renminbi in bilateral trade. This progressive regional convertibility is the first step to realize the full convertibility of the currency, in order to counterbalance the likely depreciation of the US dollar in the coming years, which would be the more convenient way for the US government to decrease its foreign debt.[23]

Secondly, they are signs that the economic integration of East Asia, which was mainly designed to increase the export competitiveness of the region, may turn out to be more self-centred, and thus stronger, as in the case of Europe. The economic regionalisation of East Asia was the unexpected result of the G 7 Plaza Agreement, in 1985, whereby the forced revaluation of the yen, and then the Korean won and the Taiwan dollar, was seen as a appropriate monetary response to the trade surpluses of these countries vis-à-vis the US and European markets. Facing strong export competitiveness falls, Japan and the four dragons (South Korea, Taiwan, Hong Kong and Singapore) delocalised massively towards Southeast Asia and China, which were then opening up, the manufacturing of their labour-intensive and low-added value products (toys, clothing and consumer electronics), while moving into capital-intensive and higher added-value sectors (automobile, ICTs, finance etc.). This process accelerated after 1994, with the de-facto fixed exchange rate of the Renminbi to the US dollar, and the strong non-inflationary growth of China, which attracted MNCs. China became not only the axis of the intra-Asian division of labour, but also the world's factory, producing practically everything, except big aircraft. It survived the Asian crisis, which destabilised for a certain period of time Southeast Asia, by adjusting its internal economy through cost cutting, the transfer of State social welfare to households, and by launching a huge program of highway construction, which now covers the entire nation.

With its accession to the WTO in 2001, a quarter of China's growth was generated by exports and investments linked to exports. But this proportion, based on national figures, is much more important, if we take into account the concentration of most of foreign direct investment and exports in the high growth and relatively rich coastal regions, and its effects on the construction industry, services, and on inland regions, through commodities demand, outsourcing in small and medium firms, employment and labour migration. If we add that underground lending, mainly based in coastal regions, is equivalent to almost a third of the loans extended through the banking system[24], we may

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23 Wu Xiaoling, former vice-governor of the central bank, in Xinhua, 25/10/2008. On the likelyhood of an US dollar depreciation to decrease the US foreign debt, see Yu Yongding, Director of the Institute of World Economics and Politics, Chinese Academy of Social Sciences, in *Caijing* (Finance Magazine), 17/12/2008.

24 Nicholas R. Lardy, « Financial Repression in China », Peterson Institute of International Economics, September 2008, according to a study by Li Jianzhun, Capital University of Finance and Economics,

reasonably estimate that during the early years of the 2000s at least 40 percent of China's growth was directly or indirectly dependent on external demand.

From 2001 to 2007, Chinese exports, growing at an unprecedented yearly average of 28 per cent, more than quadrupled while its imports more than tripled. About 45 per cent of its trade receipts came from Asia in 2007, while Europe and North America each received 21 per cent of China's exports. This dynamic of regional integration is even stronger in the case of Japan. More than half of its exports and nearly half of its imports are made with Asian countries, and China became its main supplier in the early 2000s, with more than 20 per cent of its market share.[25] So, despite an expected sharp decline of Chinese exports to Europe, North America, and to the new emerging markets of commodity exporters that it gained in the early 2000s, such as South America ($39 billion of exports in 2007), Africa ($37 billion), the Middle East ($44 billion) or the CIS ($48 billion), which are suffering from the fall of commodity prices, China has the scope to keep or develop its export status of low-cost products in Asia, especially in Japan, South Korea, Taiwan, Indonesia, Thailand and India, and to appear more and more as an importer's market for equipment, transport goods and other technology intensive products from the US and Europe.

Since the globalisation of the crisis in September 2008, China has renewed and strengthened relations with the heavyweights of the Asian region, such as Japan, and South Korea, and to address liquidity problems in South Korea, which has seen its currency plunge, as foreign investors have fled from the country's financial markets amid the worldwide credit crunch[26]. Following an agreement between the three central banks, Seoul can obtain a combined $46 billion from Tokyo and Beijing in case of necessity. An Asian monetary fund with an $80 billion reserve available to fight a regional financial crisis is de facto taking shape. What is more, China has taken decisive steps towards Taiwan, with the historic agreement of November 2008, expanding cross-straits air services to more than 20 Chinese towns, allowing direct shipping and postal links, as well as setting-up a reporting mechanism on food safety, to enforce its quality control after the melamine scandal. This agreement represents a "giant step in cross-strait relations" according to Taiwanese business leaders who are eager to enhance financial cooperation with China and to set-up a mutual mechanism to

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« Irregular Credit Completely Offsets the Retrenchment Gap », *China Economic Management Report*, July 6, 2008. As for the strong bias in favour of the coastal regions, since the opening up of China in 1984, let us remember that in 2005, with 43 % of the population, they were responsible for 62 % of GDP, 86 % of FDI and 93 % of exports.

25 WTO, *World Trade Report 2008*. If we include re-exports through Hongkong, the real breakdown of China's exports are in 2007, 27 % for Europe, 22 % for the U.S, 9 % for Japan, 21,6 % for Hongkong, Korea and Taïwan and 3,9 % for CIS-Ukraine, cf. *Missions économiques, MINEFI*, 17/03/08.

26 Kyodo News Service, Tokyo, 13/12/08; Chungang Ilbo, Seoul, 13/12/08.

manage the strong foreign exchange reserves of the mainland, Taiwan and Hong Kong. On the trade field, there is an ample range for further cooperation between the two complementary economies, since 40 per cent of Taiwan exports are shipped to China, especially under the form of processing trade for the ICTs, while China represents only 12 per cent of Taiwan imports. Two-way trade was $130 billion in 2007, although the traders had to go through a third territory, usually Hong Kong. The same restrictions were limiting Taiwanese investment in the mainland until the new President of Taiwan, Ma Ying-jeou lifted most of these restrictions during the summer of 2008. Around 80 per cent of Taiwan's FDI is directed to China, especially in the ICT sector (computers, telecom and audio-video equipment), which has become the driving force of Chinese exports in the early 2000s. Since the late 1980s, Taiwanese companies have pumped at least $100 billion in China, about a fifth of the realized FDI stock. Four hundred thousand Taiwanese are officially working in China, mainly in the Shanghai (Kunshan district), Fujian and Guangdong regions, but most observers estimate they may be at least twice that number. In 2008, Taiwan-based large banks and stocks and securities firms have opened representative offices in Beijing, Shanghai, Kunshan and Shenzhen and hope to engage quickly in meaningful business opportunities "to overcome the negative effects of the ongoing financial tumult, which is not going to end anytime soon."[27]

In short, the general concentration on China of Taiwanese businesses, eager to overcome the reduction in their export markets, may lead to the emergence of a real common market of Greater China (China, Hong Kong and Taiwan), which will have tremendous consequences on the global economic order, as well as delicate consequences on China's internal political system, which has always been based on a monopolistic approach.

3. China and the global crisis

This does not mean that China will not suffer from the global crisis. First of all, the general climate of increased living standards, similar to the one prevailing on the other side of the Pacific, began to deteriorate in October 2007, two months after the subprime crisis, with the continuous fall of the Chinese stock market, by almost two third in the following year. This has reduced the savings of the 60 million of the middle class shareholders, who tended to favour investments funds and stocks instead of low-yield bank deposits in an inflationary context. And the real estate boom, which represented around 15 per cent of overall investment and an important part of local authorities revenues, began to decline, after exceptional gains in 2007. This weakness in the building industry in turn caused a slowdown in

[27] Central News Agency Website, Taibei, 3,5,6/11/08.

upstream industries and services, such as steel, cement, electricity, and freight.[28]

Secondly, falling demand for exports, higher material costs, stricter labour laws adopted in 2008, and a strong appreciation of 23 per cent of the Renminbi to the Euro between July and October 2008 have combined to reduce China's growth in the last quarter of 2008. The greatest impact was on the labour-intensive, small and medium sized export-oriented enterprises, situated in the coastal areas, and vulnerable to market changes. These are major employers, absorbing 70 per cent of the 20 million new jobs every year.[29] In the first half of 2008, 67,000 such companies, each with an annual turnover exceeding 5 million Yuan ($735,000) closed and laid off more than 20 million employees, according to the National Development and Reform Commission[30]. Two-thirds of the toy exporters, mainly small-sized businesses situated in Guangdong province, shut down in the first nine months of 2008, according to Chinese customs officials. And this is just a beginning, since the Federation of Hong Kong Industries has warned that a quarter of the 70,000 Hong Kong owned firms in Southern China, which employ 10 million people, may go bust by February 2009. The flows of migrant workers from inland provinces to coastal areas, is reversing. Statistics from the Ministry of Human Resources and Social Security showed 10 million of China's total 130 million migrant workers went back jobless to their rural place of origin in 2008[31].

But these developments, which have strong social implications in terms of employment, concern labour-intensive exports and low added-value industries, mainly based in Guangdong or in other coastal provinces (toys, shoes, clothing, textiles, accessories, furniture etc.) which were already migrating to Cambodia, Vietnam or Bangladesh in search of lower wages. Things are less dramatic for the higher added-value sectors, such as machinery, equipment and ITC, which have been slowing with the reduction of external demand since the mid 2008. As during the Asian crisis of 1997-1998, national authorities will openly use this opportunity to restructure the economy, this time in favour of higher added value and technology intensive sectors, and to organise the return of migrant workers to their original provinces in order to participate in the development of the poorest regions. [32]

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28 World Bank, Beijing Office, *Quarterly Update*, December 2008.

29 *Xinhua*, Beijing, 1/11/08.

30 *Xinhua*, 13/12/08. That figure does not include smaller firms, for which there are no available statistics.

31 *Xinhua*, 3/01/09 ; *Xinhua*, 20,21/11/08 ; *Nanfang ribao*, Guangzhou, 18//11/08.

32 *Bulletin économique Chine*, Missions économiques, Pékin, novembre 2008, p.2 ; *Xinhua*, 18/12/08.

4. From export-led growth to domestic consumption-led growth? (Or "where have all the savings gone?")

In the wake of the global financial crisis, the Chinese leadership at last realised that it could no longer rely on exports as the engine of economic growth, and that it was urgently needed, and not only at the level of rhetoric, to boost domestic demand. This necessity, underlined long ago, became more pressing as the export led growth strategy was undermining the balance of Chimerica, and more recently Sino-European trade[33]. As half of this trade is linked to FDI and outsourcing by foreign corporations in the quest for low labour costs, Chinese export competitiveness has long been based on the capacity to discipline its workers, especially migrants, by prohibiting workers unions, and violating routinely the international agreements on civil rights it has agreed to under the UN. As the US and the European businesses, not to speak of the developed Asian ones, were largely benefiting from this situation, the USA and Europe never really raised this issue, which could have had strong repercussions on a more equal income distribution in China. They preferred to focus on the question of exchange rates, and accused China of "monetary dumping", which was just the result of severe restrictions on workers salaries and workers rights. As Thomas Palley has underlined, "unions have historically been especially important since they engage in decentralized wage bargaining that tie wages to firms' productivity", they are in a position to "expand markets in developing countries, which means tackling income inequality and getting income into the rights hands."[34]

The Chinese leadership has chosen rural policy as the main leverage of domestic demand. Rural consumption represents about a third of total consumption, although 60 percent of the population still live in the countryside. On October 12, 2008, on the thirtieth anniversary of the historic plenum, which launched Chinese reform in 1978, the Chinese Communist Party Central Committee adopted a new reform extending farmers' leases on land from the current 30-year term to an open-ended one, and protecting land-use rights, including the right of land transfer. As land works as a rural safety-net for 250 million farm

[33] Guilhem Fabre, « Integration Versus Fragmentation ?: A General Framework for Post Deng Xiaoping Economic Policy », London, Imperial College, September 1994 ; « Une politique économique alternative pour l'après Deng Xiaoping », Cahiers du Centre Chine, EHESS, 1996 ; Nicolas Lardy, « China : Toward a Consumption-Driven Growth Path », Institute of International Economics, Washington, October 2006.

[34] Thomas I. Palley, ex- Chief Economist with the US-China Economic and Security Review Commission, « Humpty Dumpty and Global Financial Imbalances », Project Syndicate, 2007. As China's huge trade surplus with the US is more the reflection of structural issues than the under appreciation of the China's currency, it can't be addressed by a change in relative prices. Justin Lin, from the World Bank, underlined, « If the yuan were allowed to appreciate as much as 40 %...it could increase the price of imports to the US and reduce Chinese exports. That would put even more of a dent in the struggling world economy ». (Conference organized by Brooking Institution and *Caijing* (Finance) Magazine, *Wall Street Journal*, January 13, 2009.)

households, this new policy, which may allow farmers to use their land as collateral to access credit, or to rent it when they migrate, may develop rural incomes, narrow the gap between the rural and the urban sector, stimulate urbanisation on a sound basis, and raise productivity growth. In recent years, much farmland had been abandoned or under-cultivated as 130 million migrants flocked to the cities to work in factories or construction sites. A report from Qinghua University revealed that at least 120 million farmers needed loans but only 60 per cent of them were able to obtain financing.[35] The recent injection of 130 billion Yuan ($19 billion) in the Agricultural Bank of China, China's third largest Bank, enables it to sell shares to strategic investors and the general public, with the aim of developing an effective agricultural lending network, through its 24,000 outlets nationwide.[36]

The new rural land reform was launched as early as 2006 by a four-year joint project of the United Nations Development Program and the Chinese government, covering eight pilot provinces[37]. Throughout Chinese history, land has always been a strategic resource, as it was the main factor of production in a densely populated territory. Today the economic potential of the transfer of land use is considerable, as land assets value are greater than industrial assets: 119,000 state-owned enterprises have a book value of around $ 4 trillion while state-owned land is valued at more than $ 7 trillion[38]. Official statistics show that revenue from the transfer of land amounted in 2005 to 550.5 billion Yuan ($68.8 billion), accounting for one third of the revenue of local governments, and 3 per cent of GDP. But as "two thirds of land is transferred far from public scrutiny" [39], the potential value of such deals may be at least twice that number ($137 billion) or 6 per cent of GDP, a figure that may be compared to the share of agriculture in GDP at the same time, around 15 per cent.

Thus the importance of land requisition or of this grey market, which has developed in a context of quick urbanisation, is considerable in terms of resource transfer and rent seeking. They are the source of the millions of complaints and the hundreds of violent incidents, which have erupted in the period 2000 to 2008 around land requisition and housing demolition and resettlement, and were the top source of social conflict in China, opposing land grabbers (real estate developers) in collusion with local government officials in opposition to peasants or local residents. Official figures show that more than 40 million farmers had their farmland partially or wholly used for non-farming purposes, while only six million of them, who became landless in land

[35] *Xinhua*, 30/12/07.
[36] *Xinhua*, 6/11/08.
[37] *Xinhua*, 20/12/06.
[38] Chen Zhiwu, Yale School of Management, *South China Morning Post*, Hongkong, 29/11/2008.
[39] *Xinhua*, 22/11/06.

requisitions, have been covered by the basic living or old age security programmes[40]. Other estimates are much higher: between 80 and 100 million of rural residents, out of a total of 730 million, are landless or do not have access to enough land for subsistence[41]. The real estate boom and land rush in a context of quick urbanisation, contributed significantly to social polarisation, as 10 per cent of the richest Chinese families now own more than 40 per cent of total wealth, while the poorest 10 per cent share less than 2 per cent.[42] According to the newspaper columnist Yao Zhongqiu, "land acquisition, infrastructure and real estate development contribute profits as well as astonishing economic growth, to bolster the political career of officials. A government's social responsibilities are relegated to a minor place when compared to making profit."[43]

The economic potential of the transfer of land use which may raise peasants' income and productivity through a better allocation of land, largely depends on the local authorities, which, in the absence of any independent judiciary system, are responsible for implementing laws and policies, fixing the value of land, and providing appropriate documentation ensuring the rights of peasants on a piece of land. That is apparently the case for only half of the peasants[44]. And the paradox of this policy of non-compliance is that it will deprive the local governments of a part of their land revenues, which represents at least a third of their income, not to mention the hidden commissions they used to receive for commercial development.[45]

The same logic applies to the stimulus plan, which has been announced with great fanfare before the November 2008 G 20 summit in Washington. On this four trillion Yuan two years plan ($585.76 billion), 45 per cent will go on the construction of 17,000 km of new railways lines, and to new highways, airports and power grids, 25 per cent will go to reconstruction following the snowstorms and the Sichuan earthquake of 2008, 10 per cent has been earmarked for rural development and infrastructure, while the environment and housing will amount to roughly 7 to 8 per cent each. The remaining 5 per cent includes spending on health, education and innovation. This stimulus package is expected to improve the infrastructure of the country and to create employment, especially for railway construction, and may create 6 million new jobs[46]. However, most beneficiaries of the infrastructure spending are state-owned enterprises rather than

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40 *Xinhua*, 17/11/06 ; 29/12/06. More than 7 million hectares, nearly 9 percent of the country's total farmland, have been taken over for industrial and other purposes, according to official data (*South China Morning Post*, 6/01/09).

41 *Wall Street Journal*, 2/12/2008.

42 *Xinhua*, 7/01/07.

43 Cited by Fiona Tam, *South China Morning Post*, January 06/09.

44 *International Herald Tribune*, 12/10/2008.

45 Contribution from the property industry account for a quarter of Beijing's tax revenue, according to *Xinhua*, 13/01/09.

46 *South China Morning Post*, Hongkong, 28/11/08.

small and medium sized enterprises that contribute to the biggest share of industrial output and more than 70 per cent of jobs[47]. The progressive acceptance of the informal banking market, which has been tried-out in Wenzhou, Zhejiang, may help these labour-intensive companies, if the authorities carefully control the liabilities of these financial actors and the interest they can charge[48]. As for the stimulus spending, the central government will apparently just provide less than 30 per cent of it (1.180 trillion Yuan or $173 billion), while local governments and state companies will supply the rest. Provincial authorities have begun to compete to get a share of the pie by drawing-up investment plans that total 10 trillion Yuan ($1.5 trillion), the largest being that of Yunnan province which has drawn-up an annual investment plan of 600 billion Yuan over the next five years, more than its actual GDP! Behind such unrealistic expectations, there are open worries about corruption that may develop with the stimulus package, and ritual calls for strict control of local cadres, who were responsible for large-scale mass incidents in 2008.[49]

This plan, is forecasted to contribute over 4 percentage points to GDP growth in 2009, and about 1.5 percentage points more than in 2007[50]. Other measures such as the increase in tax rebates for labour-intensive exports, or the successive large cuts in the interest-rates and reserve requirement ratios by the Peoples Bank of China, will improve the growth record in 2009 and 2010, but they do not provide an answer to the structural problems of the Chinese economy. While the central as well as local authorities are focused on strong investment to create economic growth and social mobility in the context of urbanisation and expansion of export markets, household consumption has continued to fall to a low level of 35.3 per cent of GDP in 2007. This low propensity to spend can be viewed in conjunction with the high savings rate, which represents 25 per cent of disposable income and 45 per cent of GDP, and which feeds the trend for overinvestment through the state banking system. The restructuring of the state sector in the 1990s under Zhu Rongji, has led to the progressive transfer of health, education, welfare, pensions and housing costs to the urban households, whose motivation to save has become precautionary in nature i.e. for retirement, illness, education of children, and unemployment. Health expenses are the highest of these costs.

Hu Angang, an economist from Qinghua University, has estimated the extent of what he calls "health poverty". Between 1995 and 2005, the number of people suffering from illness increased by 16.5 per cent, while those without social medical

47 *South China Morning Post*, 10/12/08.
48 *Wall Street Journal*, November 24, 2008.
49 *Financial Times*, 15/12/08 ; Xinhua, 29/11/2008 ; Zhong Zhuwen, Renmin ribao website, 28/11/08.
50 *China Quarterly Update*, World Bank Office, Beijing, December 2008.

insurance coverage rose from 900 million to one billion, which is more than 80 per cent of the population[51]. In 2004, a think-tank of China's Ministry of Health established that AIDS and Hepatitis B Infection caused by unsafe injections had caused 390,000 premature deaths and 6.89 million Disability Adjustment Life Year Losses. Statistics showed that 30 per cent of immune injections and 50 per cent of therapeutic ones were unsafe, and in western rural areas, more than 70 per cent of disposable syringes for single use were reused[52]. Of China's total medical fees, the government's input only accounted for 15 per cent and patients paid 60 per cent in 2005. As hospital treatment is too expensive for Chinese citizens and only about half of the urban population is covered by basic health insurance, the other half choose not to go to hospital when ill, and about a third give up hospitalisation because of expensive medical fees.[53] The medical coverage network has progressed since with a medicare system covering more than 91 per cent of China's rural families who have joined the new rural cooperatives. [54] Yet 11.8 per cent of household expenditure goes to health care, while 8 per cent of urban household expenditure goes to education.[55]

As lower income people have a higher propensity to consume than to save, any policy aiming to increase domestic demand should relieve health care and education costs which decrease private consumption, not only for the masses of peasants but also for urban dwellers. But despite recent efforts in these fields, these expenses are only a small part of the stimulus plan. Health care, social security, and unemployment welfare programmes were just about 15 per cent of the 2007 budget and 2.4 per cent of GDP, far below the percentage of other developing nations. [56] Besides, the situation varies greatly as more than 90 per cent of these public expenses are managed by local authorities[57]. In reality, boosting domestic demand requires more than investment plans, as overinvestment has been a recurrent trend of China's economy in the 2000s. Otherwise, China may face the situation of post-bubble Japan in the 1990s, when ten years of public spending in infrastructure created a "liquidity trap", unable to boost private demand. The widening income gap is responsible for the low domestic consumption rate, as most of the savings are concentrated in the hands of the urban middle class and the few hundred thousands millionaires, who will certainly benefit

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51 Zhongguo xinwen she, 7 /01/05.

52 *Xinhua*, 5/08/04.

53 *Xinhua*, 8/12/2005.

54 *Xinhua*, 2/11/2008.

55 *Xinhua*, 7/01/07. National Bureau of Statistics of China, 2005.

56 Chen Zhiwu, Yale School of Management, *South China Morning Post*, Hongkong, 29/11/08, and Project Syndicate. Brazil's government spends 4,7 % of GDP on health care alone, and 5,4 % on education, against around 3 % for China.

57 *Bulletin économique Chine*, Mission économique de Pékin, n°7, novembre 2008, P.5 Local governments manage 91 % of retirement funds, 87 % of social security, 99 % of social assistance, 97 % of health care, and 94 % of education funds.

from the recent opening of a subsidiary of the Bank of China in Geneva, specialising in non-resident Chinese wealth management.[58] Thus, any realistic plan should address the question of income redistribution, not only by way of public goods such as health and education, but a bold, immediate initiative, which would be able to electrify the population, and to reverse the adverse current situation.

Chen Zhiwu, from the Yale School of Management, suggests distributing the remaining state assets equally to China's 1,3 billion citizens, by putting these assets into national wealth funds and distributing the fund's share to citizens at no cost, and to open the state budgeting process through public hearings in the national legislature and public participation via the media, in order to reorient public spending towards people's needs. [59] This would certainly be the best plan to boost domestic demand, when one considers the institutional difficulties of land reform, but it would be a far cry from the dynamic of "transition", which has been until now characterized by the conversion of the power of decision of the nomenklatura into a power of appropriation of public assets, in industry, commerce and land. One of the main ex advisers of former party chief Zhao Ziyang, and former premier Zhu Rongji, the economist Wu Jinglian, popularly known as "Mr Market", has recently underlined these institutional difficulties. As corruption has infected crucial party organs including the police and the judiciary, "if the mainland is to become fully modernised", he declared, "it must introduce three principles: democracy, constitutionalism and the rule of law".[60] That is word for word what the young Wei Jingsheng, who was sentenced to 14 years in prison, wrote in 1979 on the Beijing democracy wall, in his famous wall poster "the fifth modernisation: democracy".

Whatever the future of Chen Zhiwu's proposition, it is certain that the stimulus plan, based on investment, will not be able to contain the dramatic reversal of the flows which have funded China's growth since the end of the Asian crisis ten years ago, and which are not only translated by the return of migrant workers to the countryside.

Anyway, if the government sticks to its proposal and neglects the importance of social safety, people, especially lower income earners will react negatively and are already reacting. They are numerous signs that China is now entering a new phase, which has already been passed through by Taiwan and South Korea after 1986, with the revaluation of their currency, and the end of their old fears and anti-communist martial laws, a phase of strong labour unrest in favour of a better income distribution. In Qingdao for instance, the main port of Shandong, which is the

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58 *Le Figaro*, 28/11/2008.

59 Chen Zhiwu, Project Syndicate, November 2008.

60 *South China Morning Post*, Hongkong, 3/12/08.

largest economic province in terms of GDP, after Guangdong, they were more than 7800 cases of labour disputes in 2008, up 140 per cent from 2007. Half of these dispute cases were about wages, and a third involved social insurance and welfare[61]. Unlike in 1989, this unrest will not be limited to the towns, as in the case of the September and October 2008 strikes of cab drivers in eleven cities to cut the monthly fee they pay to their employers and limit the number of licences issued. In October 2008, the CCP Central committee decided to enrol for regular training the weakest-link of party management, the 2000 county-level party secretaries. The weeklong programme was widely interpreted as one of the latest moves to improve the performance of local officials, who "were extensively taught on how to deal with mass incidents such as protests and strikes".[62]

In such circumstances, it is unrealistic to wait for China to become a source of the world's "growth". Chimerica is not going to collapse, as China needs to recycle its huge foreign exchange reserves and to make its exports to the U.S affordable by buying US Treasury bonds. But Chinese officials, who have an asset portfolio estimated at $1,100 billion in the US, are rightly worried about the sustainability of these assets. The American model of finance-led growth nearly collapsed along with the shadow banking system, and its rescue added a soaring public deficit to the private debt, some $7,800 billion of loans, investments and guarantees, compared to a pre-crisis Federal debt of around $10,000 billion. As Niall Ferguson has underlined, the Treasury may have to issue $2,200 billion new debt in 2009, and it is not surprising that the cost of insuring against a US government default has risen 25-fold in little over a year[63].

5. The two faces of the same coin

The problem is not reducible to an adjustment between American "overconsumption" and Chinese "oversaving", which will take years to take shape[64]. As noted in 2005 by *The Economist*, the entry of China's vast army of cheap labour in the global system of production and trade has modified the relative prices of labour, capital, goods and assets. It has increased the worldwide return on capital: in 2004, America's corporate after tax profits rose to their highest level as a proportion of GDP in 75 years, while the shares of profit in Japan and the Eurozone were close to their highest for 25 years. It has reduced the price of many consumer goods, but also the bargaining power of workers in developed economies, by the threat of offshore production. In

61 *Xinhua*, 23/11/08.
62 *Xinhua*, 1/12/08.
63 Niall Ferguson, « The age of obligation », *Financial Times*, 18/12/08.
64 Michael Pettis, who teaches finance at Peking university, has estimated that a decline in U.S consumption equal to 5 % of U.S GDP would require an increase in Chinese consumption equal to 17 % of Chinese GDP, or a nearly 40 percent growth in consumption (*Financial Times*, 14/12/08).

this sense, the East Asian economies and China have exported wage deflation (the disconnection between growth, wages and productivity), which was largely responsible for households running into debt[65]. And China has also held down interest rates in rich economies, by recycling its foreign exchange reserves in Treasury bonds, indirectly creating a global liquidity bubble, which did not translate into goods inflation (thanks to its cheap products) but into asset inflation (real estate and stocks).[66]
Thus credit consumption in the West, largely reflects the long-term fall of wages in the sharing of profits, as well as widening income disparities. In the U.S particularly, asset inflation (real estate and stocks) combined with the privatization of what is still known as public goods in most of the Eurozone, i.e. health and education. Health insurance costs and education fees inflation accelerated the decline of savings and the demand for credit[67]. Average household debt rose from 75 per cent of annual disposable income in 1990 to nearly 130 per cent in 2008.
It is striking to see how this picture looks similar to what we have observed in the case of China, where savings, and not credit, in the hands of the urban middle class, mainly finance the rectification of the failure of public goods supply, such as health and education, which have been largely privatised. But apart from the obvious developmental levels of the two countries, there is a difference in the process of accumulation, which may influence future economic policies. In the USA as well as in the Eurozone, the big winners of the last thirty years have been a small financial and entrepreneurial oligarchy, which, with the help of the political elite, have accumulated incomes completely disproportionate to their productivity levels, in their quest for capital profit maximization. Whereas in China, the dynamics of accumulation have been largely under control of the party-state oligarchy, under the form of a decentralised state capitalism. Chen Zhiwu has calculated that from 1995 to 2007, "inflation-adjusted government fiscal revenue increased 5.7 times. In contrast, over the same period, the cumulative increase was 1.6 times for urban residents' per capita disposable income and 1.2 times for rural peasants per capita income". So, China's 'socialism with Chinese characteristics' is an economy where an increasing share of national income goes to the state[68]. Here again, the disconnection between growth, wages and the level of wealth redistribution is responsible for under consumption, and

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[65] This point is well illustrated by Jacques Sapir, for the case of France and the Eurozone (see « Les souces internationales de la crise actuelle »).
[66] *The Economist*, « How China runs the world economy », July 30th-August 5th 2005, p.65-67. However, it is not relevant to blame China as responsible for the asset inflation in the US. As Martin Neil Baily and others rightly underline : « Without access to foreign funds, the US economy would have invested less in all kinds of capital. The problem was the diversion of too much investment into housing, that was not productive at the margin, a problem we should blame on ourselves more than on those who lent the money », *The Origins of the Financial Crisis,* Paper cited, p.38.
[67] *Le Monde*, 6/01/09, p.8.
[68] « China's Construction Fetish », Project Syndicate, 2008.

overinvestment, as the savings are massively reallocated through the state banking system.

Finally, the macro-economic imbalances on the two sides of the Pacific, which are translated by oversaving and overinvestment in the case of China, and credit consumption and leverage investment in the case of the US, are two faces of the same coin. They reflect the crisis of an accumulation model tailored for a financial, entrepreneurial or party-state oligarchy, which created an unsustainable model of "growth with inequity". The remedies adopted up to now in the west, which tended to add excessive leverage in the public sector to excessive leverage in the private sector[69], may have controlled the fire, but not the embers, which may inflame again if the structural question of wage deflation and the sharing of profits, which has strong social and fiscal implications, is not addressed. Chimerica has been basically built on an international division of labour and capital that is no longer sustainable. On one side, the finance-led growth model has been built on the monetary supremacy of the US $, which has created an addiction to debt, in order to sustain a consumerist mode of living. On the other side, the export-led growth model has pushed the gigantic capacities of production,[70] invested by developed Asian and the MNCs in China, to flood the world. In this sense, the vessel of Chimerica may be heading towards twilight, but certainly not, *its* twilight, as these capacities of production will remain, and China, whatever its political and social tribulations, will climb up the ladder of technology to become more and more competitive in a more and more interdependent world.

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[69] Niall Ferguson, *Financial Times*, 18/12/08.

[70] Let us remind that these capacities of production concern practically all sectors, from ICTs to naval construction and aeronautics, as Boeing and Airbus have outsourced in China parts of their new programs to reduce their production costs.

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