Journal of International Development
J. Int. Dev. **22**, 739–757 (2010)
Published online in Wiley InterScience
(www.interscience.wiley.com) DOI: 10.1002/jid.1727

IS CHINA TURNING LATIN? CHINA'S BALANCING ACT BETWEEN POWER AND DEPENDENCE IN THE LEAD UP TO GLOBAL CRISIS

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Abstract: China's apparent escape from the external constraints of peripheral late industrialisation in the build up to the global economic crisis of 2007–2009 has been recent and remains tenuous. Before its spectacular trade surpluses of the 2000s, China's external accounts reflected many of these constraints. Even in the midst of the surplus surge, external vulnerabilities of a peripheral nature have persisted. Besides the issue of export dependence, which is the conventional focus of most crisis-related studies on China, vulnerabilities have been more profoundly related to the dominance of foreign ownership in China's export sector and to the relatively subordinate position of this export sector within the massive rerouting of international production networks via China that followed the East Asian crisis, in large part led by Northern transnational corporations. Copyright © 2010 John Wiley & Sons, Ltd.

Keywords: China; global imbalances; balance of payments; late industrialisation; international production networks; transnational corporations; structuralism

1 INTRODUCTION

Has China escaped the vulnerabilities of peripheral late industrialisation in the build up to the recent global economic crisis? This question is important with regard to expectations that have been placed on China to play a central role in mediating the crisis due to its large

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[†] Although not responsible for any of the views expressed herein, this article benefited from many exchanges with Kari Polanyi Levitt and Mary Zsamboky. Much thanks is also due for feedback over the last two years from: James Galbraith, Jayati Ghosh, Charles Gore, Arjan de Haan, Jan Kregel, Howard Nicholas, James Putzel, Ken Shadlen, Geoff Tily, Zhu Ling and two anonymous reviewers. I am also indebted to the lasting influence of Athar Hussain and Tom Naylor.

holdings of foreign reserves and its large trade surpluses with the US and Europe (albeit, as of April 2010, China's overall trade surplus had almost vanished).[1] It is also important with regard to the degree to which the Chinese experience of the last decade, during which most of its reserves were accumulated, can or should be held up as a replicable or sustainable model for other developing countries, or whether it vindicates important lessons from development experiences of the past, albeit on a much larger and more dramatic scale.

Accordingly, interpretations of China's rise fall broadly into two camps. A 'developmentalist' camp, often called a 'Beijing Consensus', emphasises the centrality of state-led industrial policy throughout the reform period, together with other 'heterodox' policy approaches such as capital controls and state control of finance. These need to be maintained, it is argued, until China truly graduates from its latecomer status. The other camp, which might be called 'transitionalist', emphasises the centrality of liberalisation in the transition from state socialist to market capitalist systems. Heterodox interventions in the economy are seen as peculiar, perhaps necessary but nonetheless temporary distortions of transition. Further liberalisation is seen as necessary to keep the show on the road. As is usual in development debates, tension between these two camps revolves around typical state versus market or intervention versus liberalisation dichotomies.

While the two camps disagree on many points, both lean towards a supply-side interpretation of China's contribution to global imbalances and, via these imbalances, to financial bubbles and crisis in the US.[2] China's surpluses are seen as the result of interventionist domestic industrial policies, irrespective of whether these are deemed as positive or negative. Hence, a consensus has emerged across both camps that global imbalances need to be corrected in large part through China's domestic policies, including currency revaluation and increased import and domestic consumption. Without denying the importance of this domestic dimension, its near-exclusive emphasis in discussions about China's role in global imbalances nonetheless diverts attention away from other more systemic trends that underlie China's emergence as a major surplus nation. In turn, these trends reveal important vulnerabilities that are usually overlooked by mainstream debates on China's so-called 'mercantilism', which usually treat China's export-dependent surpluses as a cause of crisis rather than as a symptom of much deeper forces at work, many beyond China's control.

In this sense, it is useful to examine China through the lens provided by earlier structuralist critiques of peripheral and dependent industrialisation in Latin America in the 1960s, then the most industrially advanced region of the Global South experiencing decently rapid rates of growth. There are obviously enormous differences between China and Latin America. Besides sheer scale, China began its ascent into rapid growth from the basis of an entirely state-owned and controlled economy, under which considerable industrial and technological capacity had already been developed, mostly on the basis of domestic resources. Much of this state ownership remains in the economy, whether explicitly or implicitly, particularly in key strategic sectors such as rural land and finance. In this context, the terms 'liberalisation' and 'privatisation' have carried fundamentally different implications in China than in Latin America, the latter with its mixed economies, transnationalised private sectors, and high degrees of inequality rooted in colonial legacies of private land ownership. However, bearing in mind these very poignant differences,

[1] See Fischer (2009b) for a discussion of these expectations and a prediction that China's trade surplus could quickly erode, although I did not anticipate the speed of erosion at that time.
[2] Again, see ibid for a detailed exposition of these arguments by Martin Wolf, Paul Krugman and others.

DOI: 10.1002/jid

‘opening and reform’ in China since the late 1970s has ushered in a variety of notably Latin American characteristics, setting it aside from some key attributes of South Korea and Taiwan. These include rapidly rising inequalities to levels that are now within the lower range of Latin American countries and the rapid transnationalisation of ownership in its manufacturing export sector.

In the early post-war period, analogous attributes were analysed by economists involved with the centre-periphery approach of the Economic Commission for Latin America (CEPAL). They focused on two patterns of disequilibrium; one internal in the form of polarisation and marginalisation in the domestic economy and society, and one external in the form of structural weaknesses in the balance of payments. Although rising inequalities in China arguably carry stronger comparative potential with Latin America, this article focuses on the less obvious issue of external disequilibria given that this helps to highlight certain aspects about China’s role in the global economy that have been largely absent in recent debates.

On first reaction, it would seem that China’s huge current account surpluses and its enormous build-up of foreign exchange reserves effectively eliminate any comparative relevance to this earlier structuralist focus. However, China’s apparent exceptionalism with regard to its external position has been recent and remains tenuous, appearing only after 2000. Before this time, China’s external accounts reflected many aspects highlighted by earlier structuralist critiques of Latin American industrialisation. Moreover, even in the midst of China’s surging surpluses in the 2000s, certain external vulnerabilities of a peripheral nature have persisted. Besides the issue of export dependence, which is the conventional focus of most crisis-related studies on China, vulnerabilities have been more profoundly related to the dominance of foreign ownership in China’s export sector and to the relatively subordinate position of this sector within the massive rerouting of international production networks via China that followed the East Asian crisis, in large part led by Northern transnational corporations.

There is a tendency, in other words, to see China’s trade surpluses in ‘methodologically nationalist’ terms (to quote Charles Gore, 1996), as if Chinese firms are trading final goods in arms-length transactions with US firms and national adjustments need to be made accordingly. However, the emergence of these surpluses has been intimately related to transnational reorganisations of global production and distribution systems within which China has been playing a relatively subordinate role. While this might be a passing stage that China will eventually overcome, determinism should not be presumed. Indeed, the recent economic crisis and the enormous surge in liquidity that ensued might turn out to be a prelude to more profound peripheral crises in the near future, much as crises and similar liquidity responses in the US in the 1970s prepared the ground for the eventual demise of dependent developmentalism in Latin America through debt crisis in the early 1980s. Hence, it is important to understand China’s own balancing between power and dependence in order to appreciate the potential dangers it faces in its own attempts to climb the global economic hierarchy, as well as the caution often expressed by China’s leaders versus the bellicose certitude often expressed in the West with regard to China’s rise.

The analysis is presented in three parts. The first reviews some of the main CEPAL structuralist insights on the external vulnerabilities of peripheral dependent industrialisation, focusing on the contribution of Osvaldo Sunkel. The second part offers an inductive analysis of China’s balance of payments position with the world from 1982 to 2008, focusing on various aspects of external vulnerability before and during China’s

DOI: 10.1002/jid

spectacular surplus surge in the 2000s. The third part examines the regional breakdown of China's trade accounts in more detail. The conclusion reflects on the dialectical nature of China's strengths and vulnerabilities that have flowed from the relatively dependent nature of its rapid integration into global production and trading systems dominated by northern transnational corporations, arguing that overly optimistic evaluations of China's strength do little service to China or to the important lessons that other countries of the Global South need to learn from China's experience.

2 CEPAL STRUCTURALISTS ON EXTERNAL DISEQUILIBRIA

External disequilibria received the brunt of attention in early development economics because these were understood as potentially snubbing out nascent efforts at rapid industrial catch-up. Similar to other leading pioneers of the sub-discipline, the early CEPAL economists focused on chronic foreign exchange gaps that arose due to the intensive import demands of late industrialisation and urbanisation, and subsequent tendencies towards domestic price inflation and balance of payments instability and crisis.[3] Raul Prebisch argued that declining terms of trade in primary commodity exports further exacerbated these disequilibria, in tune with many of his contemporaries such as Ragnar Nurkse, Hans Singer and Arthur Lewis. The dominance of Northern firms in various services, such as transportation, insurance, finance and patent and royalty payments, was also commonly noted as an additional route by which Southern surpluses were siphoned. While Prebisch, like Lewis and others, initially posited in the late 1940s that aid or foreign direct investment (FDI) could have a positive and stabilising influence on these external disequilibria, later work by Celso Furtado and Osvaldo Sunkel (as well as by Prebisch and Lewis)[4] became increasingly critical of the rising dominance of transnational corporations (TNCs) in Latin American import-substituting industries (ISI). Together, this combined tradition of structuralist thought highlighted the trade and financial mechanisms that accentuated the already-existing structural propensity of peripheral developing countries to experience chronic foreign exchange shortages in their attempts to industrialise.

The work of Sunkel, like that of Furtado, was grounded on the centre-periphery approach of Prebisch (see UN/Prebisch, 1950), which aimed to elucidate the challenges posed by the historical integration of Latin America into the international economy. As outlined by Prebisch, the propagation of technical progress from centre to periphery established the outward-directed, externally propelled development of peripheries and the four characteristics of peripheral capitalist economies: declining terms of trade; marginalisation of disadvantaged populations in the peripheries; imitative metropolitan consumption patterns of periphery elites; and macroeconomic instability in the form of inflationary pressures and chronic foreign exchange gaps due to vulnerable economic structures.[5] Prebisch promoted ISI as a way to break out of this mould, although he was cognisant of the fact that the intensive import requirements of ISI would exacerbate the tendency of foreign exchange gaps, thereby calling for the support of foreign finance.

Sunkel and Furtado extended this CEPAL analysis to the patterns of ISI that were already emerging in Latin America as early as the mid-1950s, such as chronic balance of

[3] See Fischer (2009a) for further discussion of these points.
[4] See Lewis (1978: 38–46) for his discussion of the difference between foreign debt and FDI.
[5] See Polanyi Levitt (2005) for a synthesis of the thinking of Prebisch.

DOI: 10.1002/jid

payments problems in Brazil and the Southern Cone countries, the leading industrialisers of the region. They criticised the initial optimism of Prebisch, Lewis and others that FDI could lead an autonomous process of industrialisation. Instead, they noted that it quickly led to the encroachment of US-based TNCs in key industrial sectors, with the result that much of the benefit expected from industrialization went abroad in payments, transfers and profit remittances. Both Furtado and Sunkel conceded that the massive penetration of foreign firms had accelerated industrial growth rates, although this also accentuated the uneven nature of development. As such, they were among the first theorists of the expansion of TNCs into the South. While steering clear of the more radical determinacy of neo-Marxist tangents of 'dependency theory',[6] both brought particular attention to the structures of ownership and the resultant control over flows of wealth that ensued from these increasingly transnationalised forms of industrial organisation.

In the article that introduced him to the US academic mainstream, Sunkel (1972) highlighted four highly negative effects of the massive expansion of FDI. These are worth detailing given their pertinence for the analysis of FDI in China. First, the process of vertical integration between subsidiaries and headquarters results in flows of goods, finance and technology, as well as market-sharing agreements, which generally take place within firms even if they are against a country's interests. Second, subsidiaries within one country tend to integrate horizontally, conglomerating among themselves and thereby influencing consumption and production patterns. They also influence the allocation of resources in the public sector, to the extent that they can acquire significant financial resources, private and public, with which to finance local expansion and foreign remittances, almost without the need of net additional foreign capital. Third, foreign subsidiaries exhibit a strong tendency to remit excess profits by manipulating the prices, kinds and quantities of their international transactions, which are mostly kept within the boundaries of the firm. Finally, a definite life cycle is associated with foreign subsidiary activities, with substantial initial contributions of capital, skilled personnel, technology and management, followed at later stages by cash outflows exceeding inflows and with little educational effect given the policy of retaining a monopoly of skills and technology within the firm (ibid: 525–527). Beyond these economic effects, he concluded that the socio-political consequences are of even far greater importance (ibid: 527).

This seminal analysis helped to elucidate the ways that TNC-led FDI could undermine national processes of accumulation even in the midst of relatively rapid growth. In particular, Sunkel and his contemporaries brought attention to ownership structure, in addition to earlier foci on trade and production structure, thereby shedding light more clearly on various financial mechanisms of wealth transmission from peripheries to centres. These mechanisms could be identified on the income account (i.e. remitted profits of TNCs and interest payments on debt) or on the financial account (i.e. licit or illicit capital flight by domestic elites or else various mechanisms of capital repatriation by TNCs). As noted by Sunkel, some of these mechanisms of financial transmission could also take place on the trade account through the emerging TNC techniques of transfer pricing, as also analysed by Vaitsos (1973). Indeed, transfer pricing added additional insight to the dilemmas of

[6] It is questionable to what degree Furtado or Sunkel should be associated with the subsequent school of 'dependency theory'. Kay (2005: 1205) traces one of the earliest uses of the term 'dependency' by a social scientist to Furtado (1956), while he was still working in CEPAL, although he also notes that Furtado was later criticised by Cardoso and other 'dependistas' for having an exaggerated confidence in the ability of the state to lead an endogenous process of development (ibid: 1204). I am also indebted to discussions with Kari Polanyi Levitt for insights on these matters.

DOI: 10.1002/jid

declining terms of trade. Notably, these financial aspects of vulnerability accentuated the already-existing propensity of late industrialising countries to run chronic current account deficits due to their structures of trade and production.

3 CHINA'S TURBULENT TAKE OFF FROM THE PERSPECTIVE OF ITS EXTERNAL ACCOUNTS

As a point of departure from these earlier analyses, it is useful to sketch out several important similarities and distinctions between China and earlier industrialisers in Latin America and East Asia. The most obvious is the exceptional manufacturing export performance of China, which bears most resemblance to East Asia. However, a similarity with Latin America is the TNC dominance in China's export industries, analogous to the TNC dominance in Latin American ISI. Moreover, as clarified by Naughton (1996), industrialisation in China is best understood as a mixture between export-orientation and import substitution. It therefore bears more similarity to the industrialisation of large Latin American economies such as Brazil in the late 1960s than is normally accorded, albeit on a much larger scale and with more careful retention of national ownership in its ISI sectors, while segregating TNC participation to its export sectors.

Indeed, the role of foreign ownership within the interplay between export and import substitution strategies is a key difference between China and both the Latin American and the East Asian models. Both South Korea and Taiwan were able, for various reasons, to excel in manufacturing exports without relinquishing control in their export industries to foreign investment and ownership.[7] In contrast, the export sector in China today is dominated by 'foreign-funded enterprises' (FFEs), which accounted for 58 percent of China's exports in 2005, up from 13 percent in 1990, 41 percent in 1995 and 48 percent in 2000 (Li *et al*., 2007: 93). The share would be even higher if subcontracting arrangements with locally owned firms are included within a wider understanding of these networks dominated by transnational corporations (TNCs). While 'round tripping' undoubtedly accounts for some of this increase, particularly in the 1990s,[8] the bulk of the share represents genuinely foreign forms of ownership. Moreover, 'wholly foreign-owned enterprises' accounted for 71 percent of the actually utilised value of FDI in 2005, versus 27 percent for joint ventures, and the wholly-owned share rose steadily throughout these years, reaching 81 percent in 2008.[9] In other words, the doorway for TNC entry into China has been predominantly through the export sector, similar to Malaysia, where exports are also largely based on foreign ownership. This contrasts with Latin America in the 1950s and 1960s, where TNC entry occurred largely through FDI in the ISI sectors as means to take advantage of protected domestic markets through foreign-owned subsidiaries. The Chinese model has resulted in exceptional export performance but also considerable foreign control over its means of earning foreign exchange.

[7] See Amsden (1989) for the seminal analysis of this in the case of South Korea.

[8] Round-tripping is the term used to describe the evasion of capital controls by Chinese nationals, who then invest from Hong Kong to take advantage of preferential terms for FDI. World Bank (2002: 41) estimated that such round-tripping accounted for about one quarter of FDI flows to China in the 1990s, although care must be taken with this estimation because clear definitions and explanations of the estimation techniques were not provided and also because of the implied policy agendas. It was also probably less of a factor in the 2000s than in the 1990s, when the capital account was much more closed, when there was more of a distinction in the treatment between FDI and domestic investment, and when traditional export sectors held a greater weight in total exports.

[9] Calculated from CSY (2009: Table 17-16 and equivalent tables in previous yearbooks).

DOI: 10.1002/jid

Terms of trade is another related point of comparison that has received some attention in the literature. It is already well established that China has been experiencing deteriorating terms of trade in its manufacturing exports, in some cases even within a single product category.[10] According to Zheng and Zhao (2002), this deterioration was greater vis-à-vis developed countries than developing countries and it was worst in the medium to high technology intensive manufactures such as computers and office equipment, which were precisely the sectors in which China has increased its participation in international production networks most rapidly (before and after 2001). At the time, the authors concluded that this reflected the segmentation within such product categories between high-technology or high-value inputs produced outside China and the labour-intensive processing of these inputs in China. As a result, much of China's involvement in international manufacturing networks effectively relies on leveraging its supply of cheap low-skilled labour even within these high technology exports, resulting in a fallacy of composition within its manufacturing exports.[11] Similarly, Li *et al.* (2007: 94) argue that the deterioration of China's terms of trade since the 1990s has been the result of large FDI inflows into labour-intensive export sectors. They also suggest that TNC practices of transfer pricing for the purpose of tax avoidance is another possible reason, echoing the criticisms of Sunkel (1972) and Vaitsos (1973) mentioned above.

Arguably, the dazzling export performance of China would seem to compensate for these various weaknesses. In order to judge whether China has truly escaped from the external vulnerabilities of peripheral late industrialisation, it is useful to analyse the balance of payments data more broadly. These data are presented below. Figure 1 presents China's balance of payments in nominal current value terms from 1982 to 2008, with the sign of the reserves reversed in order to allow for easier analysis. Figure 2 normalises these nominal data as a proportion of China's current value GDP converted at year-average market exchange rates.[12] Episodes of major devaluation or revaluation of the exchange rate are also roughly indicated. Figure 3 contextualises these data with general consumer price inflation and real per capita GDP growth rates.

Figure 1 presents the common view of China's balance of payments. It is difficult to analyse these nominal data, beyond the fact that China's emergence as a major surplus nation only became evident from 2002 onwards. The increasing volatility on the capital account and in the net errors and omissions (E&Os) is also striking. These patterns are much clearer in the Figures 2 and 3.

From the perspective of the normalised data in Figure 2, it is clear that the internal and external imbalances of China up until the mid-1990s epitomised the classic structuralist prognosis of late peripheral industrialisation, albeit with vigorous attempts to escape from this predicament. Periods of spurting industrial growth tended to lead to both inflation and current account deficits, which in turn were only resolved through austerity (relative to Chinese norms). For instance, after a few initial years of rapid growth and moderate inflation in the early 1980s, the current account fell sharply into deficit in 1985 (−3.7 percent of GDP), which was corrected through a combination of a sharp devaluation of the official exchange rate by over 40 percent in 1984 together with further liberalisation of

[10] For example, see UNCTAD (2002: 119); UNCTAD (2007: 11–12); Zheng and Zhao (2002) and Li *et al.* (2007).

[11] See UNCTAD (2002: 113–139) for a more general discussion of fallacy of composition within developing country manufacturing exports.

[12] Market exchange rates are used instead of a PPP conversion because they reflect the weight of external balances in the local economy, relative to local resources. This obviously accentuates the appearance of shifts on the various accounts in periods of devaluation.

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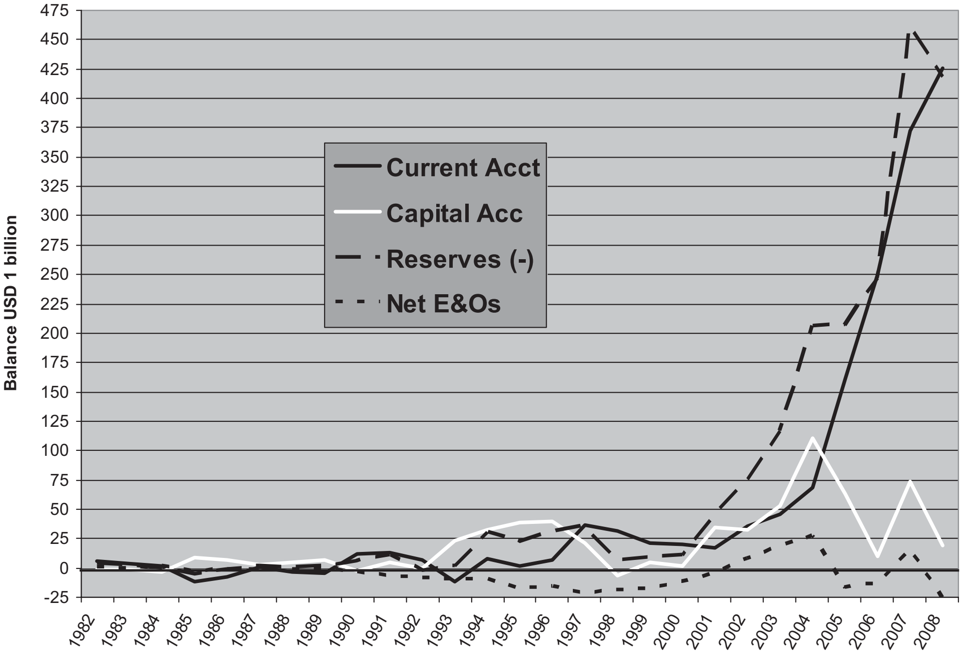

Figure 1. China balance of payments, current USD, 1982–2008 (reserves reversed). *Source*: CTEESY (2007: Table 3-1); CSY (2008: Table 3-32); CSY (2009: Table 3-32)

foreign investment in the Special Economic Zones (SEZs).[13] The current account deficit nonetheless persisted chronically throughout the 1980s, while price inflation peaked at almost 19 percent in 1988. Both deficit and inflation were only corrected through the austerity that surrounded the events of Tiananmen in 1989, together with further large devaluations in 1989–1990, after which the current account returned to a solid surplus in 1990–1991. However, as soon as these brakes were released and strong growth resumed, particularly with the unleashing of SEZs across the whole country following the Southern Tour of Deng Xiaoping in spring 1992, the current account fell sharply back into a deficit in 1993 (-1.9 percent of GDP), while inflation surged to a peak of 24 percent in 1994. China's take off was turbulent indeed; throughout this entire period, rapid growth tended to induce current account deficits, while strong current account surpluses were only achieved through austerity or slowdown.

Even in the lead up to WTO accession in 2001, it was not obvious that this predicament had been solved. The current account surplus was tenuous in 1994–1996 despite another sharp devaluation of almost 50 percent in 1994 – the last and the one that also enacted the unification of the two-tiered exchange rate system – along with a huge surge of net capital inflows elicited by the new SEZ policy, which reached 5.6 percent of GDP in 1994. On the other hand, the peak in the current account surplus in 1997 at 3.8 percent of GDP was again partly related to the slow down induced by the East Asian crisis, which also threw China into an entirely new internal disequilibrium of general price deflation in 1998–1999 and

[13] See Yang (1997) for an excellent discussion of these policy dynamics.

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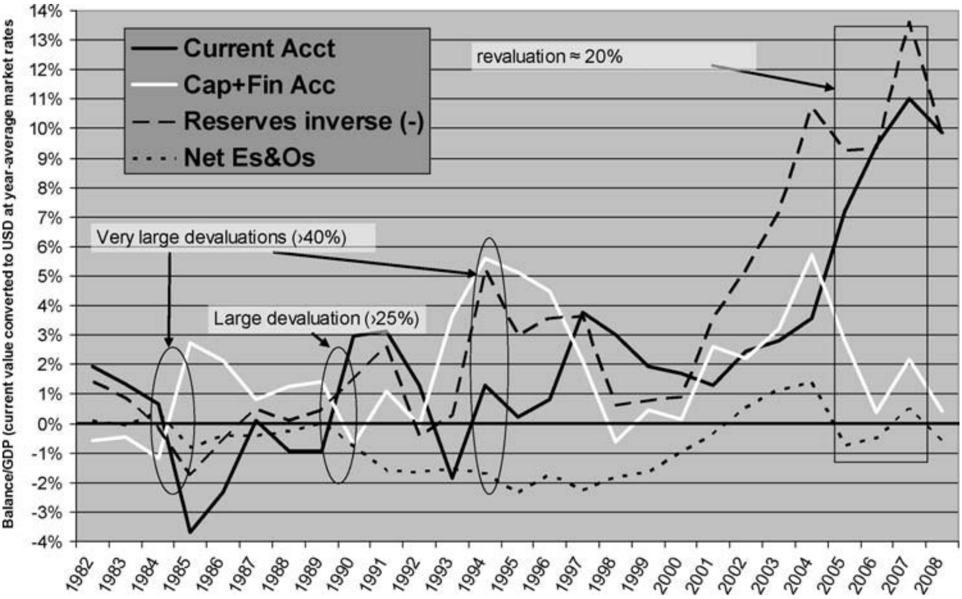

Figure 2. China balance of payments relative to China GDP, 1982–2008. *Sources*: calculated from the sources of Figure 1 and the IMF *International Financial Statistics* database (accessed 22 July 2009)

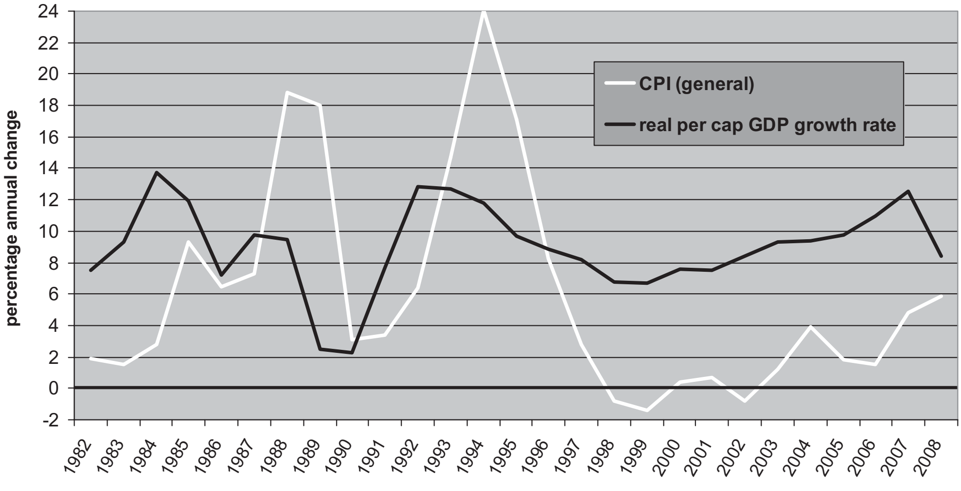

Figure 3. China price inflation and real per capita GDP growth rates, 1982–2008. *Sources*: CSY (2009: Tables 2-4 and 8-1) and equivalent in CSY (2000) for data in 1990s (note that RPI used instead of CPI from 1982 to 1984 because CPI only starts in China from 1985 onwards)

again in 2002. The current account surplus was also counterbalanced by the capital account, which briefly turned negative in 1998, and the strong illicit or unrecorded outflows represented by the errors and omissions, equivalent to a deficit of 2.3 percent of GDP in 1997. Notably, reserve accumulation in 1998, at 0.6 percent of GDP, was equivalent to the net capital outflow in that year and only one-third of the net outflows implied by the errors and omissions. From 1998 to 2000, reserve accumulation remained at less than 1 percent of

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GDP, while the current account surplus declined to 1.3 percent of GDP by 2001. From a contemporaneous view, this was not a particularly secure position, particularly given the increasing volatility on all accounts and the uncertainty that followed the bursting of the dotcom bubble in the US.

The reasons for government concern at the turn of the millennium are quite obvious in the light of such fragile reserve accumulation and the persistent deficits in errors and omissions despite the relatively closed capital accounts, particularly considering the very fresh memory of chronic current account deficits earlier in the 1990s. Lessons from the financial meltdown in the ex-Soviet Union undoubtedly heightened these concerns. Moreover, minor aggravating deficits on various components of services, such as transportation, insurance, and patent and royalty payments, continued unabated into the 2000s, unlike leading industrial countries that generally earn surpluses on these accounts. The income account remained in deficit by more than 1 percent of GDP up to 2002 and only turned positive in 2005, probably due to the building backflows of interest income coming from China's reserve holdings in the US, which counterbalanced the negative effects of profit repatriation that dominated the previous deficits. This perspective also helps to explain the government's resistance to revalue in 2004 and 2005, especially in the face of the sudden surge in speculative capital inflows reflected by the errors and omissions, which turned positive for the first time in 2002 and reached 1.4 percent of GDP in 2004. This added to a surge in net capital inflows reaching 5.7 percent of GDP in 2004, much of which were probably also speculative. If these capital flows would have suddenly reversed, which was a possibility given early warnings signs of an impending credit crunch in the US economy already at that time, together they could have easily overwhelmed the budding current account surplus, which reached 3.6 percent of GDP in 2004. Such suspicions were not far off given that the capital account surplus subsequently fell below 0.5 percent of GDP in 2006 and 2008. In both years, net outflows implied by the errors and omissions exceeded these meagre net capital inflows.

The increasing volatility of capital flows is even more evident in the disaggregated financial account, shown in Figure 4. Other than FDI, the various components of the financial account and the errors and omissions entered a pro-cyclical pattern of boom and bust following the East Asian crisis in 1997. For instance, the surge on the financial account in the early 1990s was entirely due to net FDI inflows. Since that time, net FDI was more or less a stable slowly declining share of GDP at around 2–3 percent in the 2000s (Chinese direct investment abroad only surpassed 1 percent of GDP for first time in 2008). Instead, the volatility on the financial account from 1997 onward was due to 'other' investments and, increasingly, 'securities and portfolio' investments, which registered a net outflow of 2.5 percent of GDP in 2006. Net outflows on 'other' investments reached 4.2 percent of GDP in 1998 (greater than the current account surplus in the same year), and again passed 2 percent of GDP in 2007, reaching 2.5 percent in 2008. 'Other' investments represent trade credits, loans, currency and deposits, and other assets, transferred by monetary authorities, general government, banks or other sectors. Given that the largest outflows on this account in 2007 and 2008 were with monetary authorities and banks, the plummeting of this account could represent major divestment from China by foreign banks that were selling off their recent acquisitions as a means to bolster their balance sheets back home.

Also notable is the pro-cyclical upswing in 2004 in all of the financial accounts besides FDI. This was in large part related to speculation on the anticipation of currency appreciation at the time, which was facilitated by gradual liberalisation of the capital account and financial sector over this period. Much of the movement on the errors and

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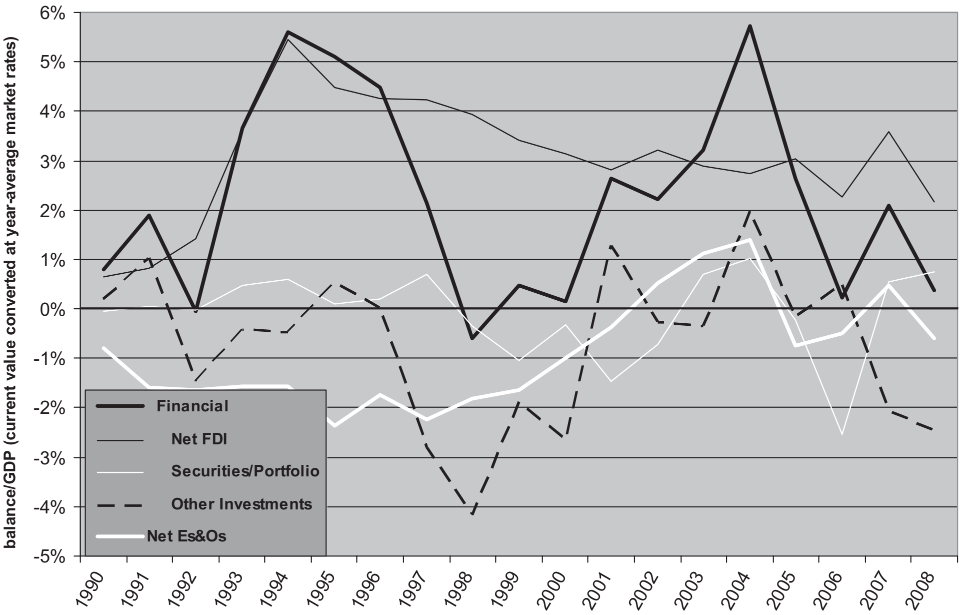

Figure 4. China financial account, composition relative to GDP, 1990–2008. *Sources*: same as Figure 2

omissions was also probably due to such speculative inflows and outflows surrounding the unpegging of the renminbi in 2005, or else to currency speculation in the final phases of the international financial bubble in 2007 and subsequent deleveraging in 2008. Indeed, in the light of the post-crisis return of what Nouriel Roubini has called the 'mother of all carry trades' lashing East Asia in the autumn of 2009 (RGE, 2009), it is easy to imagine how such financial volatility will continue to increase and, in the event of a pro-cyclical swing downwards, could overwhelm both the shrinking share of net FDI inflows and even a moderately strong trade surplus. Naughton (2007: 421–422) argues that this increasing ability of capital flows to subvert capital controls is precisely one of the strongest reasons for capital account liberalisation, given that a legal, regulated open capital account might function better than the status quo. However, this logic is akin to arguing that the door should be left open because thieves are getting better at picking locks.

4 CHINA'S EXCEPTIONALISM IN THE CONTEXT OF GLOBAL TRANSFORMATIONS

Given such increasing volatility, the sudden surge in the trade surplus after 2001 has been crucial to the sustainability of this situation. Hence, it is important to question how the surge came about. It was not obvious even as late as 2001; the current account surplus (mostly trade in goods) only really took off above the previous heights achieved in 1990–1991 (3 percent of GDP) and 1997 (3.8 percent of GDP), from 2005 onwards. As noted above, these earlier heights were achieved through slow-down. Hence, even as late as 2004, it would not have been clear whether the improvement on the trade account was simply another short bout or a lasting occurrence. The sheer collapse of the capital account surplus in 2005 no doubt

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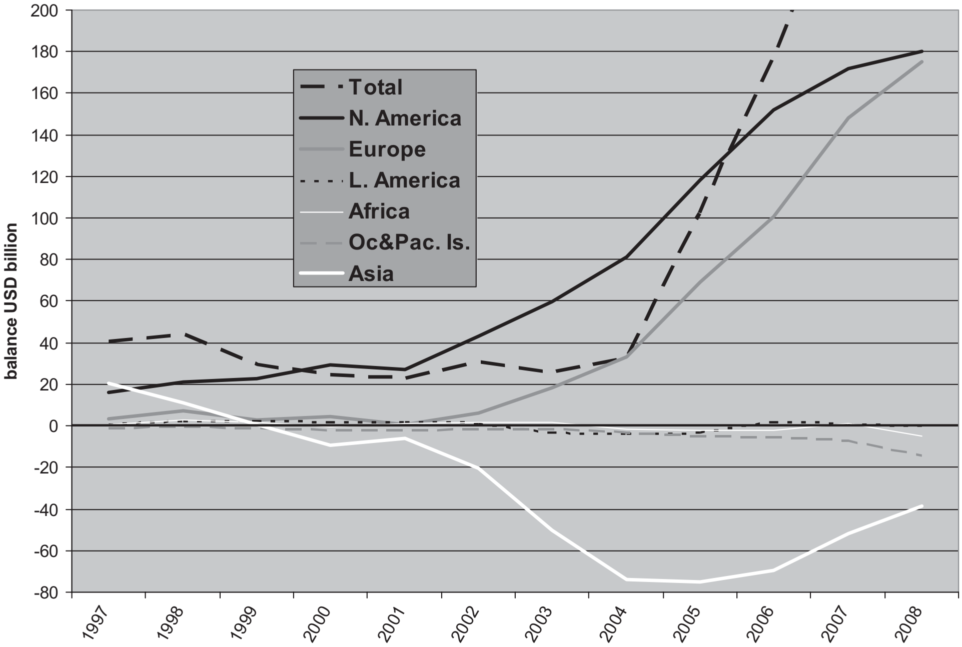

Figure 5. China regional trade balances, 1997–2008 (current USD). *Sources*: calculated from CSY (2009: Table 17-8) and equivalent tables in earlier statistical yearbooks

encouraged the government to prepare for the worst and to buttress the trade surpluses in case bubble came to bust on the current account as well. In other words, the idea of Chinese exceptionalism – that the country was free from the external financing constraints faced by most other peripheral late industrialisers – derives from very myopic hindsight. The government of China was clearly well aware of this, even if the western financial press was not.

The easy explanation for the surplus surge was China's entry into the WTO. However, this was merely an institutional facilitator of the more systemic rerouting of TNC-dominated production networks through China that followed the East Asian crisis in 1997–1998. Some brief insights of this restructuring can be offered through the regionally disaggregated trade accounts, presented in Figures 5 and 6.

Figure 5 shows how the pattern by which China has built very large trade surpluses with North America (mostly the US) and Europe parallel to large trade deficits with East and Southeast Asia, only emerging since the East Asia crisis.[14] The rising bilateral trade surplus with the US receives most of the popular attention; this did accelerate after 2001 and increased more or less continuously up until 2008, as did the surplus with Europe. Indeed, the surplus with Europe grew even faster, starting from almost zero in 2001 and actually surpassing the surplus with the US in 2009 for the first time. However, these observations need to be qualified by the equally dramatic descent into deficit with the rest of Asia (mostly East and Southeast Asia), from a surplus equal to that with the US up to 1997, to a slight deficit in 2001, to a sudden increase in the trade deficit to -74 billion USD by 2004, almost equal to the surplus with the US of 81 billion in the same year. This descent stalled from 2005 onwards, not because of a slow down in trade but because China's exports to Asia started to catch-up

[14] See Athukorala and Yamashita (2009) for a similar analysis, based on data starting from 1990.

DOI: 10.1002/jid

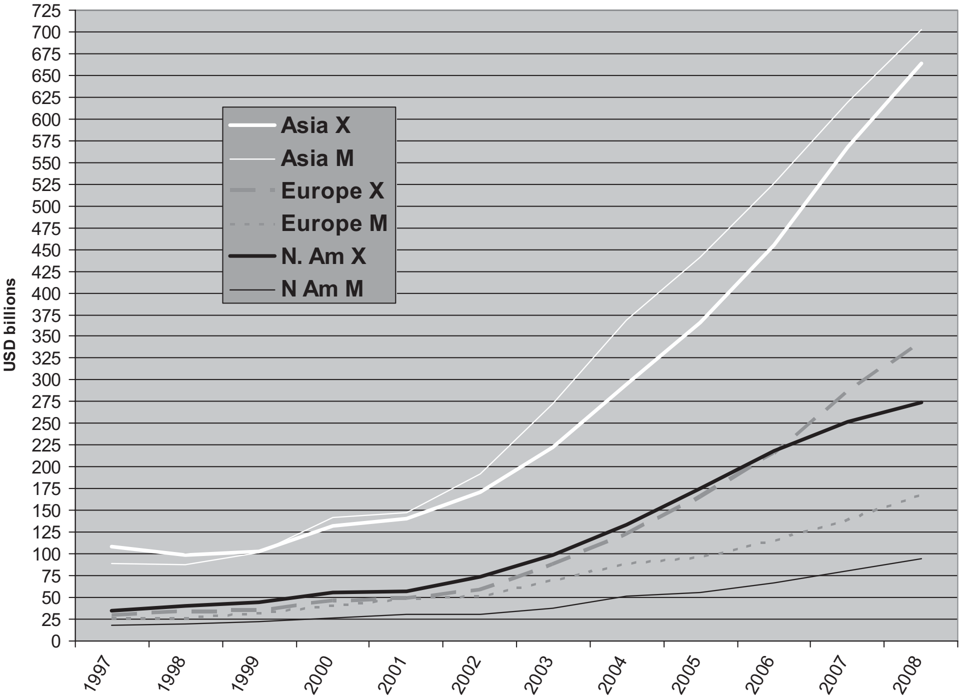

Figure 6. China regional trade volumes, 1997–2008 (current USD). *Source*: same as previous figure

with its imports from Asia. Nonetheless, about 29 percent of these exports to Asia in 2008 were to Hong Kong (calculated from CSY, 2009: Table 17-8). Thus, they were also largely reflective of the broader production and trading networks occurring between Asia and Europe and North America, with Hong Kong serving a classic function as trading entrepôt.

The picture is even more dramatic from the viewpoint of gross import and export volumes with Asia, shown in Figure 6. These exceeded the combination of trade volumes with the US and Europe. For instance, China's imports from Asia increased from 147 billion USD in 2001 to 703 billion USD by 2008 (62 percent of total imports in 2008), while its exports to North America increased from 52 billion USD to 274 billion USD and its exports to Europe increased from 49 billion USD to 343 billion USD. In other words, the growing trade surpluses have been built on an enormous increase in the scale of turnover in the regional economy.

More specific disaggregation of these trade flows and balances with Asia further reflects the emerging third or even fourth-tier position of China within the restructuring of production networks implied by these data.[15] For instance, China's trade surplus with Hong Kong was 178 billion USD in 2008. In contrast, its largest (and growing) trade deficits were with Taiwan (at -77 billion USD in 2008), South Korea (-38 billion USD); and Japan (-34 billion USD). Following these three leading and/or first-tier industrial countries, China also had significant deficits with what are considered second or third-tier countries within the regional industrial networks, namely, Malaysia (-11 billion USD), Thailand (-10 billion

[15] 'Tier' is a commonly used term in the industrial organisation literature, in this case referring to position within the subcontracted supply chain of a production network.

DOI: 10.1002/jid

USD), and Philippines (-10 billion USD). With the exception of obvious oil exporters, China otherwise ran relatively minor trade surpluses with most other Asian countries. Indeed, it would appear that China's trade expansion into other parts of Asia and the Global South more generally is the twist side of its increasing integration and subordination within East Asian centred production networks. Subordination in this sense refers to the fact that Chinese firms generally take on bottom-tier roles within these networks, such as low-wage processing of higher-technology inputs designed and produced elsewhere in higher tiers of the supply chain, rather than taking on lead-firm roles.

A growing body of literature on TNCs in Asia confirms this observation of China's subordinate third or even fourth-tier position within these networks.[16] Athukorala and Yamashita (2009) argue that the growing trade deficit between China and the US is structural, 'related largely to the pivotal role played by China as the final assembly centre in global production networks' (p.41). This role, they argue, has been '. . .based on its ample supply of labour, and moves taken by US firms to supply high-end parts and components from their Asian bases to China' (ibid: 54–55). Hence, instead of China becoming an advanced-technology superpower based on its structural shift away from traditional labour-intensive products and towards ICT products, 'closer examination of the data suggests. . . the rapid consolidation in China's final-assembly stages of East Asian-centered global production networks of these products' (ibid: 48). Yao (2009) similarly argues in a strong critique of Rodrik (2006) that the export surge in the sector of machinery and electrical machinery and parts in China does not necessarily represent technological upgrading. 'All indications suggest', he concludes, 'that the rise of the sector in China's foreign trade is closely associated with its processing trade regime and foreign outsourcing to China, a reflection of the country's trade development along the lines of its comparative advantage' (ibid: 63).

By referring to comparative advantage, Yao implies that China's participation in such trade is largely based on the use of its abundant and cheap labour within these processing sectors. That China has been able to amass such large trade surpluses on the basis of this specialisation is thus more a matter of sheer scale and productivity (within low-wage assembly work) rather than one of technological upgrading or of capturing more value-added within these international production networks. Of course, China is achieving much technological upgrading in its domestic state-owned sector.[17] In this respect, a key aspect of China's industrial policy has been to use its export sectors to overcome the financing constraints of an import-substituting strategy of domestic industrialisation, similar to South Korea in the 1960s and 1970s.

However, in contrast to South Korea, the Achilles Heel of China's strategy is the increasing TNC dominance of its export sector. For instance, as mentioned earlier, 58 percent of China's exports (and imports) in 2005 were by foreign-funded enterprises. Once the State purchases the foreign exchange surpluses generated by these enterprises, the resulting reserves effectively represent foreign claims on domestic financial assets. Similarly, the foreign exchange reserves collected through FDI also represent, by definition, foreign claims on domestic assets. Hence, Zheng and Yi (2007: 19) note that 'China's growing foreign exchange reserves do not imply wealth that is disposable at any time, but rather a sizeable indirect debt.' They suggest that in 2005, 'only half of China's

[16] In particular, see Athukorala (2007, 2009), Li *et al*. (2007), Sung (2007), Athukorala and Yamashita (2009) and Yao (2009). Also see Bergsten *et al*. (2006).
[17] For instance, see UNCTAD (2002: 77–83).

DOI: 10.1002/jid

accumulated foreign exchange reserves were consistent with its wealth, which allowed Beijing to fulfil international payment obligations. The remaining capital inflows (FDI and short-term foreign borrowings) could be interpreted as implied debts. . . that China would have to pay back eventually.' Similarly, in communications with Jan Kregel, he indicated that from information presented to the recent meetings of the Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System, it was quite clear that the external figures on the foreign exchange holdings of China are meaningless for most purposes, especially since a large proportion are apparently non-repatriated profits of joint ventures with foreign multinationals.[18]

Ownership is crucial in this regard. It is useful to compare the situation of China with that of Germany, the other large surplus country in the global economy at the end of the 2000s. Current account surpluses in Germany are mostly earned by the private corporate sector in Germany, largely based on German or trans-European forms of ownership. As a result, the net capital outflows that compensate the current account surplus mostly take place as private capital transfers. In this way, the public monetary authorities are not burdened by foreign reserve accumulation or sterilisation operations and current account surpluses become an instrument of German corporate expansion abroad. Similar processes of corporate expansion are also at work in the US given that the US sends net FDI abroad despite the general surplus on its financial account.[19] Both countries are able to mediate their imbalances in this manner because the vehicles of surplus accumulation and/or direct investment abroad are largely national, that is, firms with head offices that are located in the national economy.

The opposite condition increasingly prevails in China. Its surpluses that are generated through foreign forms of ownership do not become a vehicle of expansion for the Chinese corporate sector except by way of the limited share of reserves that the government diverts to the activities of state-owned enterprises abroad or else to its sovereign wealth fund. In any case, and contrary to popular conception, the government is actually quite limited in terms of how it can use its reserves in this way given the need of the People's Bank of China to match, as much as possible, the reserve assets on its balance sheet with the domestic liabilities that it used to purchase these reserves.[20] Instead, surpluses generated through foreign forms of ownership effectively serve as a vehicle for the expansion of foreign acquisitions in the domestic economy. Moreover, government efforts to sterilise the monetary effects of their currency purchases also effectively result in a subsidisation of these foreign claims on domestic financial assets. For instance, Zheng and Yi (2007: 21–22) note that China was paying out much higher rates of return on inward foreign investment and on its related sterilisation operations in China than it was earning from the resultant sterilised foreign currency, much of it held in US Treasury securities. In other words, China has not only been financing the US government deficits; it has also been effectively subsidizing such financing, as well as FDI in China more generally. This situation is analogous to earlier structuralist critiques that ISI policies were effectively subsidising the expansion of TNC operations in Latin America, as discussed previously with reference to Sunkel (1972).

[18] E-mail communication with Jan Kregel, 22 August 2009.

[19] See an excellent discussion of the US case in Kregel (2008). I am also grateful for insights provided by communications with Geoff Tily.

[20] See Pettis (2010) for a superb discussion on this specific point, albeit he does not consider the dimension of ownership as discussed here.

DOI: 10.1002/jid

Of course, these dilemmas could be taken as arguments for capital account and financial liberalisation, although there are several reasons why such capitulation would be a bad idea for China. One important reason is that liberalisation would probably facilitate the increasing denationalisation of China's means of generating foreign exchange, thereby worsening this underlying source of structural vulnerability. Although FDI accounts for a very minor share of total investment in China, it has been strategically concentrated in the export sector to such an extent that foreign-funded enterprises have come to dominate this main means of generating foreign exchange. The export sector in turn has become the focal mechanism of transmitting foreign ownership into the domestic economy, rather than through FDI as would be conventionally conceived. It is in this sense that while China's surpluses and reserve accumulation do represent aspects of strength in the global economy (although relatively minor in comparison to the ability of the US and the UK to create liquidity), they also represent, in a dialectical manner, a significant source of vulnerability, similar to the early successes of ISI in Latin America albeit through quite different mechanisms. Revaluation or capital account and financial liberalisation would not solve these underlying structural vulnerabilities. Instead, the adoption of full convertibility could potentially render China very susceptible to the types of instabilities that occurred in both Latin American and East Asian financial crises.

5 CONCLUSION: BETWEEN SOFT POWER AND HARD DEPENDENCE

This article offered a reflection on the nature of Chinese strength and vulnerability in its integration into the global economy, drawing inspiration from earlier CEPAL structuralist prognoses of peripheral late industrialisation in Latin America. Through an analysis of China's balance of payments from 1982 to 2008, the article argued that simplistic evaluations of China's strength on the basis of its external surpluses are exaggerated. Notably, the trade surplus and reserves of China only started to surge spectacularly after 2001. Before this time, China's current and capital accounts were much more typical of a peripheral late industrialiser, in the sense that growth spurts ended out exacerbating domestic price inflation and driving the current account into deficit. This tension was exacerbated by persistent deficits in services and on the income account, while increasingly large and volatile movements on the capital account and in the errors and omissions underscore the importance accorded to defensive reserve accumulation.

Further inspection of the trade accounts also offers some clues on how China managed to transition in the late 1990s from classic peripheral late industrialiser to 'mercantilist' *tour de force*. Within the surplus surge on the trade account, China has built very large trade surpluses with the US and the EU parallel to large trade deficits with East and Southeast Asia, both patterns emerging only since the East Asian crisis in 1997–1998. This reflects the massive rerouting of East Asian centred international production networks through China that followed the crisis. It also reflects China's subordinate third or even fourth-tier position within these networks as a point of final low-wage processing before exporting to North American and European consumers, as well as Northern corporate consolidation of control over these production networks, as argued by a growing body of literature on TNCs in Asia. In this context, the increasing dominance of foreign-funded enterprises in China's export sector has become an important transmission mechanism of foreign ownership into the domestic economy. This is arguably a much more endemic vulnerability than China's export dependence (which itself is a reflection of these processes in any case). In principle,

DOI: 10.1002/jid

export dependence on its own can be resolved through domestic rebalancing whereas already-embedded structures of transnationalised ownership are far more intractable, exhibiting powerful momentum to reinforce vested interests, as is already being argued by many Chinese scholars.[21]

It is vital to view current debates about China in this light. The presumption that China is in a position of strength and should thus move from its defensive strategy of reserve accumulation to one that adopts a much more pro-active position of mediating imbalances in the international monetary and trading system through greater financial openness and less interference in its exchange rate is one that treats China as if it were a central power behind the expansion and regulation of this monetary and trading system. A false evaluation of such strength could have dramatic implications for China, particularly if the proposed strategies of currency, capital account and financial liberalisation would accentuate vulnerability to volatile capital flows in near-future reverberations of the recent crisis. This concern is all the more important given that, despite the attention focused on China's reserves (held in low yield and possibly depreciating US government assets), these have been in fact dwarfed by the volumes of international liquidity that contributed to the build up to the current crisis and that were largely generated by Northern financial systems. They are also dwarfed by the massive volumes of liquidity that were suddenly created by Northern central banks in response to the crisis, estimated at well over 13 trillion (i.e. more than six times China's total estimated reserves in 2009), and by the volumes currently involved in the enormous resurgence of carry trading that resulted from such central bank interventions. In the wake of such huge surges of international liquidity, it is plausible that China's own foreign exchange reserves today could quickly erode in the medium term. Indeed, already in March 2010, China registered its first trade deficit since April 2004 due to a sharp rise in imports and fewer exports of labour-intensive goods. While probably temporary, this dip nonetheless highlights that China's trade position is more tenuous than usually appreciated. From this perspective, the concern of the Chinese leadership would seem to be based not so much on maintaining the value of the country's saved assets stored largely in the US, but much more pertinently, on avoiding the predicament of Latin America and East Asia before it.

This is the dialectical predicament of China's rise. Its emerging clout in the global economy contains within it aspects of increasing vulnerability that are more peripheral and dependent than central and dominant in nature. This contrasts with the interdependent vulnerability associated with leading countries of the centre, which continue to retain the privilege of being the primary sources and regulators of international liquidity and continue to display strong drawing power over this liquidity in times of crisis. This distinction is important given that China is still a relatively poor country with enormous developmental challenges ahead of it. China's leaders are probably quite rightly concerned with the predicament of falling back into the stringent external constraints typical of post-war peripheral late industrialisation, from which China only very recently escaped on the basis of riding a wave of financialisation and industrial restructuring emanating from the North.

Similarly, the wrong messages should not be sent to other developing countries through a false sense of strength of the so-called 'Beijing Consensus', as if the developmental lessons of previous latecomers no longer apply, or as if the Chinese experience of the last three decades could be somehow sustainably replicated. China is only now entering a middle rung position within global industrial hierarchies, which is precisely where the leading

[21] For instance, see Ho-Fung (2009).

countries of Latin America stalled and then fell after the 1970s. Hence, the strength of China must be qualified. Premature delusions of power might serve the leading global economic powers quite well, much as the ambitions of South Korea in the 1990s or of leading Latin American countries in the 1970s left them exposed to subsequent financial crises. While the channels of vulnerability might be different, the potential adversities are similar.

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