

POST-SOCIALIST TRANSFORMATION AND GROWTH REGIME: SOME COMMENTS ABOUT THE CHINESE CASE¹

Sébastien CHARLES*
(LED-EPEH, University of Paris 8)

Ilyess EL KAROUNI**
(LED-EPEH, University of Paris 8)

Abstract

This article attempts to show that Chinese post-socialist transformation has involved a deep change in its growth regime. China's current growth strategy is the consequence of institutional changes that operated from the end of the seventies. Thus, since its transition is gradual, the economic system is "hybrid" with both capitalist and socialist elements.

During the Maoist era, the growth strategy took the form of a "forced growth" as theorized by Kornai (1972). Today, it is not the case anymore since China follows an *export and investment-led growth* regime. Indeed, "investment hunger", inherited from the socialist system, is still standing and the economic opening of China results in an increase of its exports. This new situation could be particularly difficult to manage with respect to inflation stabilization and China's dependence on external demand in a context of low domestic-demand. In particular, the main difficulty to which this export-led growth regime could be confronted with concerns the occurrence of an external contraction in the US. We then try to assess why such an event may appear by providing a list of external risks and their possible outlets in order to emphasize the economic vulnerability of China.

Finally, we conclude on the difficulty to switch regimes and to adopt a more balanced growth strategy.

Keywords: Institutional Change, Post-socialist Transformation, China, *export-led growth*
JEL Classification: B52, F19, P33

¹ The authors would like to thank Sylvie Lupton without whose assistance this paper could not be prepared in the present form.

* E-mail: sebcharles92@yahoo.fr

** E-mail: ilyess.el-karouni@univ-paris8.fr

Introduction

During the last 30 years, we have witnessed the gradual collapse of the Chinese Maoist system. China experienced some reforms which made it become a superpower with a phenomenal economic growth. Although the Chinese Communist Party still leads the country, it is not the same country as that of Mao's era. And the foreign firms have often introduced advanced technologies. For instance, in 2005, the flow of Foreign Direct Investment (FDI) was higher than \$ 60 billion (cf. *US-China Business Council*). As for the large-scale famine experienced by China during the Great Leap forward (1958-60), it does not exist anymore since familial contracts in 1979. Even though numerous problems have been solved, it seems that new difficulties may appear regarding the export and investment led growth strategy followed by China.

We argue that Chinese institutional change began with China's opening. Admittedly, this opening began under Mao and the normalization of diplomatic relations between China and the US with the official visit of President Nixon. But the breaking point was the death of Mao and, above all, the plenary meeting of December 1978. The institutional change appeared openly taking the form of a gradual exit from Maoist socialism². These transformations had serious consequences on the Chinese socio-economic system. China's current growth regime is the consequence of institutional changes that operated from the end of the seventies. Here, our objective is to answer to the following question: what are the risks of the Chinese growth regime emanating from the post-socialist transformation? In this article, we put the emphasis on the dependence of China toward foreign countries especially the US and Europe.

The outline of the paper is the following. First, we detail the institutional background of our study, i.e. the Chinese post-socialist transformation (I). Second, we compare growth regimes both in Maoist and post Maoist eras (II). Finally, we deal with the difficulties and challenges of the current growth regime (III).

² The often used term "transition" seems to be inappropriate because it implicitly assumes that China gave up socialism to adopt capitalism. However, we are currently unable to be objective about the form of the Chinese economic system at the end of the process. So, we prefer to use the term "transformation" which evades the determinist aspect of the Chinese institutional change.

I. Institutional background: the Chinese post-socialist transformation

The post-socialist transformation experienced by China since the end of the 1970's is a typical case of institutional change. Here, institutions (as defined by North [1990]: formal and informal rules which constrain human action and their enforcement mechanisms) altered gradually. The existence of a Stock Exchange Market in a country in which the Communist Party has all powers was unthinkable during Mao's era. Moreover, Deng Xiao Ping did not hesitate to proclaim "letting some people get rich first, and gradually all people should get rich together". These are only two examples of the transformation of institutions and mentalities in China. The process under way since the end of the 1970's is not yet completed, and nothing assures that it will be one day.

For a start, let us consider three types of economic change. The first one is economic policy as illustrated by the *IS-LM* model. In this model, knowing the parameters of an economy (propensity to spend, elasticity of money demand...), we have to find the income of full-employment by using tools of economic policy (public expenditures and money supply). Consequently, this model aims at finding a solution to temporary disequilibria ("fine-tuning"). The second form of economic change is reform. It tries to redress more structural disequilibria and is implemented less systematically because it often needs political or social consensus. Finally, the third type is systemic change that concerns the transition from a system to another: China, Russia and other countries of Eastern Europe experienced such a change. The objective is to rebuild a new order with new institutions. This kind of change is at the heart of our article. Such a change can be more or less fast, taking the form of a shock therapy (like in Russia or Poland) or it can be gradual (like in China). In the first case, decision-makers decide to move from socialism to capitalism through a unique wave of reforms. In the second case, reforms are implemented gradually.

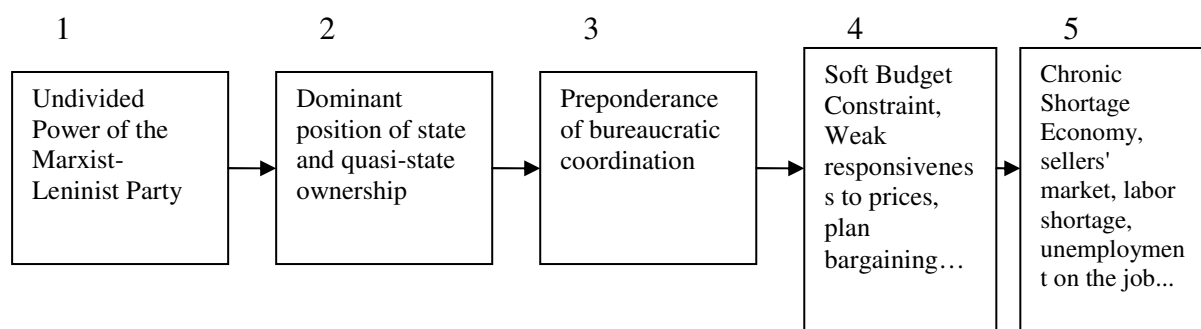
During the 20th century, the world has experienced two economic systems: capitalism and socialism. Kornai (2000) shows us the differences between those two systems in a systemic and institutionalist view. He uses five criteria to differentiate them and integrates these distinctions in a series of blocks. In this figure, the first three blocks represent an institutional characteristic while blocks 4 and 5 represent economic phenomena. Therefore, we have:

- Block 1: political power;
- Block 2: property rights;
- Block 3: coordination mechanisms;
- Block 4: behaviour;
- Block 5: typical economic phenomena

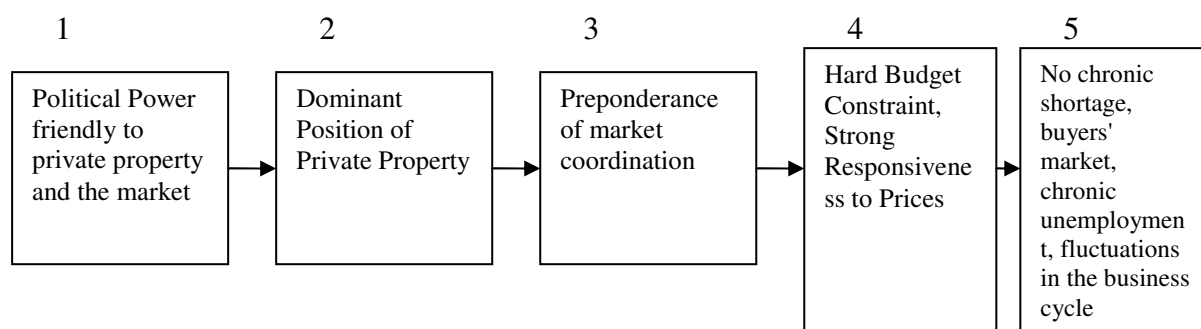
Each system is characterized by a special configuration in terms of blocks. Blocks 4 and 5 depend on blocks 1, 2 and 3 which represent the foundations of the system studied. By examining these three pillars, we can classify a system in one or another category (socialism or capitalism). That is why coming across some "socialist" elements again in a country is not enough to call it "socialist". For instance, in France, the public sector is relatively significant, but France is not a socialist system since the other elements of the system (blocks 1, 2 and 3) are typically capitalist. The configuration is drawn as follows:

Figure 1: The model of socialist and capitalist systems

Model of the socialist system



Model of the capitalist system



As for the change of systems *per se*, Kornai considers that it will not come into effect until a breakdown occurs at the level of the political block. From this perspective, even if the Chinese Communist Party (CCP) stays in power, China would be a country in transition because we note the “embourgeoisement” of the political power. From an ideological viewpoint, it is not hostile to market and private property anymore. On the contrary, the Chinese march toward a market economy takes place under its acceptance. Despite every indication of the contrary, it is not the same Party anymore because its ideals have changed. The growth regime should be looked for in blocks 4 and 5 but it depends on changes that occur upstream (blocks 1, 2 and 3). A set of factors (cultural, political, and institutional) then led the economic growth in Maoist China to take the form of a "rush" with forced growth and "disharmony". Along the same line, the transformation of these same factors led China to base its growth on external demand. The following section will be precisely devoted to the examination of both growth regimes.

II. The nature of economic growth in China

II.1. Forced growth during the Maoist era

The current growth in the post-socialist China contrasts with the existing one during the Maoist era: the forced growth (Kornai, 1972) as illustrated by the Great Leap Forward. It also contrasts with a more "harmonic" growth that could be seen as an ideal-type. Forced growth should ensure the production of resources needed by the development of the economic sectors considered to be the most important. So in Maoist China, during the Great Leap Forward, the productive resources were drawn from agriculture into industry.

Several factors affect the speed of growth in one way or another. For instance, Kornai (1972) mentions natural resources, geopolitical considerations (like war or peace), exogenous factors... But, above all, he insists on the fact that sacrifice, postponing and omission are in favour of the increase in growth.

The notion of sacrifice is very intuitive. Forced growth is characterized by an aware renunciation of a certain level of consumption in order to not jeopardize future. By doing so, it would be possible to increase profitable investment and therefore to generate growth and a greater level of consumption in the future. There is consequently a trade-off between present

consumption/future investment and future consumption/current investment³. If we spend less today, it would be possible to export what is not spent and to invest export revenue. In the case of sacrifice, unlike postponement, renunciation of consumption is absolute. This means that individuals cannot often make up past consumption. Postponing also consists in abandoning our present consumption, but unlike sacrifice, it is not absolute. Omission (or negligence) means an irreversible loss too insofar as it concerns the formation of capital stock (particularly human capital like instruction). The negative effects of omission still stand even after its end. However, in all cases, the share of investment in GDP is very important. Although living conditions are difficult due to the sacrifices required from the population, the decision-makers count on workers' competitive spirit. More ideological incentives (like socialist conscience that is put forward in the Chinese system) can replace traditional economic incentives (notably monetary incentives).

The Great Leap Forward which began near the end of the 1950's and ended in the beginning of the 1960's illustrates this conception of growth. This experience was disastrous: it resulted in a dreadful famine. Depending on sources, between thirty and fifty million people died of starvation in only three to four years (from 1958-59 to 1961). Causes were numerous. Agriculture was neglected, so agricultural production plummeted and became insufficient. Furthermore, for ideological reasons, the level of harvest was greatly overvalued. So, taxes were too high with respect to the real level of agricultural production. Taxes were paid in kind and peasant stocks fell. Moreover, bad weather conditions (floods and drought in 1959 and 1960) aggravated the crisis and famine. All these factors contributed to this human disaster.

Nevertheless, we cannot understand this growth strategy if we do not explain the expansion drive and the investment hunger which exist in socialist systems. This will be developed in the next section.

II.2. Investment Hunger and Economic Growth

Like other socialist countries, China is characterized by expansion drive and investment hunger. According to Kornai (1980, 1992), investment hunger corresponds to an internal desire of expansion. Since Chinese post-socialist transformation is gradual, it is quite understandable that some institutional features of post Maoist China are inherited from the Maoist era. When Mao and the CCP took power, China was drained. And in order to win the

³ Note that Chinese decision-makers, who were Marxists, by encouraging savings and frugality, added up, in some respects, the conclusions of Solow's neoclassical model of growth (Solow, 1956) and optimal growth theory (cf. Cass, 1965).

population's trust, they had to improve living conditions of Chinese people. The best way to do this was to increase the economic growth which must be as fast as possible. Expansion drive and investment hunger also exist in capitalist economies. But, unlike socialist countries, they are limited by an internally self-restraint. Indeed, the budget constraint of a capitalist firm is hard (i.e. its revenue has to cover its costs, Kornai 1993) and decision-makers should therefore assess investment risks. In case of a bad assessment, the consequences will be directly borne by the firm. Furthermore, Keynes (1936) considers that firms compare the marginal efficiency of capital with the interest rate. Managers invest if and only if the former is higher than the latter. Things are different in the classical socialist system. Because of shortage and soft budget constraints (see for instance Kornai, 1979, 1986 who explains that socialist firms are not subjected to the budget constraint), decision-makers are deeply encouraged to increase investment expenditures. Unlike the capitalist firm (with a "hard" budget constraint), the survival of a socialist firm depends on its relations with bureaucracy and not on its profits. Despite their bad results, Chinese state owned enterprises do not go bankrupt. Within the framework of an economy in which the administrative coordination is still important, an expression of the assistance of bureaucracy is the "soft" credit. That is why in classical socialist systems, investment hunger is ubiquitous and it is a desirable tool to generate growth. Today investment hunger inherited from this period is still common as Table 1 demonstrates.

Table 1: Investment data

	1973	1983	1993	2003
Share of investment in real GDP	34.1	33.7	38.6	42.6
	1973-1983	1983-1993	1993-2003	
Average growth rates based on constant prices (1990)	8.8	19.8	16.7	
Contribution to GDP growth	33.3	41.6	45.4	

Source: Felipe et Lim (2005)

In China, this investment hunger is strengthened by federalism that is a key element of the reform process (Vahabi, 2002). Because of the reform of taxation and decollectivization, local governments have more power and more incentives to growth (Oi, 1992, 1996, 1999). These institutional reforms and new incentives lead to a peculiar form of economic organization

which is coined "local State corporatism" by Oi (1992). Since reforms in the beginning of the 1980's, although decollectivization resulted in a loss of income for local governments, taxation reform allowed them to retain a part of taxes. In addition, the reform of bureaucracy also generated new incentives for the bureaucrats to go into business (the so-called *xiaohai*) (cf. Li, 1998).

II.3. Recent Transformation: An Export-Led Growth Economy

During the Mao era, the economic relations of China with capitalist economies were peculiar to its socialist nature with Import Hunger, Export Aversion and Propensity to Indebtedness as mentioned by Kornai (1992). Today, this is not the case anymore, as we shall analyse below.

Some stylized facts

In three decades, China, more than any other country before, has known an impressive commercial and economic development. Indeed, its growth rates are sustained: for instance, between 1998 and 2006, the Chinese average growth rate of GDP is greater than 9% (see Table 2).

Table 2: Chinese GDP growth rate

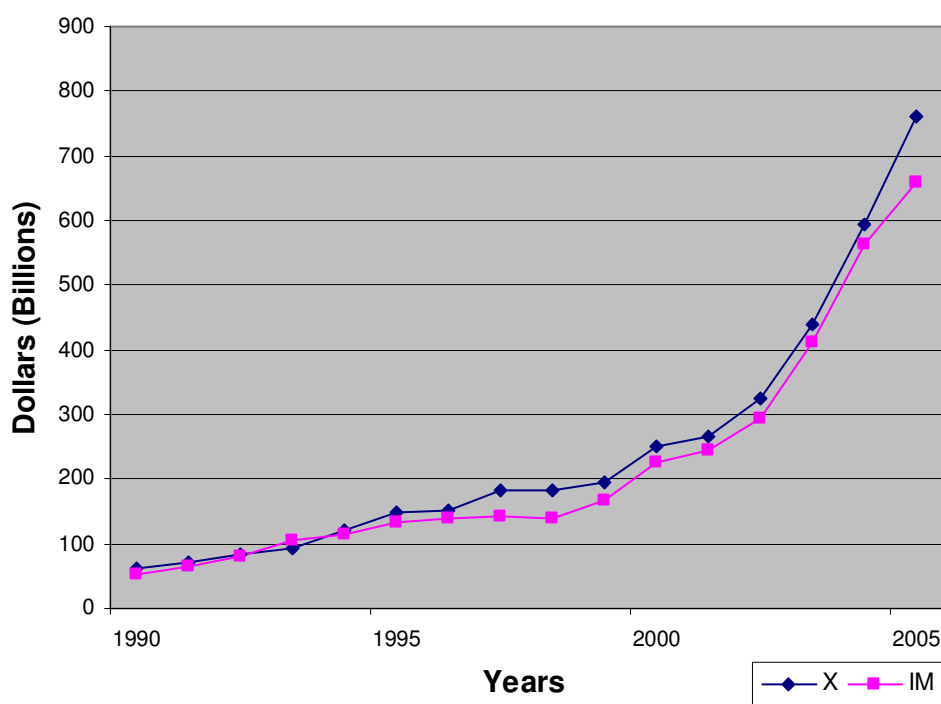
Years	1998	1999	2000	2001	2002	2003	2004	2005	2006
Growth Rate (%)	7.8	7.6	8.4	8.3	9.1	10.0	10.1	10.2	10.7

Source: US-China Business Council, 2007

This development has been accompanied by several warnings, regarding its banking system considered as extremely fragile due to the important number of important debts. Since 2003, the government implements a policy of discharge of the banking system. Even if the result of reforms remains uncertain (cf. Havrylchyk, 2005) –in particular due to the flow of new loans – it seems to be heading in the right direction in order to limit the risks of collapse of the Chinese banking and financial system. As for its balance of trade, Figure 2 shows that China has recurrent surplus since 1994. This period should be distinguished from the previous one in which it was structurally showing a deficit regarding the rest of the world. In reality, this surplus position should be linked to the devaluation of the RMB of almost 50% in 1994. Table 3 shows that it was the higher devaluation of the Chinese currency since more than twenty years. Moreover, despite the successive revaluations made by the monetary

authorities, the RMB is largely undervalued. Actually, they did not yield to the pressure of Washington that wants China to revalue RMB significantly.

Figure 2: Chinese Exports (X) and Imports (IM)



Source: National Bureau of Statistics, China Statistical Yearbook, 2006

Last but not least, the opening of the Chinese economy has accelerated since its entry into the WTO in December 2001. The growth rate of exports has reached an unequalled level: 28.4% in 2005 (cf. Table 4). We can therefore say that with the post-socialist transformation, China now follows a new strategy of growth which can be coined an *export-led growth* regime.

Table 3: Exchange Rate RMB/Dollar

Periods	Exchange rate
1985	2.93
1986	3.45
1987-1988	3.72
1989	3.76
1990	4.78
1991	5.32
1992	5.51
1993	5.76
1994	8.61
1995	8.35
1996	8.31
1997-2004	8.28
2005	8.07

Source: National Bureau of Statistics, China Statistical Yearbook, 2006

Table 4: Growth rate of Chinese exports

Years	2001	2002	2003	2004	2005	2006
Growth rate (%)	6.8	22.3	34.6	35.4	28.4	27.2

Source: US-China Business Council, 2007

The Export-led growth strategy per se

At the end of the seventies, China broke with the Maoist conception of economics by fitting into the world economy. Export-led growth corresponds to a growth regime that is not proper to China since it constituted the main source of income for several Southeast Asian economies. An export-led growth strategy consists in promoting the production of goods that will be sold on external markets. According to this conception, international trade is seen as the source of growth and the main cause of economic development. Opening up a country's market to international competition exposes its economy to a "learning by doing" process that brings about new technologies. Indeed, several Asian countries (South Korea, Taiwan...) left the status of a developing economy (for the one of a recently industrialized country) by following an export-led growth strategy.

It is possible to make a list of arguments justifying the adoption of such a regime:

- ◆ Participating in international trade forces countries to integrate new technologies in order to be competitive on external markets. This tends to encourage the emergence of technological innovations and their diffusion into the other sectors of the economy, with the consequence of increasing the level of production and important economies of scale (Felipe, 2003).
- ◆ Developing countries really need foreign exchange in order to buy their imports from developed countries. The best way consists in increasing the amount of exports, which enables to raise the capacity to import without deteriorating the trade balance (Thirlwall 1994, 2002).
- ◆ Imports (permitted by exports) may be productive because several crucial goods (capital goods, high-technology equipment...) necessary for economic development are not produced domestically (Thirlwall 2002).
- ◆ An export-led growth strategy also allows an expansion of aggregate demand without much inflationary pressure and the appearance of a wage-price spiral as it may be the case after an increase in domestic demand (cf. Felipe, 2003; Felipe and Lim, 2005).

In consequence, we follow Felipe and Lim (2005) who consider that a country adopts an export-led growth strategy if the following conditions hold:

- (i) High export growth accompanied by high GDP growth.
- (ii) A substantial improvement in net export growth, which means that exports grow faster than imports.

Regarding these two criteria, we shall see that China has adopted an export-led growth strategy. Indeed, it takes advantage of a great capacity to export. Hereafter, we shall deal with the risks and constraints of the Chinese development regime based on the importance of exports and followed after the post-socialist transformation.

III. Constraints and risks concerning the Chinese growth strategy

III.1. Investment-led growth economy and macroeconomic stability

Investment hunger generates inflation. In order to understand this situation, we should first look into the nature of prices in a socialist economy. The inflation issue is closely related to prices issue. In the socialist economies (the classical system), the producer prices are officially administrative producer prices. However, reality is complex and it is therefore very difficult to control them administratively. Prices are in fact *pseudo-administrative prices* (Kornai, 1992, p. 149). In China, before 1979, almost all prices were controlled by the State. They were then gradually liberalized.

Inflation exists in socialist and capitalist systems. But it does not have the same nature in both systems. There are indeed three types of inflation: open, repressed and hidden inflation (Kornai, 1992). Open inflation corresponds to an increase in prices that encounter no administrative resistance. The repressed inflation is artificially contained due to the presence of administrative prices. And the third kind of inflation refers to the inflation which is not declared by the government: for ideological reasons, it can deliberately underestimate inflation statistics.

In the case of China, economic decentralization leads to coordination failures in the management of the economy in particular regarding investment which results in inflation. Thus, reforms turned repressed inflation (particular to socialist economies) into open inflation. Inflation is a sensitive political question in China. In effect, the Chinese hyperinflation of the 1940's left a trace on Chinese collective memory like the German hyperinflation of the 1920's. The CCP is thus motivated to control inflationary pressures. However, inflation is not appreciated in the same way by central government and provinces. Provinces, unlike the central government, have no incentives to control it because they prefer a high level of employment (Vahabi, 2002).

How can the central government stabilize inflation? It can be good, at least in the short term, to control it administratively. According to Vahabi (2002), stabilizing inflation requires the combination of two elements: a budgetary discipline and a strict monetary policy. Nevertheless, it is difficult because inflation is linked with local initiatives and it is therefore tricky for the central government to regulate it.

III.2. The constraints regarding the export-led growth strategy

Recently, Palley (2006) analysed the Chinese growth strategy in a Post-Keynesian perspective. According to him, low labor costs combined with a huge reservoir of poor workers, contributed to bring foreign investors on the national territory (cf. Table 5). The contribution of external technologies, through foreign direct investment (FDI) allowed China to develop its industrial sector and to modify the structure of its production. A crucial point must be underlined regarding this aspect: Chinese production is mainly intended for the US and European markets. Moreover, the rural depopulation helps in keeping low wages and, thus, indirectly contributes to perpetuate a developing strategy based on a “blind” promotion of exports.

Table 5: FDI in China (Billions of Dollars)

Year	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
FDI	45.2	45.6	40.3	40.7	46.8	52.7	53.3	60.6	60.3	63.0

Source: US-China Business Council, 2007

This leads us to emphasize a risk that China may have to face: how to absorb a decrease in exports (i.e. its main source of growth)? The main difficulty here is that China has become more and more dependant on the level of its exports, so that an external recession could have an important negative impact on its internal conditions.

Table 6: Data regarding China's global demand

Share of expenditure components in real GDP (%)

	Private Consumption	Public Consumption	Exports	Imports
1973	55.7	9.4	5.0	4.1
1983	54.3	12.1	13.2	13.4
1993	49.1	13.1	18.6	19.3
2003	39.6	12.0	24.4	18.6

*Average growth rates of expenditure components
based on constant prices (1990)*

	Private Consumption	Public Consumption	Exports	Imports
1973-1983	9.0	14.7	40.6	52.3
1983-1993	16.1	18.0	26.7	27.7
1993-2003	14.2	12.2	21.8	13.3

***Contribution of demand components to GDP growth (%)*⁴**

	Private Consumption	Public Consumption	Exports	Imports
1973-1983	52.9	15.2	22.3	23.6
1983-1993	45.9	13.6	21.9	23.1
1993-2003	32.9	11.3	28.6	18.1

Source: Felipe and Lim (2005)

As an illustration, Table 6 above clearly demonstrates that the share of exports in Chinese GDP never stopped growing during thirty years. More recent data from the US-China business council for 2004 and 2005 confirm this trend. The contribution of external demand, i.e. exports, to GDP growth has also raised to reach its highest level since the 1973-1983 decade. Moreover, by using data from Tables 2 and 6 we are able to conclude that, according to Felipe and Lim's criteria, China has really adopted an export-led growth regime. Nevertheless, this strategy could well come up against the following macroeconomic constraint: in order to keep on growing, China needs that American and European households keep on importing Chinese manufactured goods at the same rate, otherwise an imported recession could not be easily avoided. If it maintains its actual growth strategy, in the case of a fall in exports, domestic demand will not be able to take over external demand. This assessment is based on two arguments. First, it is unlikely that investment counterbalances a decline in exports since its prime objective is to increase the capacity production of Chinese manufactured goods destined, to a large extent, to external markets. Second, the share of households' consumption in GDP has reached a very low level. The crucial point here is the following: the contribution of consumption to GDP has never been so low since thirty years (from 52.9% to 32.9% between 1973 and 2003 according to Table 6). This established fact brings us to consider that Chinese authorities do not really envisage the domestic market as a natural outlet for their firms. Therefore, it seems that China is, notwithstanding high growth rates, relatively vulnerable to negative shocks on external demand. According to us, this economic situation is a direct consequence of the post-socialist transformation. This is what we shall assess in the following section.

III.3. Risks and threats from the post-socialist transformation

The macroeconomic constraint exposed above constitutes a risky situation for China in the case of a contraction in international markets and particularly in the United States. Indeed,

⁴ In the third part of Table 5 imports represent a negative contribution.

they still absorb one third of Chinese exports (cf. Table 7) which represents more than any other country. Actually, China is often considered as the main responsible of the abyssal US trade deficit (about \$716 billion in 2005 according to the Bureau of Economic Analysis). Therefore, it is possible to summarize the economic threats for China in the following way: in the medium and long run can we reasonably ignore the possibility of a fall in external demand from the US?

Table 7: Chinese exports (Billions of Dollars)

Year	2000	2001	2002	2003	2004	2005
Total exports	249.2	266.2	325.6	438.4	539.4	762.0
Exports towards the US	100.0	109.4	133.5	163.2	210.5	259.8
Ratio of dependence (%)	40.0	41.1	41.0	37.2	39.0	34.0

Source: US-China Business Council, 2006 and WTO, 2006

Since the main difficulty to which the Chinese export-led growth regime could be confronted with concerns the occurrence of an external contraction, we have to assess why such an event may appear. In consequence, hereafter, we provide a list of external risks and their possible outlets in order to emphasize the economic vulnerability of China.

Risk 1: The tightening of economic policy

The first risk concerns the possibility of a tightening in fiscal (an increase in tax in order to counterbalance the current deficit) or monetary (a raise in the Federal funds rate to avoid an increase in inflation) policy. The US budget deficit is still high, notwithstanding high growth rates in 2004 and 2005. Indeed, it represents 2.36% of GDP at the third quarter of 2006 (cf. Table 8). A crucial point is that such a disequilibrium cannot last forever. However, the policies that allow to reduce this deficit may well have recessive consequences. Assuming a constant GDP growth rate, the Government has two choices: either it raises the level of taxes or it strongly diminishes public spending. In both cases, this affects negatively the amount of GDP. In the same vein, an increase in the rate of interest would have a negative impact on economic activity.

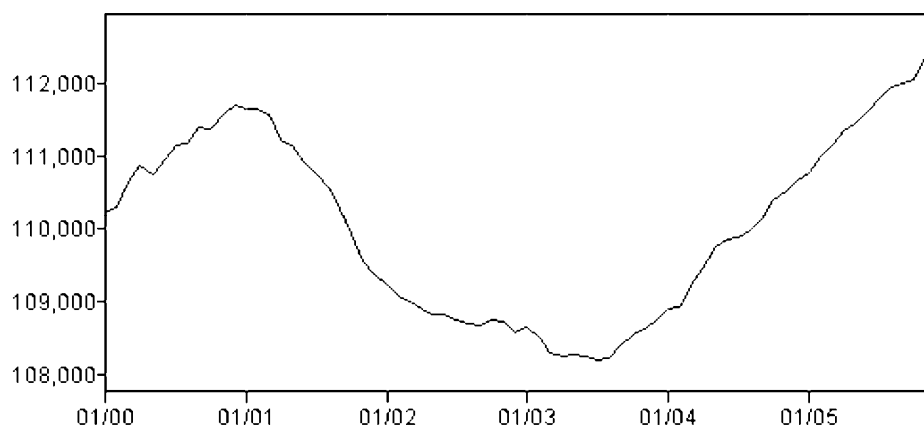
Table 8: US public deficit (Billions of dollars)

Year^a	2000	2001	2002	2003	2004	2005	2006
Budget deficit	159.0	- 39.3	- 396.7	- 543.3	- 553.6	- 474.8	- 311.7
Deficit/GDP (%)	1.61	- 0.38	- 3.78	- 4.95	- 4.71	- 3.80	- 2.36

Source: Bureau of Economic Analysis, ^a third quarter of 2006.

Risk 2: The endogenous recession

An endogenous contraction in the US, for example through a decline in household consumption, represents a serious threat for China. We think it should not be underestimated since consumption growth has been largely financed *via* indebtedness, due to very favourable financial conditions (in 2004 the Fed funds rate was at 1%) which contributed to raise prices in the real estate sector. Even though these two phenomena have their own limitations, monetary policy mistakes, for instances a wrong increase in the interest rate, would be sufficient to put an end to this period of consumption-led growth. Moreover, on the assumption of an internal contraction, it is unlikely to wait for an “assisted” recovery by the US Government, as was the case in 2001. Indeed, before 2001 it ran a budget surplus of \$159 billion, which is very different from the current deficit of \$311 billion (cf. Table 8). The main issue here is to know whether it will be able to stimulate domestic demand, as it did between mid-2000 and 2005, by creating 1.13 million jobs in the public sector, in order to counterbalance the decline in private-sector employment between 2001 and mid-2003 (cf. Figure 3). However, such an intervention seems unlikely simply because the room to manoeuvre is very small with respect to the current US budget deficit.

Figure 3: Private-sector employment in the US (thousands of workers)

Source: Bureau of Labor Statistics

An endogenous recession in the US would surely be the worst scenario for China's economy. Other things constant, it would have a deep and negative impact on its GDP through the export channel. As Estiot (2003) recalls, the economic history of the US shows that its imports are very sensitive to internal economic conditions. For example, over the declining period 1987-1991, the trade deficit has been divided by almost five, diminishing from \$151 billion to \$31 billion (cf. Table 9). Moreover, taking into account the strong dependence of China towards the US, the effect will certainly be magnified.

Table 9: US trade deficit (Billions of Dollars)

Year	1987	1988	1989	1990	1991
Trade balance	- 151.6	- 114.5	- 93.14	- 80.86	- 31.13

Source: Bureau of Economic Analysis

Risk 3: A counterbalancing European effect?

Previously, we implicitly assumed that China had bilateral trade relations with one country, i.e. the US. In reality, the Euro-zone also constitutes an important outlet for Chinese manufactured goods. At this stage, it is quite justified to ask the following question: in the case of a recession in the US, is Europe able to absorb Chinese exports and avoid a deep economic contraction in China? If so, such a mechanism would be rather limited. Indeed, it seems very difficult for Europe to absorb the totality of the decrease in Chinese exports. Table 10 indicates the amount of US and European imports from China:

Table 10: Imports of the US and European Union from China (Billions of dollars)

Year	2001	2002	2003	2004	2005
US	109.4	133.5	163.2	210.5	259.8
European Union^a	67.3	77.1	107.8	157.8	195.8

Source: WTO, a European Union (25) after 2003

We observe that the average growth rates of imports of the US and Europe from China are, respectively, 24.1% and 30.5%. Assuming a 10% decrease in US imports, i.e. \$25.9 billion, which represents a very limited decline regarding Table 9, some simple calculations show that European imports should increase by 43.7% in order to counterbalance the fall in US imports. However, this is largely beyond the average growth rate of European imports between 2001

and 2005 (30.5%). At this stage, the counterbalancing thesis seems very unlikely. Besides, a recession in the US would have negative consequences in the Euro zone since European countries are also dependant on the US through their exports. Consequently, if economic conditions are also deteriorated in Europe, that would certainly magnify the negative impact on China's exports.

Risk 4: Non-strictly economic threats

In this last scenario, we consider a non-strictly economic constraint for China. We hence deal with events, not directly linked to an economic cause (US recession, economic policy mistake), but that have negative repercussions on Chinese exports. For instances, we may take into account the threats of a protectionist temptation. Although this risk is relatively low in the scope of international economic relations under the rules of the WTO, we cannot ignore it. Notwithstanding the pressures emanating, among others, from the US Congress and asking for a substantial revaluation of RMB, the exchange rate remained relatively constant over the past decade. Therefore, considering the resistance of Chinese authorities to revalue, we cannot abandon the possibility of an increase in import duty on Chinese manufactured goods. An alternative solution, sketched by Stiglitz and Lau (cf. *Financial Times*, April 25th 2005), would be that China decides to impose a tax on its exports. Such a policy would have two main advantages: (i) an export tax could generate important revenue for Government authorities and (ii) "it would not lead to financial losses for Chinese holders of dollars-denominated assets" (People's Bank of China, commercial banks and firms). Nevertheless, whether it concerns a protectionist temptation or an export tax, these policies would not change the negative impact of a fall in exports on Chinese growth. In other respects, Stiglitz (2006) also refers to the fact that China should "put more emphasis on managing domestic demand growth".

In consequence, the risks considered above indicate that an export-led growth strategy, making China too dependant of its exports, is dangerous for its stability and growth in the medium and long run. Indeed, for some years, various studies insist on the risk that such a strategy, if generalized, would represent (cf. Erturk, 2001-2002; Blecker, 2002, 2003; Palley, 2002) and on the appearance of a crowding-out effect (Palley, 2003). Export-led development may work when adopted by one or a few countries, but it loses its property when adopted by all. Today, too many Asian Governments have adopted an export-led growth strategy, ignoring this crucial point. This is what Blecker calls "a fallacy of composition". The main problem here is that a whole continent, including its biggest country, decided to base its

development on such a strategy. By following this logic, China has become a global manufacturer without assessing the consequences of such a policy in the case of an external recession.

Conclusion

This article is an attempt to deal with the post-socialist transformation in China. During the Maoist era, as for the other socialist countries, the Chinese economy was characterized by forced growth (cf. Kornai, 1972). However, since the end of the seventies, it progressively changed by promoting its exports. This development could involve several difficulties in the medium and long run. The main problem is that China could come up against an external constraint and, in particular, an imported recession from the US. Indeed, many factors tend to show that we cannot ignore the possibility of a contraction in the US that could not be counterbalanced through an increase in the level of European demand for Chinese manufactured goods. In addition, Chinese domestic-demand is too low to prevent the negative consequence of a decrease in exports. The crucial point here is that whatever the scenario (endogenous recession in the US, a tightening in monetary or fiscal policy...), the impact would be negative on China's economy.

Regarding these risks, what are the different solutions for Chinese authorities? An intuitive answer would consist in adopting an alternative growth regime with domestic demand replacing exports, at least partially. However, such a change is not so easily achievable for two reasons. First, we showed that the post-socialist transformation is an institutional and systemic change, the new growth regime based on exports being one of its main characteristics. Consequently, it is overdetermined by several institutional factors, which make it difficult to change in a conscious way. Structural reforms are needed to diminish the risks following the Chinese export-led growth strategy. Nevertheless, these reforms will have to do with the inertia of Chinese saving behaviors, due to the absence of a welfare state. The Chinese government does not support old age pensions, unemployment and health care. In addition, many households save in order to finance the higher education of their children. Second, an increase in households' purchasing power, involving a raise in domestic demand, could have a negative impact on inflation. Here, the main issue is to know whether the raise in

domestic demand is capable of counterbalancing the fall in exports following the expected increase in inflation.

Bibliography

- Blecker, R. (2002), "The Balance-of-Payments-Constrained Growth Model and the Limits to Export-Led Growth", in Davidson, P. (ed.), *A Post Keynesian Perspective on the Twenty-First Century Economic Problems*, Cheltenham, Edward Elgar.
- Blecker, R. (2003), "The Diminishing Returns to Export-Led Growth", in Mead, W.R., Schwenninger, S.R. (eds), *The Bridge to a Global Middle Class: Development, Trade, and International Finance in the 21st Century*, Boston, Kluwer Academic Publishers.
- Cass, D. (1965), "Optimum Growth in an Aggregative Model of Capital Accumulation", *Review of Economic Studies*, vol. 32, 3, pp. 233-240.
- Erturk, K. (2001-2002), "Over Capacity and the East Asian Crisis", *Journal of Post Keynesian Economics*, vol. 24, 2, pp. 253-277.
- Estiot, A. (2003), "Is the US Current Account Deficit a Black Hole?", *Conjoncture BNP-Paribas*, October.
- Felipe, J. (2003), "Is Export-Led Growth Passé? Implications for Developing Asia", *Working Paper*, n° 48, Economics and Research Department, Asian Development Bank, Manila, Philippines.
- Felipe, J., Lim J. A. (2005), "Export or Domestic-Led Growth in Asia?", *Asian Development Review*, vol. 22, 2, pp. 35-75.
- Havrylchyk, O. (2005), "L'avancée des réformes bancaires chinoises", *La lettre du CEPII*, n° 248, Septembre.
- Keynes, J.M. (1936), *The General Theory of employment, interest and money*, London, Macmillan and Co.
- Kornai, J. (1972), *Rush versus Harmonic Growth*, Amsterdam-London, North-Holland Publishing Company.
- Kornai, J. (1979), "Resource-Constrained versus Demand-Constrained Systems", *Econometrica*, vol. 47, 4, pp. 801-819.
- Kornai, J. (1980), *Economics of Shortage*, Amsterdam, North-Holland.
- Kornai, J. (1986), "The Soft Budget Constraint", *Kyklos*, vol. 39, 1, pp. 3-30.
- Kornai, J. (1992), *The Socialist System: The Political Economy of Communism*, Oxford, Oxford University Press.
- Kornai, J. (1993), "The Evolution of Financial Discipline under the Postsocialist System", *Kyklos*, vol. 46, 3, pp. 315-336.
- Kornai, J. (2000), "What the Change of System From Socialism to Capitalism Does and Does Not Mean", *The Journal of Economic Perspectives*, vol. 14, 1, pp. 27-42.
- Li D.D. (1998), "Changing Incentives of the Chinese Bureaucracy", *American Economic Review*, vol. 88, 2, pp. 393-397.
- North, D.C. (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge, Cambridge University Press.
- Oi, J.C. (1992), "Fiscal reform and the economics foundations of local state corporatism in China", *World Politics*, 45, October, pp. 99-126.
- Oi, J.C. (1996), "The Role of the Local State in China's Transitional Economy", in Walder, A. G. (ed.), *China's Transitional Economy*, Oxford, Oxford University Press.

- Oi, J.C. (1999), *Rural China Takes Off. Institutional Foundations of Economic Reform*, Los Angeles, University of California Press.
- Palley, T. (2002), “Domestic Demand-Led Growth: A New Paradigm for Development”, in Weaver, J., Jacobs, D., Baker, J. (Eds), *After Neo-liberalism: Economic Policies That Work for the Poor*, Washington DC, New Rules for Global International Finance.
- Palley, T. (2003), “Export-Led Growth: Evidence of Developing Country Crowding-out”, in Arestis, P., Baddeley, M., Mc Combie, J. (Eds), *Globalisation, Regionalism and Economic Activity*, Cheltenham, Edward Elgar.
- Palley, T. (2006), “External Contradictions of the Chinese Development Model: Why China Must Abandon Export-led Growth or Risk a Global Economic Contraction”, *Journal of contemporary China*, vol. 15, 46, pp. 69-88.
- Solow, R. (1956) “A Contribution to the Theory of Economic Growth”, *Quarterly Journal of Economics*, vol. 70, 1, pp. 65-94.
- Stiglitz, J.E. (2006), “China and the Global Economy: Challenges, Opportunities, Responsibilities”, in Sang Ho, L., Ash, R. (Eds) *China, Hong Kong and the World Economy: Studies on Globalization*, Hampshire, Palgrave Macmillan.
- Thirlwall, A.P. (1994), *Growth and Development*, London, Macmillan.
- Thirlwall, A.P. (2002), *The Nature of Economic Growth: An Alternative Framework for Understanding the Performance of Nations*, Cheltenham, Edward Elgar.
- Vahabi, M. (2002), “La ‘fringale’ d’investissement, le fédéralisme économique et la stabilité macro-économique en Chine”, in Andreff, W. (ed.), *Analyses économiques de la transition*, Paris, La Découverte.