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Co-Dependence: The Chinese and American Economies and the World Economic Problem

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Editorial Essay by Jeffrey Barlow

Introduction

This editorial has both everything to do with the Internet, and nothing. Everything, in the sense that the underlying cause for the changes in Sino-American economic relations that we will be discussing here are largely a result of the impact of the Internet. The World Wide Web has made possible electronic banking, and the instantaneous movements of capital, whether dollars or Ren Min Bi (RMB), the People's Currency of China. It has therefore made possible the complicated interlinking of national economies in a process that is not always clearly understood, as the problems with derivatives and other financial instruments reveals.

Too, the Web has facilitated very complex production chains which see components manufactured in a variety of countries, shipped just-in-time to second countries where they perhaps undergo additional processing or pre-assembly, then sent to yet a third country for final assembly, most often to China. [1] Then of course, they are exported, usually to America or Europe.

To some, however, the issue discussed here will seem to have little to do with the Internet as we seldom refer to it directly. But it is important to keep in mind that the current financial problem, however we define it, is an event best understood as a result of the third stage of globalization, the digitalization of media, and of economies alike.

The Issue

We are writing from Wenzhou, China. After spending a week in Beijing in mid-October at a Technology Management conference, we then came onto Wenzhou where we have now been working for almost a month.
The news, of course, whether television such as CNN or China Central Television (CCTV, the Chinese governmental network [2]), or newspapers [3] is dominated by what Americans prefer to call the "world wide economic" problem, but what Chinese see largely as an American, and secondarily as a European, issue.

This problem is extremely broad in its scope. We are teaching here to Chinese students on the subject of globalization, viewed from a historical perspective. Many cultural or economic historians would argue that this is at least the third period of globalization with the first stage visible by the 9th century A.D., the second by the 14th century, and the current one largely an artifact of the digital age.

Others would argue, and I agree with them, that in fact there has been one continuous process of globalization, marked by a world economic system which has had its ups and downs, but has always been present. And that system, over most of its existence, has been dominated by Asia, and particularly by China. [4]

Europeans, and later Americans, enjoyed a relatively brief period of ascendancy, mostly as a result of military superiority initiated by English naval power in the 18th century and continued by American atomic power throughout the 20th. [5] That ascendancy, we believe, has just ended. We will now enter another period of multipolarity, again marked by the importance of Asia, and particularly of China.

This, of course, seems an outlandish view to most Americans who have been sheltered for at least one hundred and fifty years by self-satisfied visions of cultural superiority (best characterized as Eurocentrism) buttressed by unthinking racism. In this happy dream, the "West" has had inherent advantages over the "East" (both largely meaningless concepts unless the world is viewed from London) and Americans have had to fear only that those tricky Asians would copy our products and ultimately our economic systems. This is perhaps our most comforting refuge in these confusing times: the rise of China is due to their emulation of our system.
The current problem thus comes as a rather complex surprise. As is too often the case, Americans are pretty much reeling in confusion, largely obsessed with the issue of who to blame (banking?), and its closely allied concern, who to save (the auto industry?). [6] Here we argue that the crux of the problem can best be understood as an issue in Sino-American relations.

This also is a natural scape-goating intellectual response for Americans, particularly for the Democratic Party. "When we were not looking, China stole our factories and our jobs, largely by cheating in trade and manipulating its currency." [7]

I believe, rather, that we have been locked in a co-dependent economic relationship with China and that the terms of that relationship have just shifted with seismic force, as has long been inevitable. We perhaps are at last leaving the post-9/11 world and entering the post-decline age in that we have spent ourselves into much reduced national power due to our persistent failure to confront our excesses.

In doing so, we have damaged the world economy. We have given almost everybody except our lapdog, Great Britain (and even Britain is eying the doggie door in the event that the Anglo-American house is indeed aflame), cause to reduce U.S. influence in international financial institutions such as the International Monetary Fund and the World Bank.

This problem, however, cannot be seen simply as the "Rise of China." China, as is appropriate for a co-dependent, has been ignoring its own problems and now must solve them.

**The Co-dependent Relationship**

The Sino-American financial relationship is quite complex, and in understanding it I have found Charles Dumas works, *The Bill from the China Shop* (2006) and *China and America, a Time of Reckoning* (2008)
invaluable. [8] The accuracy of Dumas' analysis is surely demonstrated by the fact that his 2006 work predicted the 2008 economic crisis in its details. We follow here his analysis, augmented with our own direct observations while resident in China for one month each of the last five years. [9]

If the Sino-American relationship is complex, our joint problem is at bottom a simple one which is expressed by the economic laws that have dominated the global trading system for more than a thousand years: In the long run, markets must be in balance—there must be sales for goods produced, or some producers eventually must go out of business. Each buyer must one day pay up—or be cut off from access to goods. There must be some store of value (currency) to facilitate exchange and whether the currency is gold, cowry shells or dollars, its value will fluctuate in complex relationship to the supply of and demand for goods and services.

Unfortunately, China and America have found it to their mutual interest to largely ignore these truths for the past several years. But another truth is that, given appropriate circumstances, it is easier to endlessly accumulate wealth, as has China, than it is to endlessly accumulate debt, as has the United States.

**The Chinese Addiction**

China has attempted to, and largely succeeded, in exporting its way to economic growth via low labor costs. The rise of China has been spectacular and is, in almost every way, praise worthy. The Chinese economic system has grown steadily since 1949 with some scallops during periods of intense politicization, but has generally progressed regardless of who was in charge or which ideology was dominant. Since 1980, the Chinese GDP has averaged 9.8% annual growth. [10] More people were lifted out of poverty in the last half of the 20th century in China than ever before in human history, and in fact almost all people lifted out of poverty in the 20th century were Chinese.
Many factors can be given at least partial credit for this success including Chinese savings (now running at 50 percent), direct foreign investment in Chinese export industries, a controlled currency, Chinese willingness to adapt their ideology to pragmatic conditions, highly-educated labor and equally highly-educated leadership. Yet, underpinning them all has been cheap but productive labor vis-a-vis their American and European (and Japanese) markets.

This combination of factors has made China an export monster. Chinese exports have grown as high as 50 percent annually and it is a poor year that has seen export growth of less than 25 percent.

This method of growth has had some detractors, of course, but not as many as might be supposed. Much of the exports have been products assembled in China but parts of which have been produced in Taiwan, Japan, Korea, Europe or the United States. Any negative voices in those countries (such as those of displaced workers) have then been offset by those of supporters who benefit from the process. Hollywood may scream about pirated videos but WalMart, depending almost entirely on Chinese goods for its sales, points out that these lower costs to the American consumer and restrain inflation.

Endlessly rising exports, however, have both limitations and costs. The limitation is that no country can depend indefinitely on low cost labor. The very success of such a strategy will increase both wages and inflation, requiring still more wage increases, until ultimately a new low-labor producer will enter the market. The Chinese have responded to this in the classical fashion, by in turn investing in those low-labor countries so as to benefit even from that shift.

However, there is another powerful drive for the assembly-exporting country—to move up the value chain by producing the parts that go into the final assembly. China is, in fact, very quietly doing just this, a factor very important to the current discussion, which is largely ignored. We will come back to it at the appropriate time. But any low-labor producer will be drawn to the same strategy, ultimately "hollowing out" the
original producer, which happened to Japan and has now largely happened to Taiwan as well.

The Chinese addiction then, is to the export market. Not only has this produced great growth, but also it has cushioned one of China's potentially most explosive problems, rapid population growth (despite the one-child policy, given its vast base) which must be met with equally increasing jobs. In general, the Chinese believe that 8 percent GDP growth a year is necessary just to keep up!

Additionally, China is well aware of the fact that rural areas lag far behind urban ones, to the point where the Chinese distribution of wealth is almost as skewed as is the American one. This means that rural jobs, at least, must somehow be upgraded, but not at the expense of urban incomes. The solution thus far has been to spin off satellite production centers for the export market into the hinterlands.

There are also very complex monetary and fiscal consequences from the Chinese accumulation of export profits. These tend to drive inflation through a variety of linkages, once again putting pressure on wages.

It is then highly desirable for the Chinese to find alternatives to the export model. But it is hard to argue with success, and there is an additional factor, which is very difficult to calculate even for the Chinese themselves. That is the political link between local party bosses and the export industries. These bosses have long been rewarded for increasing production from the export industries in their regions, which has lead to a variety of effects. These bosses have little interest in labor problems, for example, but have repeatedly called out local police forces to at least control if not outright suppress labor unrest.

It is also almost impossible to believe that there is not a systematic link of corruption between powerful local producers and equally powerful bosses. The result has been scandal after scandal in China over the last few years. Spectacular problems such as food safety and vast pollution caused by illegal dumping often have their origins in this corruption,
which causes local areas to ignore national policies, the Chinese equivalent of inadequate supervision of corporate interests.

An important consequence of these unofficial links is that when central government funds go into various local projects, then, there are many pressures that will tend to funnel them into existing export industries. [11] What is good for the central government and for the national economy is often not at all seen as desirable at the local level.

Ironically, in light of the usual American argument that China is a highly centralized totalitarian economy (when we are not celebrating its capitalist successes) the central government in a very important sense, lacks the power to enforce its policies at the local level. To the historian, this is not surprising. The Chinese central government has almost always had a very light political "footprint" as a whole, but depended on value agreements mediated by ideology—whether Confucian or Communist—between local and national elites. Now that ideology says: "grow!"

The Chinese then, are in effect addicted to exporting. But every market must balance, so someplace there needs to be an import junkie.

**The American Addiction**

That junkie is, of course, primarily the United States. Our addiction to personal over-consumption (that is, consumption well beyond our incomes) is well known. One estimate is that we have been consuming 106 percent of our annual GDP. [12] Such a debt is not necessarily a problem at the level at which the accounts of countries are balanced. If America wants to buy more from China than it sells, there are a number of ways of running such a deficit, such as selling financial investments—debt instruments—in the American economy to foreigners, especially to Chinese.

While these can become worrisome and a cause for national reflection, these current account imbalances can be sustained for very long periods, perhaps indefinitely given a generally strong U.S. economy, and a
willingness on the part of foreign governments to continually finance yet more of our debt. And the Chinese, in the interest of feeding their export habit, must do so. Sino-American trade depended on both parties' willingness to enter into this implied contract.

Yet, our over-consumption has tended to be consumer driven. Business and industry have, in general, complex procedures which act as checks and balances on income and outgo. Consumers, however, are encouraged on a daily basis to over-consume and are regularly provided a variety of means to do so.

The consumer has proven to be the flaw in this structure. The edifice has depended for some time on the assumption that the equity of consumers would continually increase, allowing greater and greater amounts of debt. And most equity for Americans is in their home.

The growth required in home values to ultimately fund the over-consumption, because of a variety of reasons, amounts to more than the 6.5 percent mentioned above. Real growth in GDP plus service costs must be added in as well, giving the American consumer the burden of somehow financing over-consumption of about 10 percent annually out of rising home equity.

In the spring of 2006, this structure began to collapse, accelerated by higher fuel costs, [13] generalized anxiety at endless wars, real doubts about the future of the country, and stagnating home values. The result was a cutback in spending, and the collapse of the rickety support system of complex derivative instruments that had allowed banks to assuage their doubts about the underlying assumption of ever-increasing home equity. Values plummeted, liquidity—the ability of banks to loan money on the assumptions that the loans they had out on homes were, in fact, assets which would one day be on the plus side of their balance sheets—dissolved.

Other national economies, Iceland, Great Britain, Spain and Italy primarily, and secondarily other European countries, were also revealed
to have been burning their consumers at both ends, and to have been literally buying into the American derivatives markets.

To summarize, based on Dumas' analysis, the "Goldilocks Economy" as he calls it, had four causes:

1. Globalization—China became the export monster, the United States (and Europe) the monster consumer.

2. Consumers were encouraged to consume. National authorities told us we owed it to the country to do so; Alan Greenspan said the equivalent, both to the homeowner and the banking industry of "bubble-shmubble."

3. Chinese excess capital (export profits, savings) flowed into asset prices, housing markets, and became the collateral for our excess consumption.

4. The complex instruments created to cushion the threat to anyone bank, derivatives and other asset-backed securities, slouched abroad via, once again, digital globalization. [14]

This then, in regrettably more than a nutshell, is the current economic relationship between China and the United States. The "world economic problem," then, is to a remarkable extent, a Sino-American problem.

In our February issue, we will update this analysis, and turn to the range of solutions that have been proposed. These are, as might be expected, significantly different in China and in the United States, though there are important areas of agreement that suggest the possibility of a positive outcome for both, and for the world economy. But such an outcome will require each country to kick its habit...
Endnotes


[3] Thanks also to the Web, I have available a wide range of news to supplement my daily dose of *The China Daily*, though I find it extremely useful.


[5] There have been conspicuous exceptions to that dominance, or at least limits to its efficacy, among which I would list the Boxer Rebellion and the Korean and Vietnam wars. All of these revealed the inability of the U.S. to directly control China or its close allies by means of military force.

[6] For my own confused reeling see: "Dining, Whining, and Opining: From the Googleplex to Beijing" found at: http://bcis.pacificu.edu/journal/2008/05/edit.php

[7] To his credit, President-elect Obama did not make this an issue in the recent election, and the Republican candidate had, as is usually the case for Republican spokesmen, little interest in questioning an economic relationship which was long to the advantage of American economic elites, an issue explored below.
[8] We are using the joint edition, which contains both works, and our notes refer to the combined volume, *China and America, a Time of Reckoning*. (London: Profile Books, 2008.) Dumas, of course, is not the only one to hold these views. See Stephen Roach, Chairman of Morgan Stanley, Asia, who holds similar views at least with regard to the problems of the Chinese economy. For these views see *China Daily*, interview by Wang Xu with Roach, "How to Pick up the Economic Pieces," 11/11/2008, p 14. For Roach's views on the American problem, see Stephen S. Roach, "Double Bubble Trouble," *The New York Times*, 3/5/2008 at: http://www.nytimes.com/2008/03/05/opinion/05roach.html In this piece Roach, citing the same factors as does Dumas (an asset dependent credit bubble) accurately forecasts the October downturn, more than 6 months before it entered into its recent acute phase. The important disagreement between Roach and Dumas would seem to be Roach's belief that the trade imbalance is a more significant contributor to the problem than does Dumas. Roach accordingly stresses encouraging American exports, while, like Dumas he thinks significant investment in national infrastructure to also be an important step.

[9] For our observations on these visits see my blog, *Chinatripper*, at: http://bcis.pacificu.edu/blogs/chinatripper/chinatripper.php


[11] Immediately after China announced its national bail-out plan, the provinces and important municipal jurisdictions such as Shanghai, which would in the normal course of events be unveiling their own economic plans for the coming year in December in any event, made their responses to the government plans. I have seen summaries of these plans from Guangdong, Shanghai, and Guangxi and each, I would argue, plans additional major investment in export-industry sectors.

[13] These of course, are not unrelated to the marked increase in oil consumption by China. Its export economy and its transportation infrastructure alike are very energy inefficient and it consumes relatively more fuel than its Japanese or American equivalent per output.