CHINA: A CASE OF ‘MERCANTILISM’ IN A BACKWARD COUNTRY?

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Abstract

Despite being criticized for its inconsistencies, China’s mercantilism is considered a commonplace in the literature focused on Chinese economic development. This paper intends to criticize the foundations of China’s ‘monetary’ and ‘financial’ mercantilism arguing that both provide only a feeble explanation of its economic success. In particular, rather than echoing the practices of classical mercantilism, such supposed ‘mercantilist’ approach, on the contrary. Reflects the Gerschenkronian model of development, according to which the growth of the ‘backward’ countries is based massively on banks and State support.

Keywords: “Mercantilism”, China, economic developement

Chinese style mercantilism’ and the dispute with the United States

It is frequently assumed that China applies mercantilist policies, especially in the monetary and financial sectors. This assumption seems to be supported by specific behaviours that China has adopted with varying degrees of intensity in the most recent phase of its reform era. Examples of these lines of conduct are the exchange rate policy, the control of capital flows, and certain forms of protection of the internal market which, anyway, have been diminishing in the last decade. Some of them, for instance as regards exchange rate and intellectual property, have been the object of a bitter dispute with the US and, to a lesser extent, the EU for a long time. The exchange rate issue, in particular, is extremely complex and multifaceted if one considers that it can represent a discriminating factor which may favour domestic production, or, on the contrary, it can prove irrelevant for the competitiveness of the Chinese system depending on the variables used to estimate the actual competitiveness differential.

If some analysts are cautious about pointing the finger at the pegging of the Chinese currency[4], the vast majority of US politicians and trade unions are not like minded. Since the beginning of the Obama administration the concerned constituencies have been increasingly criticizing China, albeit with various types of arguments.

Pressures aiming at convincing China to modify its exchange rate policy to let the US manufacturing sector catch up with China on international markets typically characterise China-US relations and are consistently exerted both bilaterally (Strategic & Economic Dialogue, Joint Commission on Commerce and Trade) and multilaterally (WTO, G 20, APEC Forum). The exchange rate dispute has been lively and has involved the highest levels of the US government. Congress members have repeatedly asked the Department of the Treasury to declare China a currency manipulator. The Treasury had already proceeded in this way back in 1992 and in 1994, when China was not subject to international restrictions and would resort

[4] C. Fred Bergsten, President of the *Peterson Institute of International Economics,* called the Chinese exchange rate policy ‘*a blatant form of protectionism*’ because it subsidizes imports by roughly il 20-40% of their value. This amounts to an indirect tariff on imports (Hot topics, The Chinese Exchange Rate, Essential Reading from the Institute, http://www.iie.com/research/topics/hottopic.cfm?HotTopicID=3).

to discriminatory practices not limited to its currency. Despite this fact, though, currently the US government is apparently not inclined to formalize the accusation of mercantilism and seems to be more willing to express its stance verbally in relevant international fora. It can be safely assumed that even if Members of Congress of both sides are tenaciously determined to accuse China of being a currency manipulator, the Administration does not wish to formally initiate a dispute with a world economic leader. Thus, in the past few years the Congress has kept opposing the exchange rate policy by enacting a series of provisions aimed at justifying the compatibility of possible retaliatory actions with WTO and IMF norms, while the Government has been operating at institutional level, especially within the G20 framework, and in economic organizations.

During the G20 meeting of Finance Ministers which took place in October 2010, US Treasury Secretary Geithner presented a plan defining quantitative targets for external deficits and surpluses. The plan, which was rejected by China and other emerging countries, was aimed at reducing international financial imbalances. During the APEC meeting which took place in Honolulu in November 2011, Obama forcefully defended the US point of view on exchange rate and the respect of the rules that regulate intellectual property rights, and also during his second term he has been showing no intention of toning down the dispute with China. On the contrary, on several public occasions, Obama has repeatedly rejected Mitt Romney's accusations of having an exceedingly remissive approach to China's 'defensive' policies[5]. Even if the US has been proceeding cautiously so far, the Obama Administration has launched several appeals against China to the WTO concerning import duties and other defensive norms affecting US steel and poultry exports. Similarly, it has firmly protested against the imposition of tariffs on American-made vehicles.

It should nevertheless be acknowledged that aside from domestic political motivations, US criticism is based on objective factors. One of these factors is certainly represented by the ambiguous behaviour of Chinese leaders, who keep maintaining that the exchange rate only plays an irrelevant role in the China-US imbalance and consider the 2005 reform a signal of collaboration. At the same time, though, there is evidence that following the outburst of the economic crisis they have been manoeuvring the external value of their currency to influence China's domestic demand in contrast with their alleged exchange rate neutrality. As a matter of fact, the Chinese currency started resuming its appreciation in mid-2005 by over 20%[6], stopped in May 2008 as a consequence of the crisis and resumed its rise, albeit imperceptibly, starting from mid-2010. Anyway, such criticisms appear to be disputable. In fact, since the last quarter of 2010 the Chinese currency resumed its appreciation so that - since July 2005 to the end of 2013 - the increases were, in terms of the real and the nominal exchange rate, 24% and 34% respectively.

Nevertheless, the two countries managed the exchange rate controversy by applying an appeasement policy during the fourth U.S. China Strategic and Economic Dialogue meeting (3th-4th May 2012), where China and the US committed to introduce 'as quickly as possible' a more flexible, market-based exchange mechanism. Such mechanism would also reflect in a clearer way the fundamentals of the two economies and would make it possible to avoid frequent misalignments between the two currencies, without favouring anti-competitive policies at the same time [7]. This commitment, which is rather general and does not mention any time clause, curiously puts on the same level the 'damaged' party and the 'manipulator', i.e. China, even if it should address only the latter (Morrison and Labonte, 2013). The Chinese reply to this commitment is emblematically summarized in the words of an anonymous Chinese officer who pointed to the fact that it would be rather difficult to proceed to the immediate appreciation of the renminbi in a country where 40 billion people live on less than

[5] http://www.reuters.com/article/2012/07/05/us-usa-campaign-obama-idUSBRE8640WM20120705
[6] http://www.chinability.com/Rmb.htm
[7] http://www.treasury.gov/press-center/press-releases/Pages/tg1567.aspx

one dollar a day (Xinhua News Agency, 1st December 2009). The same source reports that also former premier Wen Jabao expressed a negative opinion pointing the finger at ‘those countries’ that accuse China of manipulating the exchange rate and of carrying out unfair trade practices, while at the same time they are flooding the global economy with liquidity and are putting China at risk of overheating (Morrison and Labonte, 2013). Aside from the heated debate and the identity of the parties involved, it should nevertheless be noted that the controversy between China and the US does not address the real problem, namely the fact that the market-based mechanisms used by the Chinese system in its own interest are not being applied in relevant fields, such as that of economic governance, the protection of property rights, and the independence of the bodies that control and regulate the economy. This is de facto an ‘alternative’ system which plays by rules that are not completely compatible with the market rules of those countries, primarily the US, that have been promoting the liberalization of international economic relations.

At the same time, though, it would be misleading to affirm that the US, and Europe as well, are not aware of competing with a player that avails itself of anomalous financial tools and that, in general, pursues the main goal of promoting first and foremost its internal objectives. Therefore, the Western world is aware that the real problem does not lie in contrasting China’s stubborn defence of a certain exchange rate or in applying ‘defensive’ tariffs and healthcare administrative norms, but rather that the world’s second largest industrial manufacturer is not willing to grant non-Chinese, potentially dangerous subjects relevant market shares.

As far as the accusation of ‘mercantilism’ is concerned, it should then be observed that the term does not give an accurate account of the overall Chinese strategy, since it addresses only its commercial aspects. It is possible to formulate a less ‘emotional’ judgement adopting a methodological premise based on the following points: 1) ‘mercantilist’ practices are banned by international agreements and the damaged countries are allowed to sanction them with prior authorisation by supra-national organisms. This ‘philosophy’ underlies the convergence process towards a liberalized free trade regime and contributes to the creation of a multilateral Free Trade Agreement (FTA) system complying with Uruguay Round rules; 2) calling a nation ‘mercantilist’ implies using a very general term which makes it difficult to determine the true nature of practices that oppose the principles of free trade. Therefore, the term is typically imprecisely used only to refer to the trade sector, whereas in the current globalization and financialization phase ‘mercantilist’ behaviours go well beyond the boundaries of the real economy and involve both monetary and financial aspects; 3) during the last decade, FTAs have been multiplying and have been re-configuring international trade relations bilaterally to bypass the blocks resulting from the Doha Round negotiations. The Asian area has been extremely active in this process, and China in particular has been concluding several agreements with ASEAN and Pacific area countries in order to create a large free trade area that can compete with other relevant areas worldwide.

As far as exports are concerned, in 2012 China was ranked second after the EU-27 and before the US with 11.0%; concerning imports, China was in second position (third considering intra-EU data[8]) after the US with 10.0%. Therefore, in addition to being an international trade leading player, China has a balance of trade that is anything but asymmetric and is therefore far from the mercantilist model.

Moreover, the accusation of ‘mercantilism’ can be dismissed by taking into account other qualitative factors discussed in the literature, with due consideration for differences between them. First of all, in China the manufacturing sector is characterized by a strong non-national component represented by enterprises, including multinational ones that have partially or completely decentralized their production. Such structure is the result of both a

[8] http://www.wto.org/english/res_e/statis_e/its2011_e/its11_world_trade_dev_e.pdf

successful policy of stimulus of direct investments, especially after joining the WTO, and of international production restructuring processes based on global 'production chains' favored by the globalisation of markets and by innovations in the information technology sector[9]. The export trade processing phenomenon, which involves mainly multinational enterprises from Japan, Taiwan, the US and Europe, is reflected in the relatively modest share of the 'Chinese' added value on the total value of each exported manufactured unit. Depending on the methodology adopted, the share of 'external' added value for exported manufactured goods in 2007 (the final year of the decade in which this value was calculated) oscillated between 27% and 40.3%. Of course, foreign-invested enterprises and joint ventures had the highest values[10].

With a strong motivation to pursue know-how learning strategies, China is inevitably facing the necessity of reconsidering the specialization model of its exports by adopting two lines of conduct: first of all by diminishing its dependency on external production chains, and then by transitioning from medium/low quality to high quality manufacturing characterized by a higher degree of technological innovation and by a higher added value. According to a Natixis report (Natixis, 2013), from 1997 to 2007 China surpassed the most advanced areas in the world and held the greatest market share in high quality sectors such as aeronautics and space, medical equipment, precision optics, computer equipment, etc., while it lagged behind in the manufacturing of medium quality products such as vehicles, electric and electromechanical materials, machine tools, etc. and it lagged even further behind in low quality sectors such as textiles, food, wood constructions.[11] It is also plausible that in perspective the products that entail innovation advancement and an increase in added value will be manufactured on site, thus reducing the import value embedded in exports and moving part of the manufacturing process away from the Chinese coast to less congested areas located in other Asian countries where the cost of labour is also lower. This would lead to a completely new scenario where China might find itself competing with new emerging countries while it is reducing its dependency on foreign countries and is proceeding to an upgrade in the qualification of its products and processes. China's 'mercantilism' may be further questioned if we take into account one of the fundamental elements of its international positioning, namely its 'dependency' on the import of both energy and non-energy raw materials that are fundamental for its production processes. Unlike colonial powers, which exerted tight control over the supply markets, China competes in these markets, and this fact further demonstrates that the country cannot be accused of employing mercantilist practices. As a matter of fact, the need to compete lies at the basis of the international protagonism of both the policy maker and of big national enterprises, and serves the goal of granting China preferential conditions and stability in the supply of raw materials and industrial agricultural products, especially those provided by 'sensitive' African and Latin American areas. Thus, it is evident that the role played by China in the global geo-economic scenario is extremely different from the role played by European colonial countries, which was at the basis of their

[9] See the section 1. *Supply Chains and Production Networks* of the work edited by Baldwin, R., Masahiro Kawai and Ganeshan Wignaraja (2013).

[10] In particular, wholly foreign owned enterprises, which accounted for 38.1% of total exports, generated a 'local' added value amounting to 44.1% of their exports value, with processing (i.e. incorporated imported goods) accounting for 83% of that value. Joint ventures provided a greater share of local added value with 17.7% of national exports, while both public and private enterprises went into the opposite direction. State-owned enterprises accounted for 19% of national exports, and generated an added value of about 72.1% of sectorial exports, while processing amounted to 25.8%. Private enterprises, which represented the real 'new entry' among exporting enterprises in the 2000s, accounted for 21.3%, 80.8% and 9.6% respectively (see Koopman *et al.*, 2008).

[11] In particular, in the high quality sector, China went from 21.2% to 33%, the Eurozone from 17.7% to 18.8%, Japan from 30.8% to 23.1%, and Korea from 28% to 32.9% over the decade considered. China still held the greatest share in the low quality sector with 21.2%, while Japan held 2.1%, Korea held 4.9% and the Eurozone held 15.4%.

trade expansion. Similarly, its growing 'political' attention to geographical areas that are rich in raw materials cannot be assimilated to the hegemony exerted by European powers in the past.

It should also be acknowledged that the Chinese system, which generates one of the largest trade volumes in the world, showed its weakness during the recent global crisis. The stall of Chinese exports (the current account balance/GDP ratio dropped from a mean value of 9.9% in 2004-2006 to a meagre 2.2% in 2011-2013) hints at the vulnerability of the foreign component of its global demand. This component is strongly affected by the international demand trend and by the economic policies carried out in the rest of the world with particular reference to the US, which have the 'privilege' of governing the international monetary system (Hang Seng Bank, 2012; BOFIT, 2013).

If, on one hand, there is no evidence supporting the accusation of mercantilism or 'neo-mercantilism', on the other hand China is still showing conspicuous residues of protectionism, as shown in the 2010 OECD Survey, where China's comparative position is not satisfying according to the PMR (Product Market Regulation) indicator of barriers to trade and investment (OECD, 2010). As a matter of fact, even if the average tariffs on Chinese manufactured products are lower than those of other emerging countries, Chinese values still lag behind those of the US and the average values of OECD and Eurozone countries (but not those of Russia). Moreover, it should be noted that in spite of progress towards greater 'neutrality' in trade, there is a 'grey area' hampering the international economic integration of China. This 'grey area' is represented by a series of both formal and informal measures which are still in place and have the twofold function of protecting certain sectors by allowing them to expand their dimensions and market power in the national economy, and of granting a few big enterprises the status of international competitors.

In this regard, the OECD report states that as far as the service sector and the utilities network (telecommunications, electricity, and energy chain) are concerned, liberalization practices are insufficient since these sectors are still controlled by big State-owned enterprises which de facto prevent both private and foreign enterprises from accessing them[12].

Monetary and financial mercantilism and the 'backward' problem

The arguments provided so far seem to confirm that Chinese protectionism is pursuing trade expansion for its own sake. Rather than following the classical mercantilist model, though, in so doing it is pursuing the strategic objectives of promoting and safeguarding its national 'champions' by expanding their presence on international markets, with specific reference, but not limited to, those of raw and energy materials. The available data, albeit incomplete, are revealing. Big State-owned enterprises dominate in strategic sectors[13] and are

[12] The progress made by the Chinese government in the liberalization of the domestic service market and of some 'sensitive' sectors dominated by national enterprises are both significant and contradictory at the same time. In 2005, the State Council issued 'guidelines' to encourage the development of private enterprises and to open to private competition the sectors dominated or completely controlled by State-owned enterprises. Five years later, China substituted the 1993 law with a new anti-monopoly law inspired by more advanced countries, which, at least formally, introduced measures against the most widespread monopolistic practices. In contrast with that, the occupation of strategic sectors ('pillars') by State-owned enterprises made it difficult to create a real competition, since numerous formal and informal barriers remained in place to preserve State control. The 2010 OECD report (OECD, 2010) correctly identifies the unsatisfactory implementation of the law and the lack of a favourable environment as the causes of the delay. The report focuses in particular on the lack of independent organisms, the presence of too many inspectors and the fact that vigilance was entrusted to governmental organisms, in particular to MOFCOM and to the National Development and Reform Commission (NDRC) (*China: China's Anti-Monopoly Law: Retrospect and Prospect on the Fourth Anniversary*, http://www.mondaq.com/x/189714/Cartels+Monopolies/Chinas+AntiMonopoly+Law+Retrospect+and+Prospect+on+the+Fourth+Anniversary)

[13] Szamosszegi and Kyle (Szamosszegi and Kyle, 2011) make an attempt to assess the weight of these sectors in the national economy.

largely represented in 'pillar' sectors by subsidiaries (Table 1). On a large scale, and with the necessary changes, China's conditions resemble those described by Geschenkron about the 'late' development of backward countries.

Tab. 1 Market share of State-owned enterprises in *strategic* and *pillar* sectors (2010, % of respective sector)

Strategic sectors	(a)	(b)	*Pillar* sectors	(a)	(b)
Defense oriented	n.a.		Automotive	74.0	n.a.
Coal industry	12.9	59.2	Steel industry	17.6	n.a.
Air transportation	76.2	n.a.	Construction	7,2	20.1
Power sector	70.6	91.6	Non-ferrous metals industry	19.5	n.a.
Petroleum and petrochemical industry	45.3	76.6	Machinery and equipment	21.0	n.a.
			IT, science and technology	9.0	n.a.
Shipping industry	60.7	n.a.	Banking sector	72.7	n.a.
Telecommunications	96.2	n.a.			

n.a. : not available
(a) Market share of 'top' State-owned enterprises of the sectorial total
(b) Market share of State-owned enterprises of the sectorial total
* Data of 'pillar' sectors are not comparable: for automotive and steel sectors data correspond to physical production, for machinery and IT to gross nominal product and for banking sector to totale assets.
Authors' calculations from SZAMOSSZEGI and KYLE (2011).

In particular, the following similarities can be identified: 1) technologies that are already available in the developed countries are quickly transferred to local enterprises which, in turn, act as innovation pioneers in an otherwise backward environment; 2) the fast development process of the industrial sector is partially autonomous, unlike the slower process of the agricultural sector; 3) the banking system plays a primary role in the accumulation of the private sector; 4) the State acts as an irreplaceable engine of development which steers and controls the economy of the country[14].

Even if the Chinese situation does not completely overlap with that described by Gerschenkron owing to contextual differences, his model can still be used as an interpretative tool to put China's development in historical perspective. The Chinese model, in fact, is characterized by the presence of several small and very small enterprises, which are mainly found in traditional sectors. Moreover, innovation processes in China do not call for great capital assets, which, on the contrary, had been necessary for the industrialization process in continental Europe. Anyway, assuming that Gerschenkron's interpretation is correct, the development strategies deployed by China in its modernization phase should not be seen as symptoms of a mercantilist revival, but rather as signs of transition from a development model based on foreign capital and technology to a more autonomous and 'national' management of production processes aimed at strengthening the overall competitiveness of the system. In such a context, a late runner can catch up effectively only by granting more space to the State and to public enterprises (Jang-Sup Shin, 2002). If we analyze the development of some newly industrialized Asian countries, as well as that of Japan, we can see that from a historical point of view they differ perceptibly from Europe, and that they also differ among themselves. In particular, it is possible to find differences between the substituting strategy pursued by Japan and Korea and the complementary strategy pursued by Taiwan and Singapore. In the substituting strategy, banks (in the case of Korea also foreign funding) play a more incisive

[14] In his fundamental work (Gerschenkron, 1962) Gerschenkron analyzes the economic history of Europe and Russia and identifies the following characteristics for the development of 'backward' countries: 1) faster growth than 'forerunners' like Great Britain; 2) investment in fixed assets prevailing over consumption; 3) growth progressing intermittently rather than gradually; 4) creation of large scale plants and firms and greater emphasis on up-to-date technology from advanced countries; 5) a more active role for banks and State as economic players stimulating fixed investments.

role in the catching up process. In this strategy, the State progressively acts as a regulator and big national enterprises become a major player both in internal and in international markets. The complementary strategy is characterized by the greater role played by direct investments, by partnerships between multinational enterprises, and by the State acting as a co-protagonist in the creation of an autonomous national sector. For the time being, China's position is eclectic since it adopts a combination of the two approaches, but there are signs that it might move from a complementary to a substituting strategy (Jang-Sup Shin, 2002).

Before we set aside the accusation of 'commercial mercantilism', though, we should focus on the even more controversial issue of 'monetary and financial mercantilism', which China is allegedly practicing to a great extent. Anyway, also in this case it would be too far-fetched to claim that China is applying purely mercantilist policies in this sector. As far as monetary mercantilism is concerned, according to this simplistic interpretation the exchange rate control (i.e. the 'manipulation') would represent an indirect form of protectionism, i.e. an 'opportunistic' policy aimed at promoting exports by taking advantage of the opening up of markets and by hampering imports through the artificial alteration of prices at the same time. Financial mercantilism, then, would entail credit dirigisme aimed at supporting export sectors, and would thus correspond more closely to the traditional definition of mercantilism. In the case of China, though, it is not easy to distinguish between the various types of mercantilism, and monetary and financial mercantilism can be related to a comprehensive strategy strongly affected by the development policies described by Gerschenkron about 'backwardness'. In particular, in the Chinese modernization phase the exchange rate policy should be seen as a part of a more comprehensive strategy which, despite being functionally connected with the foreign component of the aggregate demand, still uses the control of credit flows to promote development. As a matter of fact, credit obtained through the control of State banks has always represented the main way to promote, partially reform and strengthen the most productive and strategic State-owned enterprises. On the contrary, exchange rate liberalization and its effects on consumption would have exposed the system to problematic fluctuations in the foreign component of the demand and would have caused regular flows to bank deposits to decrease. Thus, even if capital controls had been kept in place, it would have been difficult to stabilize wages by decreasing consumption and by safeguarding at the same time the 'savings-deposits-financing of State-owned enterprises' cycle, which serves both 'command' policy and internal development purposes. Fundamentally, calling exchange rate control 'monetary mercantilism' and, what is even more far-fetched, referring to the financing of exporting enterprises as 'financial mercantilism' leads to a simplistic representation which does not account for the fundamental characteristics of the Chinese development model.[15] Exchange rate control in fact, exerted only surreptitiously a 'mercantilist' function and should rather be described as one of the elements of a more comprehensive policy that used credit to finance the gradual transformation of the collectivist productive apparatus.

It should also be noted that the creation of the mighty Chinese manufacturing sector, which has made the country the biggest exporting economy in the world, was founded on the stimulus of direct foreign investment and on the ensuing import of technologies rather than on the financing of exporting enterprises. With the catching up process still pending and with the contradictions that typically characterize the backward countries in general, China is now at a crossroads: it has to decide whether it should leave behind the heavy residues of 'command 'economy, which in its renewed version corresponds to an original and more effective form of 'State capitalism', or whether it should reconfirm the status quo adapting it to the new global scenarios. The first option would call for the following actions: 1) opening up the economy to free capital movements and to international banks, 2) allowing competition in protected

[15] Scepticism on the 'monetary mercantilism' hypothesis in favour of some kind of 'financial mercantilism' is expressed by Aizenman and Lee (2008); for a critical view on 'monetary' and 'financial' mercantilism of China see Subramanian (2011).

sectors, 3) giving up credit policy as a way to indirectly support State investments and enterprises, 4) liberalizing the exchange rate. These actions would entail a radical transformation of the modus operandi of several generations of policy makers who have been gradually and hesitantly putting into practice the reforms started by Deng Xiao Ping.

According to the mercantilist hypothesis, the Chinese policy maker would see the accumulation of reserves as an objective in itself and would use current account surpluses to build a 'treasure' that is still mainly dollar-denominated[16]. Indeed, the accumulation of wealth through foreign trade is a typical, albeit controversial, characteristic of classical mercantilism[17], but it should also be noted that the geo-economic and geo-political international context has undergone profound changes and that it is extremely different both from the context of the golden age of mercantilism and from the situation at the end of the XIX century, when the US emerged as an economic power threatening the hegemony of rival countries, especially Great Britain. The accumulation of wealth in the form of reserves served the purpose of reaching a high accumulation rate, which was mainly financed by the banking sector. The accumulation process demanded that the credit market be 'protected' from foreign competition and that savings from families and enterprises be conveyed in that direction. Since it was produced in a backward country, accumulation was protected from the stress which it typically undergoes in countries that are open to capital movements, and had to catch up with production efficiency levels that were higher than those characterising the former socialist plan. To reach this goal without exposing the system to destabilizing repercussions it was decided to choose a model that was open to direct investment and that, at the same time, did not expose the system to the dangerous volatility of capital movements. The latter was responsible both for the crisis of Asian countries in 1997 and for the crises of other emerging economies in the 1990s. The financial compensation of this strategy consists in the accumulation of foreign reserve assets, which are also a sign of the presence of a capital account that is capable of granting a stable development. This goal is achieved by attracting physical capital assets from abroad on one hand, and by investing in international liquidity on the other. In so doing, the capital account neutralizes all possible threats coming from international financial flows.

One final objection remains to be addressed. It is clear that the relative financial isolation of the country served the purpose of financing investments, especially concerning State-owned enterprises. Nevertheless, it is not equally easy to interpret the heavy decline in consumption which took place over the first decade of 2000s and which was aimed at 'financing exports'. The interpretation is further complicated by the fact that the supply of foreign fixed capital enabled China to increase its capital stock, with particular reference to its most innovative component, without recurring to internal savings. It could be objected that a less rigid consumption policy would have made the country dangerously dependent on imports, thus compromising both its wage stabilization and its savings rate policies, and forcing China to choose an exchange rate that would grant stability to its development process. Nevertheless, the strong outward projection of the Chinese economy and the defence of some of its protectionist practices primarily involving exchange rate control are a consequence of the need to safeguard 'national champions', who were deemed worthy of special protection, and of the decentralization strategy deployed by multinational enterprises, who moved their production to China. These enterprises saw China as a 'low cost factory' in order to compete in the world markets.

Finally, defining the accumulation of reserves as a mercantilist measure implies overlooking the fact that their growth has posed a relevant monetary policy management

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[16] In mid 2011, Chinese dollar-denominated foreign reserves were equivalent to around 54% of the whole amount after reaching 65% in 2010 (Orlik and Davis, 2012).

[17] Schumpeter wrote engaging pages on the 'automatic mechanism', namely the connection between the 'balance of trade' and the accumulation of precious metals (Schumpeter, 1996).

problem rather than representing a strategic objective. As a matter of fact, reserves acted as an almost exclusive channel for the creation of the monetary base, thus forcing the Central Bank to intervene in order to neutralize their potential inflationary effects. In particular, the Central Bank intervened by manoeuvring the legal reserves of banks. Paradoxically, the increasing penetration of the Chinese economy in foreign markets could have determined a monetary vulnus which, in turn, would have reduced its momentum through the increase of internal prices. Furthermore, if there is little doubt that reserves represent a resource for investments in foreign markets, in particular in those where China is now the biggest buyer of raw materials, the country's 'passive' financial strategies in those same markets deprive it of the financial connections which have characterized the development of some advanced countries. At the same time, though, these 'passive' strategies grant China the ability to strongly influence global balances and to strengthen its spending capacity in the markets of emerging and developing countries (Meyer, 2014).

Finally, it should be remembered that if China adopted alternative strategies for the management of its reserves, unpredictable consequences would be felt by the international monetary system. These consequences, in turn, would have repercussions on the China's development itself. This scenario is radically different from the situation at the beginning of the XIX century, when the British, who were true mercantilists, introduced Indian opium into China causing the inversion of its balance of payments and a halt in the accumulation of its silver reserves[18].

Is the Chinese model in danger?

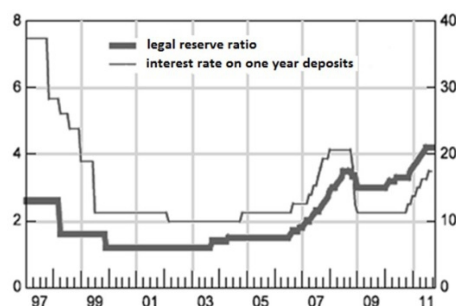
The financial crisis has shown that the Chinese development model is not 'mercantilist' in nature, and it has also highlighted weaknesses and contradictions in the economic dirigisme. Unlike classical mercantilism, the dirigisme has pursued its credit-based, internal accumulation policy (i.e. the 'financial way to development') with perseverance on the background of the global contraction of demand. Indeed, the severity and duration of the crisis have strained China's ability to compensate export contraction with greater investments in infrastructures and in the construction industry, and to rapidly find alternative policies to 'restructure' the global demand and promote consumption and social spending. In this context, the need to face the contraction of foreign demand with a view to granting continued development and an acceptable level of social stability and the need to keep inflation under control and to prevent bubbles from busting in the housing sector went hand in hand. Chinese leaders had to face these challenges at a time when important market and welfare reforms had not yet been made.

Credit, as usual, was used as an anticyclical policy to prevent development from coming to an abrupt halt, while direct control of banks was massively activated also to curb the inflationary consequences of expansionist policies. The repeated interventions in legal reserves and bank interests (Fig.1), together with the revision of quantitative restrictions on loans introduced at the beginning of 2007, show that the policy makers were both quite worried by the new scenarios[19] and extremely loyal to the interventionist model.

[18] These events are vividly described by Ferguson (2004) in the Chapter 'Heaven Breed' of his volume.

[19] In 2007-2011, direct interventions to regulate credit have been speeding up. They had the double aim of stimulating the demand and, at the same time, of preventing inflation from jeopardizing the real growth. In 2010-2011 the central bank (PBOC) lifted several times the legal reserve of banks and revised upwards the 'benchmark' interest rate on loans and deposits, including the interest rate on mortgage loans, in order to curb the inflation (Lardy, 2012).

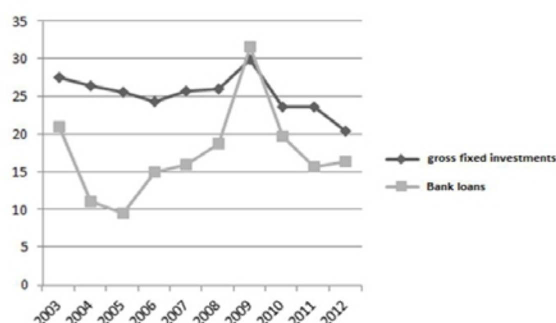
Fig.1 Interest rates and legal reserves of banks



Source: Guonan Ma and Yan Xiandong, Liu Xi (2011).

When the crisis peaked and foreign demand started to contract, the policy makers resorted to the mighty 'machine' of bank-financed accumulation. From 2007 to 2011 the growth rate of gross fixed investments remained high and peaked in 2009 with 30.5%. It then contracted in the following years, but this did not invert the trend started in 2002 (Fig.2). Also bank loans remained high, thus confirming that despite an increase in direct public financial interventions, banks provided the biggest support both to internal demand and to capital accumulation. According to some analysts, 'compensatory' measures against the contraction of net exports (which, starting from mid 2009, have had a negative impact on GDP) have only exacerbated overinvestment and the saturation of the country's production capacity. This, in turn, impacted negatively on the banks' budgets and jeopardized the results of the rebalancing operations carried out at the end of the 1990s and in the following decade (Pettis, 2012). Bank-financed accumulation supported development by intensifying internal imbalances, i.e. by decreasing consumption and by keeping to a minimum the redistribution of profits made by State and local enterprises. This led to an increase in households and families' savings, which are needed by banks to support investments[20]. Ultimately, during the crisis the review of spending decisions (which had been repeatedly announced by Chinese leaders and strongly encouraged by international organizations) has been managed with great caution and has thus failed to spark the change in development also referred to in the XII five-year plan (2011-2015).

Fig.2 Bank loans and gross fixed investments
(Yoy rate of growth)



Source: Hang Seng Bank (2012), China Economic Monitor, October;
National Bureau of Statistical of China (graph edited by the authors)

[20] In Lardy's opinion, the fixing of bank interest rates worked as a powerful tool contributing to keep the consumption of households low. In the first half of 2004-2011 the administrative control of interest rates on deposits and its implicit tax on depositors enabled banks to maintain positive margins and to stabilize the cost of loans to firms. Moreover, by massively manoeuvring the legal reserve rather than by selling government bonds to banks, it was possible to make banks friendlier towards firms, the State-owned ones in particular. Being deposits important for Chinese households, this policy is likely to produce a not negligible 'wealth effect' which might affect their propensity to consume (Lardy, 2012).

Only in 2009 did consumption increase as a consequence both of stimulating measures adopted to promote the purchase of durable goods and of other factors that are difficult to measure (Lardy, 2008). The core component of the manoeuvre, instead, addressed mainly housing and infrastructural investments, thus deviating from the traditional (mainly State-driven) accumulation plan. Rather than being the result of a long term strategy, this was an emergency-driven choice. Certainly, government spending has been increasingly supporting demand[21], but it has not backed social spending and business support measures. Moreover, it has not prevented credit from being consistently and massively used to support the demand sectors that have compensated the decrease in exports, such as infrastructures (many of which were hardly useful). Finally, jobs loss in export sectors has not been compensated by new employment opportunities in the housing and infrastructures sectors.

To conclude, the Chinese economy is facing two scenarios. The first one is characterized by the following contradictory factors: 1) overinvestment (together with an increase in productive capacity), which, in the long run, might experience a decrease in its own profitability, 2) a structural excess of savings, which decreases consumption and intensifies internal imbalances, 3) accumulation of reserves, which is increasingly making control of the money supply difficult and is conflicting with the goal of keeping interest rates low, 4) an oversized State banking sector which, nevertheless, still manages to promote the extraordinary development of the country, 5) severe environmental and energetic problems (which were not addressed in this paper). These contradictions may hamper the economic growth of China and may have unforeseeable repercussions on global demand. They may even generate a situation similar to that of Japan, where the financial crisis started at the beginning of the 1990s (Koo, 2008).

In the second scenario, these contradictions may prove less problematic than expected for several reasons (including non-strictly economic ones), and thus may not cause the system to collapse (Iannini, 2009). The strong role played by the State in the economy and the greater chance of being protected from external shocks increase the ‘endurance’ of an imbalanced model, thus making it sustainable. Finally, from a systemic point of view China is a ‘backward’ country, and as such it has intrinsic strengths that may foster its growth to a great extent. In both scenarios, the future of China as an ‘emerged’ and potentially ‘dominating’ country represents an issue that is at the same time intellectually challenging and politically and economically momentous.

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[21] Since 2009 government spending/Pil ratio has been exceeding the 20% threshold maintained in the first decade of 2000s (24% in 2012), although this figure is likely to be underrated since it does not take into account local governments’ debts. It is worth considering that, since early 2010, the drive of State investments has been fading and contracting (beyond -10% in 2011), although it was compensated by private investment. However, because of their seasonal fluctuations, private investments are not a persuasive alternative to State interventions. For this reason at the beginning of 2012 a curtailment of private investments was counterbalanced by an increase in public consumption (IMF.2012).

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