

Domestic Demand and Continued Reform: China's Search for a New Model

By Wang Yong

All eyes in Asia are watching how China handles the financial crisis, given its importance to the region. Chinese political economist Wang Yong argues that the country will emerge from the crisis with a new development model that will be good for China and good for the world.

THE SUCCESS OF CHINA'S ECONOMY in the last three decades of explosive growth has been a source of great pride, but the deepening world financial crisis offers a chance to review China's development model. In Chinese eyes, what strengths and weaknesses does the crisis highlight in the Chinese model? Is the Washington Consensus discredited in the eyes of Chinese policymakers and even the public? Will the country continue its reforms and the open-door policy of the last 30 years? It is important to explore these questions, because Chinese policies will have an immediate impact not only on China's development, but also on the future of the global economy.

REFLECTIONS ON THE FINANCIAL CRISIS

In China, as elsewhere in a world consumed with worry over the future of economic well being, the causes and implications of the financial crisis are hotly debated. Some commentators argue that greedy Wall Street financial firms are to blame for the crisis, while others insist that the US government, especially the Federal Reserve Board and its former chairman, Alan Greenspan, should take responsibility for failing to properly regulate financial markets. Some left-wing scholars, meanwhile, trace the crisis to basic flaws in capitalism, stressing that the positive values represented in Marxism are nowhere to be seen in this era of globalization. More locally, there is a small group of people within China who angrily accuse those with economic power in China of selling out the national interest by squandering China's foreign reserves on speculative investments in American financial organizations such as Blackstone, Fannie

Mae and Freddie Mac. These critics even called for the intervention of the National People's Congress to identify who within China is really responsible for investments of this nature.

Ironically, in December 2008, the Chinese government officially celebrates the 30th anniversary of reform and opening that began in 1978. Obviously, the global financial crisis and its increasingly serious impact have come at the wrong time, and cast a shadow over this important political milestone. Moreover, the crisis has

as the Asia-Europe Meeting, the Group of 20 summit and the gathering of the Asia Pacific Economic Cooperation forum in Peru in November.

In keeping with finding a Chinese way to express policies, officials have stressed what they refer to as the philosophy of the "three balances" in approaching the crisis. These three balances are between financial innovation and financial regulation; between the virtual economy and the real economy and between savings and consumption. Though it is politically and economically difficult to strike

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created incentives to strengthen state intervention in the economy, and even to reestablish barriers to reform in the banking and financial sectors.

Despite the vocal skepticism in some quarters about global capitalism and the wisdom of investments in the US market, the Chinese government has generally set aside these concerns and joined with other countries trying to manage the crisis. Like governments in the US and Europe, China has moved quickly to stimulate its economy. It has cut interest rates and announced a massive 4 trillion Yuan rescue package aimed at stimulating domestic demand. Throughout this crisis, the US-China Strategic Economic Dialogue has served as a platform for Chinese and American officials to coordinate policy. As a result, China has increased the amount of US Treasury bonds it has in hand, thereby reducing pressure on interest rates in both countries at the same time.

Since the crisis emerged, Chinese officials have made their views clear in speeches at such events

these balances, these observations are important from a Chinese point of view. They highlight the structural problems that led to this financial disaster, and reflect the traditional value of Chinese philosophy in achieving "balance" or harmony.

A CRISIS OF THE CHINESE ECONOMIC MODEL?

Driven by massive exports and foreign direct investment, China's economic model has so far produced amazing results. China has attracted inward investment of as much as \$700 billion, with total imports and exports exceeding \$2.17 trillion in 2007. Foreign exchange reserves have soared to close to \$2 trillion within 5 years, the highest in the world. Meanwhile, China is speeding up its outbound investment under a campaign involving mergers and acquisitions across the globe. Still, over half of China's foreign exchange reserves have been invested in the US, mostly in US government debt. Undoubtedly, all

these connections have strengthened the deep interdependence between China and the global economy and have also resulted in China's high growth rates in recent years. But the country is exposed to high risks that are unprecedented in Chinese history.

The challenges to the export- and FDI-driven development model come from several areas:

- First, China's overdependence on international trade. As many analysts note, the current crisis has greatly shrunk external demand. This, in turn, leads to falling exports, which have resulted in the closure of thousands of factories and a rise in unemployment, especially in developed coastal areas. Masses of unemployed workers will cause great concern over social and political instability in the next several years. Critics insist that China's dependence on trade is a major problem. Trade currently accounts for as much as 70 percent of total GDP, higher than any other major economy.
- Second, the export-oriented growth model cultivates strong inertia, locking China in at the lower end of the value-added chain. If China is going to keep its position as the "world's factory" — a place of low-cost assembly lines — some critics say the country cannot substantially improve its real productivity in terms of research and development and manufacturing technology. One often-cited example involves the auto industry. Upon China's accession to the World Trade Organization in 2001, the largest state-owned auto companies rushed to give up their R&D facilities in order to embrace joint venture partnerships with large international carmakers. As shown in research sponsored by the China Automobile Association, these state-owned firms became assembly lines for foreign-brand cars, and the lion's share of the profits went to foreign investors.
- Third, overdependence on international demand has weakened Chinese foreign policy. Some radi-

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cal nationalist critics have attacked the country's so-called low profile diplomacy (*tao guang yang hui*) as evidence of weakness. They argue that this external dependency limits China's policy options when it comes to responding to such issues as human rights, Taiwan, trade friction and even quarrels with Japan over history textbooks. Chinese diplomats and leaders often face the accusation of not doing enough and being too soft.

The current financial crisis offers an opportunity to reflect on whether the current Chinese economic model could or should be altered in light of the above concerns. Despite the criticism, of course, it's simply not possible to reverse China's integration into the international economy. But a significantly altered international economic landscape in the aftermath of the current collapse could well bring forth a new model of Chinese development.

THE CHINESE MODEL'S SECOND STAGE?

Despite suspicions about global capitalism and the internationalization of the Chinese economy, it is highly unlikely that China will retreat from the global economy. This political determination was reflected in the ruling party's mouthpiece, the *People's Daily*, in a series of editorials published in December. Recalling the painful memory of the Cultural Revolution and the disaster of a centralized command economy, both China's elites and the public firmly oppose returning to a pre-reform model, and disengaging from the world economy. In order to address doubts about the reform process engendered by the current financial crisis, the party and government leaders obviously view the 30th anniversary of the opening as a good chance to rebuild a national consensus on the future path of the Chinese economy.

On the other hand, the crisis of global capitalism has deepened the confidence of some Chinese who are searching for a new development model. For example, China's bankers and regulators have

become more confident in themselves and their management and regulation of the financial sector as a result of the global crisis. They used to be taught to copy Western regulatory models, but now they find they can survive this global crisis just fine on their own.

In the future, China will "redefine" its economic model. The effort has already begun. The new economic model will be a mixture of continuity and change, and a compromise of past achievements and lessons learned from the crisis. Besides keeping the good elements of the first stages of reform in China, we could well see some of the following changes:

- The new model will give more incentive to domestic demand in order to continue high-speed economic growth, in part to replace the current dominance of exports. To realize this transition, the government is working on a more universally accessible network of social security, which could help people to save less and spend more. As a result, a revolution of income distribution could well occur.
- The model will be more environment-friendly. The high growth of the past has exacted a heavy price on the environment, turning China into an environmental danger zone. A pressing demand to implement a new system of stricter environmental regulations comes not only from international pressure, but also from local concerns about severe environmental degradation. The fuel tax reform proposal is under public review, which is the most recent showcase of the Chinese government's effort to take advantage of market pricing to check energy consumption and carbon emissions.
- The new economic model will include important measures to deepen market-oriented reforms and create a more mature market system. This would not necessarily conflict with the principles of the Washington Consensus. Indeed, despite left-wing critics, a consensus is building that in order to solve the difficult problems such as in-

come distribution and environmental protection, further marketization is necessary. What China opposes is not the market economy per se, but the interventionist policy of the West, which is seen as imposing its models without consideration for local conditions in developing countries.

- More attention will be given to innovation in science and technology. In key technologies, such as high-speed railways, large-lift and commercial aircraft, and next generation communications, the government is increasing its support for innovative development and commercial opportunities.

to complete needed international reforms. One can attribute this to a continuation of low profile diplomacy in the broader arena.

But on Tibet, China has sent a strong warning to French president Nicolas Sarkozy by postponing the China-EU summit meeting and also issuing a perceived threat to cancel a huge Airbus purchase deal. This is proactive diplomacy, and we can expect to see more of it on issues close to home.

This financial crisis appears to be an epochal event that is reshaping the world political and economic landscape. As a response to this grim

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DIPLOMACY IN THE FUTURE

Since economic development is closely linked to foreign relations, the new economic model will also have an impact on diplomacy. Chinese diplomats will have to make more sophisticated calculations to strike a balance between being "low profile" and "proactive." In the foreseeable future, expect China to continue its low profile approach, but the policy scale could begin shifting to a more aggressive posture, especially in handling sensitive areas that are viewed in Beijing as matters of national sovereignty, chiefly Taiwan, Tibet and Xinjiang.

From recent gestures in foreign relations, however, we see chiefly continuity and adjustment. China is not keen to try and usurp the US position as the No. 1 player in the global financial system, and this has been a surprise to many international observers. China is thinking in terms of a partnership with the United States and other countries

challenge, Chinese decision makers want to reach a consensus on a new — or altered — economic model. Though we are not able to judge the success of that effort yet, it is clear that pressure is needed to deepen domestic and international reforms. The Chinese economy will not go back to its pre-reform state of inward-looking socialism, but it will stimulate domestic demand. Fortunately, this will give it a more solid domestic base on which to build further integration with the global economy. An economy driven more by the domestic market and less by exports will be good for China and good for the world.

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