Back to the Future? China’s Sea of Foreign Exchange Reserves is Not New

By David Schneider

China's modern economic history begins with the collapse of Mongol power and the restoration of native Chinese rule under the Ming dynasty in 1368. Long-developing economic patterns resumed, especially along China's eastern and southern coasts. Chinese manufacturers specialized in the production of tea, porcelain and silk textiles for export through Arab and later European traders in exchange for silver mined in Latin America.

As the southern economy boomed, the autocratic Ming moved to bring it under government control. International exchange was now conducted only at designated ports through official state trading companies and strictly regulated. Exports were promoted and imports discouraged. This led to a massive flow of silver out of the Western economies into China, and increasing monetization of the Ming economy.

A silver-based economy now possible, the Ming government began to collect taxes in coin rather than in kind. This was good for trading provinces with international connections but bad for the inland agricultural economy. The result was a sharp and growing divergence of interest between the two, creating a bifurcated economy susceptible to frequent bouts of social unrest.

The fall of the Ming to Manchu conquerors, who established the Qing dynasty in 1644, did not alter these patterns, which, by the time Lord Macartney arrived in Beijing, had become a serious problem in global international relations. The ensuing clash between the British and Chinese empires led eventually to the Opium Wars of the mid-nineteenth century.

China subsequently dropped out of the world economy as it became engulfed in civil wars and invasions by foreign powers, ending only with the establishment of the People's Republic of China in 1949. The Communist government immediately reoriented the Chinese economy toward the Soviet Union, and in another radical shift Mao Zedong pulled the country into near anarchy beginning in 1958. It was yet another twenty years before China would again open to the world.

In the 1980s Deng Xiaoping moved to integrate China's dynamic export potential into global trade and

China opens its economy, accumulates massive surpluses and immense stores of hard currency reserves. Western powers push for further opening and reform to reduce global imbalances as they begin to affect other major economies. Trade friction builds... The year 2010? No, 1793, the year King George III sent Lord George Macartney as an envoy to the Qianlong Emperor to request normal diplomatic and trade relations.

In many ways the main features of China's growth and rise are not new. The massive accumulation of silver in the Ming and Qing dynasties appears to be re-emerging with Beijing's present accumulation of foreign exchange reserves, primarily U.S. Treasury bonds. The trade practices that led to these global imbalances are different in form, but quite similar in their underlying meaning and result.
financial markets. Foreign exchange earnings from light industry exports were used to import technology and equipment for investment in further up-market export and heavy industrial capacity.

As in the Ming and Qing, trade was conducted through only a handful of state companies, which served to insulate China from the global economy while at the same time reaping the gains from international connectivity. And in a modern permutation of the open trading ports of imperial times, international capital was invited into China as foreign direct investment, but constrained initially to only three Special Economic Zones (SEZs) opened between 1980 and 1984 in the southern province of Guangdong.

But this was only the beginning of a phased program that evolved with experience. Bureaucratic management of trade and investment did not interface well with global markets. The early reforms were followed by successive rounds of administrative liberalization. Industrial enterprises were allowed to do more types of business with less government involvement, and could retain a portion of their foreign exchange earnings, and many more SEZs were opened.

Administrative reform was only one part of the program, however. As China moved toward full membership in the World Trade Organization (WTO), Beijing instituted vast market-based macroeconomic and financial reforms designed to harmonize the economy with global norms.

The results were nothing short of spectacular—thirty years of average 9 percent GDP growth. This year China overtook Japan as the world’s second largest economy. And since the 2008 global financial crisis, China has been a primary engine of world recovery.

Yet, the unbalanced character of China’s development cleaves rather closely to old imperial patterns. Modern macro-economic, controls, combined with continuing strong state guidance, have succeeded in creating a highly successful coastal economy that promotes exports, now primarily by means of an undervalued exchange rate, and massive trade and foreign currency surpluses.

Powerful government emphasis on industrial investment directs capital toward large-scale industry, still the main urban employer, and away from investment in the consumer economy, which occupies only about a third of Chinese GDP, the lowest of any major world economy. The provinces on or near the eastern and southern coasts have been the major beneficiaries of the reforms, leaving the inland provinces increasingly behind, and rather prone to bouts of social unrest.

No matter whether it uses traditional administrative regulations or modern market mechanisms China tends toward over dependence on export-led growth, large surpluses that result from shielding the domestic economy from world markets, and uneven development between the coast and the inland areas. This is not simply a matter of economic policy; it is as much a matter of civilization and political culture, both much harder to change.

Any lasting solution to the problem of Chinese imbalances will require more than a struggle for momentary diplomatic agreements. The G20 would be wise to move robustly toward a major multilateral effort to strengthen the global free trade and financial system. This is the only way to shape the long-term conditions in which Chinese civilization and political culture could evolve to the point where it would be possible to redress these imbalances through full compliance with WTO norms and eventual full international convertibility of the yuan.

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